Strategic Management

Author:
David Faulkner

This guide was prepared for the University of London by:

David Faulkner

We regret that the author(s) is/are unable to enter into any correspondence relating to, or arising from, this guide. Correspondence should be addressed to the module leader, via the WWLC.

Publications Office
The External Programme
University of London
Stewart House
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Course Overview

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Overview

Strategic management is concerned with the processes by which management plans and co-ordinates the use of business resources with the general objective of securing or maintaining competitive advantage. This course provides the student with a general insight into the historical development of management practices and international business policy. In particular this course reviews the developments and literature on corporate strategy and critically reviews the possibilities and limitations of management action in highly contested international markets.

About the authors

Prof David Faulkner

Professor David Faulkner is an Oxford-educated economist by background, who has spent much of his early career as a strategic management consultant with McKinsey and Co and Arthur D. Little. David is currently Professor of Strategy at Royal Holloway, University of London and Director of the MBA and MSc in International Management. He is also Visiting Professor at the Open University. On moving into academic life in 1989, he became a lecturer in the Strategy Group in the Cranfield School of Management, and gained a Doctorate from Oxford University (DPhil), researching into conditions for success in International Strategic Alliances. He is a former Deputy Director (undergraduate courses) and Deputy Director (MBA) of the Said Business School, Oxford University. His specialist research area is strategy, in particular international cooperative strategy and mergers and acquisitions on which subjects he has written and edited a number of books including The Oxford Handbook of Strategy (OUP).

Formative Assessment

Choose TWO of the following topics as your course assignments. Consult related literature, the Study Guide and the Core Text Materials. Remember to cite your sources as appropriate. The word limit for each essay is 1500. Your course tutor will inform you of the submission dates.

1. Compare and contrast the market-based approach and the resource-based view as approaches to competitive strategy. To what extent are they rival or complementary views?
2. How does Teece's concept of Dynamic capabilities fit into competitive strategy thinking?
3. Explain how the Customer and Producer matrix concepts extend Porter's taxonomy of generic strategies.
4. What is the importance of the parenting-fit matrix to the selection function of corporate strategy?
5. What are the attractions and limitations of cooperative strategy?
6. How does the virtual corporation work in networking theory?
7. Why do acquisitions so rarely add value in earning per share terms to the acquirer?
8. What are the different forms of organisational learning and how can these

concepts be useful?

9. How does international strategy differ from domestic strategy?
10. What are the barriers to strategic change that are often encountered, and how can they best be overcome?

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Topic 1

What is Strategy?

Aims

The aims of this topic are:

- to introduce you to strategic management;
- to explain its broad historical development;
- to show you some strategic models;
- to explain the different levels of strategy;
- to show how game theory can aid strategy development.

Objectives

By the end of this topic, you should be better able to:

- distinguish between corporate strategy, competitive strategy and functional strategies;
- justify the importance of strategic management within organisations;
- chart the origins of strategic management and strategic thinking;
- identify different strategy models;
- explain the relationship of game theory to strategy development

Overview

Your notes

This module is an introductory course into the area of strategic management. However, despite the title 'introductory', this does not mean the module will be very basic. You are studying a management unit perhaps with the intention of becoming a senior manager. You will therefore be expected to know what the needs of management are, including what they are looking for in strategy.

We will be looking at the key areas that make up this subject. The course is spread over 18 lessons and two terms, with two revision sessions, one per term. A lot of subjects will be covered, so it is very important not to miss or skip a lesson. Remember, strategy is one of those subjects where in many cases each lesson follows on from the previous one. For example, in one lesson we will be covering external analysis, and the next internal analysis before a third is added combining the two in strategy formulation. The majority of the strategy course is conceptual and does not require a knowledge of mathematics.

It is divided into subjects relating to business strategy, i.e. the strategy of a single business unit, and corporate strategy, i.e. the strategy of a multi-business unit corporation. On another plane it is divided into domestic strategy and international strategy. Whilst this course deals with the basics of domestic strategy it is heavily slanted towards international strategy, particularly in term 2.

Introduction

Strategic management is concerned with the processes by which management plans and coordinates the use of business resources, with the general objective of securing or maintaining a competitive advantage. Corporate strategic management, in both domestic and international settings, generally has three dimensions. The first is strategy process, whereby strategy formulation may be conceived as a process with a policy outcome. The second dimension is strategy content, concerned with the foundations upon which successful corporate strategy decisions can be developed. The third facet of corporate strategic management is context, wherein the particular internal characteristics of corporations and their external competitive environments must be understood in order to formulate successful strategies.

There are numerous conceptual frameworks, theoretical models and analytical tools designed to help management understand and analyse these dimensions of strategy. This course deals with some of these, particularly those that may be of most relevance in an international context. It will be of particular value to individuals employed in organisations undergoing strategic change, and those involved in the implementation of business policy in highly competitive environments. The first half of the course deals with strategy generally and the second concentrates on international strategy.

The Strategy Concept

Operational effectiveness and competitiveness

Operational effectiveness does not necessarily translate into sustainable profitability. The root of many companies' competitive problems is their failure to distinguish between operational efficiency and the adoption of a distinctive and sustainable strategy. Operational effectiveness and efficiency means performing similar activities better than rivals perform them; a successful strategy means performing different activities from rivals or performing similar activities in different ways (Porter 1996, p. 62). As Porter (1996) argues, firms need to refocus their attention on the main components of strategy: performing unique activities, choosing a strategic position, making trade-offs that underlie sustainability, and optimising the fit of an entire system of activities. Successful,

sustainable strategy is forged by managers willing to make difficult choices to preserve their companies' unique activities.

Analysing strategy

The strategy literature contains numerous conceptual frameworks, models, tools and techniques designed to help senior management understand and analyse these dimensions of strategy. Mintzberg identifies ten, Johnson six, Whittington four, and Chaffee three, as we see later in this topic.

Many have different names to describe similar approaches e.g. linear, classical, planning or adaptive, emergent, logical incremental. They advocate particular kinds of solution to particular kinds of problem and specify courses of action. Others are descriptive of what often happens in practice. They aim to add to our understanding of how strategies are formulated and implemented.

The position adopted in this course in relation to these models is that every corporation can be considered to be unique. Corporations have their own internal strengths and weaknesses and confront particular opportunities and threats. These are partly derived from the historical legacies of past strategic decisions and realised strategies and partly derived from the forces which operate in new and changing competitive environments, and also critically from the exercise of strategic choice by top management.

Unique circumstances

Competitive environments differ, from industry to industry and country to country, and corporations differ from one another in their internal characteristics. As a consequence, it is impossible to offer any universally guaranteed prescriptions for competitive success. All that can be said with certainty is that most of the models in the literature can offer insights of greater or lesser relevance to any given case.

This course attempts to relate the lessons to be learned from the literature to the kinds of strategic management issues that typically arise in international business. The international business world is a complex one. Despite the exhortations of consultants to keep things simple, managers know that in reality international business management is not simple. This course also aims to build up a framework within which many of the key models that are described can be related to one another in a systematic way. Although this exercise may not offer any prescriptions for the management of complexity, it is hoped that it will offer a perspective from which the issues involved may be better appreciated.

Let us now take a step back to examine the history of strategy.

The History of Strategy

All firms have strategies even if, at the extreme, the strategy is no more than to adopt a reactive response to market challenges, and do what seems best for survival at a particular time. A positive strategy, however, requires 'a sense of purpose'. Military strategy goes back at least to Sun Tsu's Art of War in 500 BC, but the term 'strategy' or strategic management has a relatively short history in the business field. Strategic management is not used in the academic business school lexicon much before the 1960s, and even more recently the area of study can often be seen masquerading under the title of Business Policy.

The 1950s

Porter describes the historical evolution of the field along the following lines (Economist 1989). In the 1950s there was a group of Harvard professors who propagated the concept of Corporate Strategy by interacting with corporate boards and encouraging them to think 'outside the box' in terms of what they

Quick summary

The Strategy Concept

- Operational effectiveness and efficiency means performing similar activities better than rivals perform them; a successful strategy means performing different activities from rivals or performing similar activities in different ways.
- The strategy literature contains numerous conceptual frameworks, models, tools and techniques designed to help senior management understand and analyse these dimensions of strategy. The position adopted in this course in relation to these models is that every corporation can be considered to be unique.
- Competitive environments differ, from industry to industry and country to country, and corporations differ from one another in their internal characteristics. As a consequence, it is impossible to offer any universally guaranteed prescriptions for competitive success.

were, and what they were trying to achieve, e.g. "Are we a railroad company or a transportation company?"

At the same time in the public sector Robert McNamara was busy introducing Programme Planning and Budgeting (PPB) to the US Department of Defence, who were used to resource allocation by means of lobbying and an absence of performance measures.

The 1960s

In the early sixties, the era of long-range planning began and every corporation worth its salt had a five-year plan complete with forecast, pro-forma financial statements for the future, bar charts and pie diagrams. Unfortunately the impossibility of forecasting the future, and the regularity with which extrapolating trends from the past failed to be a useful method of prediction led the long-range planners to lose credibility with the executives whose job it was to make actual quarterly profits to satisfy the shareholders.

The corporate portfolio

The scene then shifted to the management consultants and their growing 'box of tools', the most popular of which was the portfolio matrix exemplified by the famous Boston Box. This analytical tool was used by major multi-business unit (SBU) corporations to identify on one piece of A4 paper the state of their corporate portfolio.

What was the balance between SBUs that were stars, cash cows, problem children or dogs? Depending upon an SBU's position on the matrix that related growth of market to relative market share, the policy options were invest, milk, attend to or sell. McKinsey and Arthur D. Little joined the Boston Consulting Group with their own competitive versions of the portfolio matrix, and simplistic mechanistic strategies became the order of the day in the major corporates.

The 1970s

By the early seventies disillusion had set in with this strategic tool too as companies discovered that strategy formulation needed to be subtler than the mechanistic matrices proposed. The matrices were found to be helpful analytically but less so in strategy development.

The era of single word panaceas and TLA's (three letter acronyms) then began. An understanding of 'corporate culture' was said to be the key to strategy. Incremental strategy development was then touted as the appropriate method of strategy formulation, i.e. move slowly and adaptively, only identifying your grand strategy ex post.

'Intrapreneurship' was the next buzz word. This suggested that even employees of large firms could be risk takers, and should accordingly treat the firm's assets as though they owned them personally, and had the fundamental purpose of making them grow. Middle rank executives found that this only worked if your boss had that attitude too. Finally the touchstone of successful strategy was said to be in its implementation, rather than in the beauty of strategic plans.

The 1980s

All these thoughts had merits and represented the ferment into which the field of strategy had fallen by the time the 1980s began. This was when Porter arrived on the scene. He began to collect disparate models, tools and frameworks from industrial organisation economics and from the business policy and strategic planning fields to give the emerging discipline of Strategic Management some coherence, and academic rigour and discipline.

Quick summary

The History of Strategy

- In the 1950s there was a group of Harvard professors who propagated the concept of Corporate Strategy by interacting with corporate boards and encouraging them to think 'outside the box' in terms of what they were, and what they were trying to achieve.
- In the early sixties, the era of long-range planning began and every corporation worth its salt had a five-year plan.
- The scene then shifted to the management consultants and their growing 'box of tools'.
- By the early seventies disillusion had set in with this strategic tool too as companies discovered that strategy formulation needed to be subtler than the mechanistic matrices proposed. The matrices were found to be helpful analytically but less so in strategy development.
- All these thoughts had merits and represented the ferment into which the field of strategy had fallen by the time the 1980s began. This was when Porter arrived on the scene.

With his books Competitive Strategy (1980) and Competitive Advantage (1985) he introduced the world to the concept of sustainable competitive advantage, the five forces framework of competitive intensity, the value chain, the idea of his somewhat reductionist generic strategies, and of strategic thinking. Many of these concepts were to stand the test of time, and for the first time, in the 1980s, it became intelligible for business academics to describe themselves as strategists.

The following decades

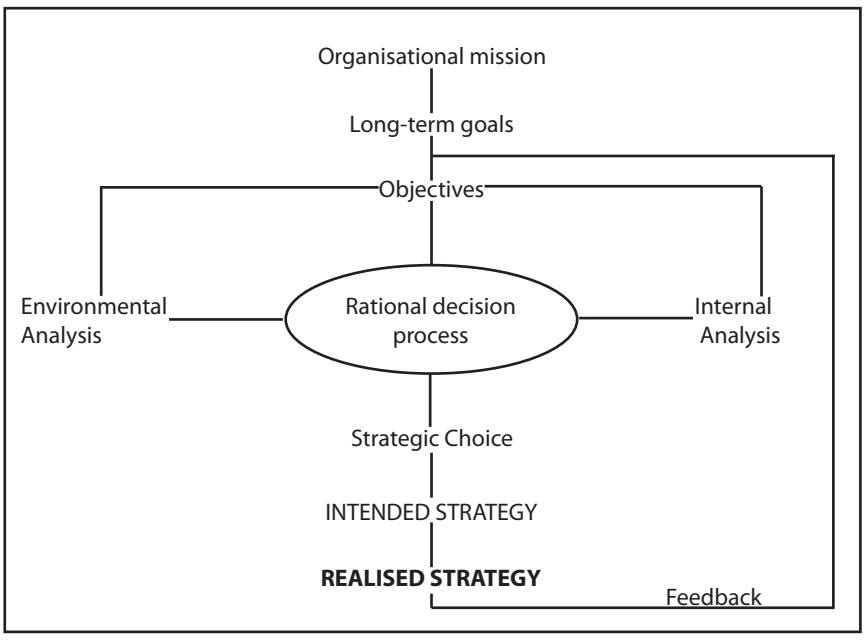
Of course the march of ideas continues and the following decades saw the revival of the resource-based view of the firm; the identification of dynamic capabilities as key to survival in an uncertain world; the application of chaos and complexity theory to strategic situations; the grafting on of game theory as a key strategic tool; the growth of cooperative strategy ideas; and adaptation of evolutionary Darwinian concepts to strategic management. A ferment of new and adapted ideas hit the world of strategic management at a time when the world markets were becoming increasingly subject to globalising forces, and hence more and more turbulent, thus throwing into question how much one really could plan for the future.

Let us now look at the different models in more detail.

Strategy Models

The strategy process ideal

During the 1960s, strategic planning emerged as a rational analytical process subsequently to be dubbed the 'design school'. The strategy process ideal was depicted as rational and analytical activity directed towards clearly defined objectives (Figure 1.1). The strategy realised is shown to be the logical outcome of this process as an intended, deliberate, planned and controlled operation.



Strategy's origins in economic analysis

Much of the work you have just read about was built upon the earlier writings of economists and decision theorists, like Herbert Simon (1960) and Norman Maier (1963) and the subsequent development of the strategy field has been strongly influenced by the work of Michael Porter who was trained as an industrial economist.

As a result strategic management still bears the hallmarks of its origin in eco-

Quick summary

Strategy Models

- Much of the work around strategy was built upon the earlier writings of economists and decision theorists. As a result strategic management still bears the hallmarks of its origin in economic analysis.
- Maier considered ways in which the effectiveness of decisions might be assessed. He proposed two criteria. One was the degree of acceptance given to a decision by those who were affected by it and the other was its objective quality.

nomic analysis. However, even though the two disciplines occupy much of the same intellectual space, there are distinct differences between them. Whereas economics is primarily concerned with the economy, industries and utility and abhors the distortions of 'misallocated' resources, strategic management concerns itself with the firm and tries to find a way of misallocating resources to the benefit of that firm.

The tools used in economics are mathematics, game theory, statistics and marginalist economic theory. Strategic management uses these tools also but allows psychology, sociology, social anthropology and organisational behaviour theory to be considered.

Economics also works on a different set of assumptions from strategic management. Its paradigm assumes rationality; determinism; exclusively self-interested motivation, profit maximising behaviour; perfect information for decision-making and a simplistic technological coefficient standing surrogate for economic progress; and inexorable movement of markets towards equilibrium as unchallengeable. Organisations and managers are largely unconsidered by economists.

Strategists regard rationality as 'bounded' (Simon 1957). Most products are differentiated; strategic choice is always present; motivation is multi-faceted and few situations present perfect information. A market in equilibrium is a rare situation, and certainly temporary, and managers and organisations are key to business success.

Nonetheless early strategic management built on the foundations of economics, but varied the purity of the economic paradigm. Simon in particular identified different categories of managerial decision and the conditions of certainty and uncertainty under which they were taken.

Let us now look more closely at managerial decision-making.

Your notes

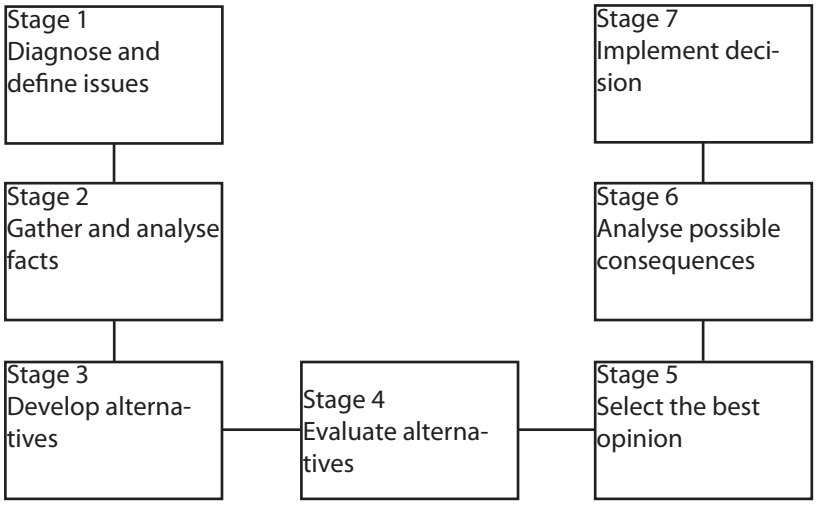
Maier

Maier considered ways in which the effectiveness of decisions might be assessed. He proposed two criteria. One was the degree of acceptance given to a decision by those who were affected by it and the other was its objective quality. Objective quality, Maier suggested, was determined by the quality of the process through which the decision was arrived at. This led him to the conclusion that there were three different types of decision-making situation:

1. Those in which quality is important but acceptance is not.
2. Those in which acceptance is important but quality is not.
3. Those in which both high quality and acceptance are important.
4. Let us look further at corporate strategy decision-making.

Corporate strategy decisions

During the 1960s, corporate strategy decisions came to be viewed by a number of theorists as 'non routine' decisions taken under conditions of uncertainty in circumstances where quality mattered. These writers turned their attention to the quality of the strategic decision-making process. They built prescriptive strategy formulation process models, with feedback and control loops to allow for corrective actions to be taken in the light of unanticipated consequences and changes in circumstance. Many were based upon elaborate rational process stage theory models of the managerial decision-making process (Figure 1.2), which were intended to apply to any specific case of corporate strategy formulation.



(Based on Charles H. Kepner and Benjamin B. Tregoe (1965) The Rational Manager: A systematic approach to problem solvijng and desision making. McGraw-Hill. NY.)

Igor Ansoff

Igor Ansoff (1965) is perhaps one of the best known theorists to have conceived of the corporate strategy process in the manner you have just read about. He builds upon the earlier work of Chandler, which he specifically acknowledges, and accords a central place to a number of Chandler's key themes. For example, he views organisational capabilities and competencies as important, assumes that structure follows strategy and that strategy is formulated from the top down. In offering his model he seeks to achieve a form of resource leverage and a fit between the organisation and its environment. At the same time, he acknowledges earlier work on managerial decision-making by Simon (1960).

Ansoff suggests that strategy can be formulated by following a sequential process of four decision-making stages:

1. Perception of the need to make a decision
2. Formulation of alternative courses of action
3. Evaluation of alternatives
4. Choice of an alternative for implementation

However, he argues that because strategic decisions, unlike some other types of decision, are made under conditions of uncertainty, a requirement for the maintenance of flexibility is imposed upon the firm. The recommendation that is offered is that this requirement can be met by following a clearly defined set of decision rules for seeking out and evaluating alternative strategies.

Ansoff's model prescribes feedback at various stages in the decision-making process, which will enable corrective actions to be taken where necessary. This is to allow for the modification of previous decisions to help the firm maintain its flexibility in the face of uncertainty. He offers checklists to help managers through this strategic decision-making process, and suggests that the outcome will be either an aggressive or a defensive strategy.

In considering which type is most appropriate, Ansoff highlights the importance of both internal strengths and weaknesses, and opportunities and threats (SWOT analysis). The strategy a firm adopts "'will be chosen subject to the availability of opportunities which can match the firm in areas of both strength and weakness" (Ansoff 1965, p. 93).

Your notes

Ansoff and the influence of Chandler

In his description of types of strategy, namely defensive or aggressive, and in his conception of environmental fit, and the importance of internal organisational strengths, the influence of Chandler is apparent. However, unlike Chandler, Ansoff offers prescriptions rather than descriptions. During much of the 1960s, prescription was the goal of a great many writers. Later, the idea that there could ever be a one best way to approach strategy issues was questioned. Even so, the rational planning image (Mintzberg 1985) that the subject developed in the early 1960s has persisted to a greater or lesser extent in the modern literature, although with some scepticism amongst both practitioners and academics as to the degree to which 'it works'.

Andrews

Andrews (1965) is another well-known theorist to have conceived of the corporate strategy process as one that can and should be approached in a planned and premeditated way.

He identified two main stages (Figure 1.3), namely strategy formulation and implementation, and described what he called the principal 'sub activities' within each one. In discussing the formulation stage, although he acknowledged that non-rational factors can enter into the process, he explicitly stated that deciding what strategy should be may be approached as a rational activity. In considering the implementation stage he considered that "if purpose is determined then the resources of a company can be mobilised to accomplish it".

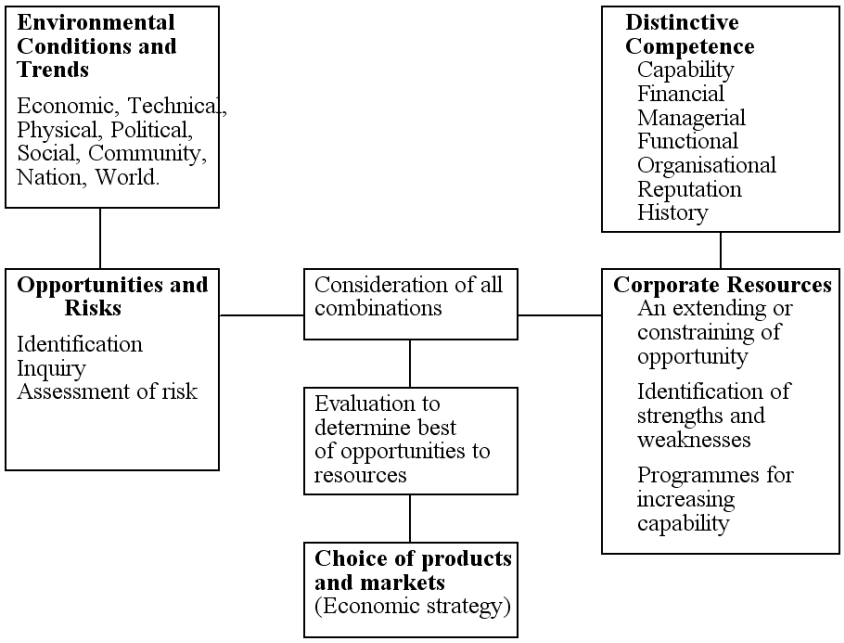
Formulation (Deciding what to do)		**Implementation (Achieving Results)**
1. Identification of opportunity and risk	**Corporate Strategy** Patterns of purposes and policies defining the company and its business	1. Organisation Structure and relationships Division of labour Coordination of divided responsibility Information Systems
2. Determining the company's material, technical, financial and managerial resources		2. Organisational Processes and behaviour Standards and measurement Motivation and incentive systems Control Systems, recruitment and development of managers
3. Personal values and aspirations of senior management		
4. Acknowledgement of non-economic responsibility to society		3. Top Leadership Strategic Organisational Personal

The model above is also designed to achieve resource leverage and a fit between environmental opportunities and organisational resources. Like Ansoff, Andrews offers a rational stage model of the strategic decision-making process. It is based upon four sequential activities:

1. An analysis in which there are four components:
   - » environmental conditions and trends
   - » opportunities and risks
   - » organisational distinctive competencies
   - » corporate resources
2. A consideration of alternative combinations of resources and potential opportunities

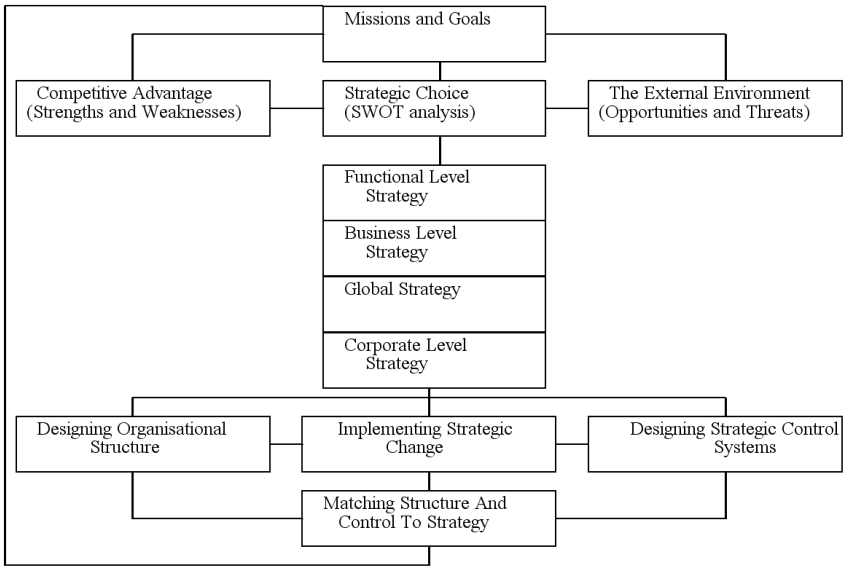
3. An evaluation phase in which the best match is determined
4. Making a choice organisational resources (Figure 1.4)

The suggestion is that if these stages are followed, the resultant choice of corporate strategy will secure a fit between environmental opportunities and organisational resources (see Figure 1.4)



The corporate strategy process models offered by Ansoff and Andrews were systematic rational approaches to the problem of strategy formulation. It is an approach that dominated the strategy process literature during the 1960s and 1970s. The orientation was towards improving the quality of the decision-making process and providing decision techniques that could lead to more effective corporate strategies.

The rational process model



Recent writers are more guarded about any suggestion that strategy should be formulated in accordance with any particular model. It is now recognised that most models have strengths and weaknesses. The tendency to advocate universally applicable models has waned, but the strategy process is still discussed by many writers in rational process terms. On account of this fact,

Stacey (1997) calls the rational process model "the conventional approach" to strategic management. A 1995 edition of a popular text book by Hill and Jones (1995) offers the following 'integrative model' of strategic management which may be taken to illustrate his point (Figure 1.5).

This model, which can be regarded as a schematic rational process model itself, attempts to show how the rational planning approach can be cascaded through all the various levels of strategic decision-making.

Let us now examine some less 'rational' models.

Logical incrementalism

The conventional planning view of the strategy process exemplified by Ansoff and Andrews implies a continuous process of strategic change and adaptation. However, much strategy in practice is rooted in stability, not change. Strategic re-orientations are not an everyday event. They only occur occasionally as brief 'quantum leaps' (Miller et al. 1984). In other words, Mintzberg suggests that strategy formulation does not normally entail a preconceived rational planning process. Instead, 'logical incrementalism' (Quinn 1980) describes what usually occurs.

The logical incremental pattern of strategic decision-making was identified by Quinn (1980) in a study of 10 large corporations. He found that, as a general rule, although managers had goals and a sense of strategic direction, they had no clearly specified plans of how to achieve them. They reached their goals by a process of discovery involving logically connected sequential decisions that led to incremental change. Using an analogy, a senior manager in a major oil company has described the process in this way: "We knew where the island was, but we didn't start out with the boat to get there. We had to construct it as we went along."

Mintzberg and Quinn (1985) distinguished eight styles of strategic management, only one of which conforms to any kind of rational planning process model. The other seven are:

1. The entrepreneurial model
   - » Strategy flows from a visionary leader.
2. The ideological model
   - » Strategy is derived from the kinds of belief that are not readily changed by a confrontation with fact.
3. The umbrella model
   - » Strategy is formulated by managers lower down in the organisations within the confines of boundaries set by targets formulated at the top.
4. The process model
   - » Top managers exercise control over the strategy process through timetables and resource allocation.
5. The consensus model
   - » Strategies emerge out of a consensus, without any issuing of directives from senior managers.
6. The imposition model
   - » This model describes the situation in which unanticipated environmental change dictates a strategic direction.
7. The unconnected model
   - » This model describes the situation in which there is no strategic intent. Overall strategy simply develops out of unconnected strategies implemented at a variety of levels by a number of groups through-

Your notes

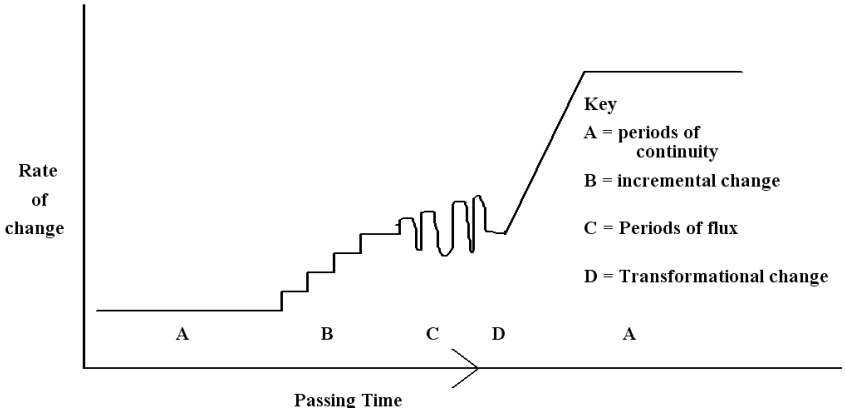
out the organisation.

In Strategy Safari (1998) Mintzberg, Lampel and Ahlstrand end up with a tally of ten approaches.

Patterns of strategy development

Mintzberg (1978) has defined strategy as a "pattern in a stream of decisions or actions" that emerges over time. That 'pattern' is the result of strategies that are intended, planned and deliberate combined with strategies that are unplanned, unintended and emergent.

Johnson and Scholes (1997) have identified four patterns of strategy development in the literature that are descriptive of the patterns of strategic development that emerge in practice (Figure 1.6).



The planning model is appropriate to transformational or radical change. However, radical change is not an everyday event. Incremental strategy development, represented by B, is more common. Organisations can also be observed to go through periods (represented by A) in which there are no significant strategic developments at all of either a planned or unplanned nature. In practice, then, not all strategic developments are planned and deliberate.

Hamel and industry revolution

Hamel argues that companies are reaching the limits of incremental improvement and that many need to reinvent themselves instead (Hamel 1996, p. 69). Within any industry he argues, you will find three types of companies:

- Rule makers – incumbents that built the industry, e.g. United Airlines
- Rule takers – companies that pay homage to the industrial 'lords', e.g. US Air
- Rule breakers – the industry revolutionaries, intent on overturning the industrial order, e.g. Southwest Airlines.

Hamel (1996, p. 70) contends that strategy is revolution and everything else is just tactics. This concurs with Porter's distinction between strategy as unique positions and hard choices, and everything else being merely operational efficiency. To achieve this strategy insurrection, Hamel outlines nine routes to industry revolution.

1. **Radically improving the value equation.** In every industry, there is a ratio that relates price to performance: X units of cash buys Y units of value. The challenge is to improve that value ratio and to do so radically – 500% or 1000%, not 10% or 20%. Such a fundamental redefinition of the value equation forces a reconception of the product or service.
2. **Separating function from form.** Another way to challenge the existing concept of a product or service is to separate core benefits (function) from the ways in which these benefits are currently embodied in a product or service (form). An example is the way in which conventional credit cards

Your notes

have been transformed by enterprising card makers into so-called 'smart cards', through the addition of a microchip.

3. **Achieving joy of use.** Ease of use is now largely taken for granted; the next step is joy of use – to produce products that can be both informative and whimsical. Any company that can wrap these attributes around a mundane product or service has the chance to be an industry revolutionary. 'Fashion food retailers' such as Trader Joe's in the US, is an example of this type of industry revolutionary.
4. **Pushing the bounds of universality.** Revolutionary companies focus not just on their existing or served market but on the total imaginable market. The development of the cheap disposable camera is one example of a product developed for an imaginable market (children).
5. **Striving for individuality**. Most people, given an affordable and accessible alternative, would prefer to buy a unique product rather than be part of a mass market. Companies such as Levi's have recognised this fact and now provide personally tailored jeans for the discerning customer. The price is not considerably more than the standard sum.
6. **Increasing accessibility.** The traditional notion that customers must go to a specific store at a specific location between certain hours, is being abolished by industry revolutionaries. Consumer expectations about accessibility are being reset by these firms. Direct banking is an example of such an industry revolution and the success of a company like First Direct on entering the British market sustains this thesis.
7. **Rescaling industries.** Many industries are consolidating, as local businesses increasingly become national and national industries become international. Companies such as Service Corporation International are rescaling traditionally fragmented industries like funeral operators. This concept can also work in reverse, e.g. the emergence of microbreweries is the result of the scaling down of a large, consolidated industry to better meet narrow or local customer segments.
8. **Compressing the supply chain.** This basically involves the removal of intermediaries. Wal-Mart, for example, essentially turned the warehouse into a store, thus getting rid of the traditional intermediate retailer.
9. **Driving convergence.** Revolutionaries not only radically change the value-added structure within industries but also blur the boundaries between industries. Deregulation and new customer demand allows them the opportunity to transcend an industry's boundaries. For instance, a consumer in Britain can now obtain banking services from Sainsbury's food retailers.

Chaffee and categories of strategy development

Chaffee (1985) reduces strategy development into three categories:

- Linear, which in other terminology can be called planning, classical, orthodox or rational.
- Adaptive, which is otherwise described as emergent or indeed perhaps logical incremental by other writers. It is constantly reacting to a changing environment, and therefore inevitably short-term. If a long-term, large capital investment is needed, an adaptive strategy is unlikely to be able to give the necessary reassurance to decision-makers.
- Interpretive, or more transparently culturally constrained, thus firms only adopt strategies that fit with their corporate culture. In this approach it is considered that reality is not objective, but socially constructed, and that strategy develops through a series of contracts between individuals. The importance of symbolic behaviour and artefacts like company logos is stressed.

Conclusion

You have been reading about the wide variety of different terms that are applied to the strategy process in the literature on this subject. Despite the variety of terms, a single descriptive process goes a long way to describe what actually tends to happen when firms attempt to behave strategically. First they put together what they believe to be a rational strategic or business plan and attempt to apply it. Then they observe that as time passes different things happen not predicted in the plan, and more positively perhaps new opportunities arise not thought of in the plan. They then adapt the plan in response and continue to adapt it as they go along. In doing so they are constrained by their corporate culture, i.e. the type of firm they are, and by the evolutionary forces out there in the market-place. Realised strategy is therefore the result of all these factors and influences over time.

Levels of Strategy

Until the 1980s, it was rare to formally distinguish the different levels of strategy in the literature. The terms corporate strategy, strategic planning, business strategy and competitive strategy tended to be used loosely and somewhat interchangeably and intermixed with the term business policy. As an illustration of this, Johnson and Scholes' well-known textbook was (and still is) entitled 'Exploring Corporate Strategy'. However, the contents are predominantly concerned with business or competitive strategy. Had its first edition been published in 1992 and not 1989, it would almost certainly have had a different title.

After Porter's seminal contributions in the '80s and Campbell's contributions in the same decade, the distinction between Corporate and Competitive strategy became quite clear, and the two major, distinct forms came to be treated differently in lectures, books and articles.

Competitive strategy

Competitive strategy, after Porter (1980, 1985), came to be defined as that strategy of a business unit that seeks to achieve sustainable competitive advantage (SCA). In order to achieve this, it needs to understand both the logic of the industry in which it is operating, and its own capacity to contribute distinctively to that industry.

In Porter's generic strategies rubric, this means:

- becoming the lowest cost producer, and hence being able to offer the lowest prices,
- focusing very specifically on the needs of a particular market segment, or
- finding some way to differentiate the product from other competing products.

He warns against what he believes to be the risk of underperforming by getting 'stuck in the middle' between two or more of these approaches. In this view, however, he has many critics. Competitive strategy is what business is really all about, i.e. how to sell products and services to actual customers. Competitive strategy is sometimes referred to as business or SBU strategy. This is because it is concerned with how the individual business units aim to compete in their particular competitive environments.

Corporate strategy

Corporate strategy is quite different. It is concerned with the multi-business unit firm, and addresses such questions as resource allocation and control. It seeks to decide what businesses to engage in and how to run these businesses.

The aspects of the firm that corporate strategy has to deal with come under four main headings (Bowman and Faulkner 1997):

Quick summary

Levels of Strategy

- Competitive strategy came to be defined as that strategy of a business unit that seeks to achieve sustainable competitive advantage (SCA). In order to achieve this, it needs to understand both the logic of the industry in which it is operating, and its own capacity to contribute distinctively to that industry.
- Corporate strategy is quite different. It is concerned with the multi-business unit firm, and addresses such questions as resource allocation and control. It seeks to decide what businesses to engage in and how to run these businesses.
- Functional level strategies are a further level of strategic concern, but since they are the subject of specific functions like HR, finance or marketing they are not part of a strategy course, but are taught in the courses that relate to their specific functions.

1. Selecting: deciding on the scope of the firm and which businesses to be in and in which countries
2. Promoting: through mission statements, interviews, advertisements and other image developing activities, attempting to create a favourable impression of the firm with its stakeholders and others, both inside and outside the firm.
3. Resourcing: having completed the selecting function, deciding whether to 'go it alone' with internal firm resources, form alliances and joint ventures or make appropriate acquisitions.
4. Controlling: controlling the firm by deciding on the appropriate level of delegation of authority, setting the firm style, establishing incentives and developing an organisation and systems to make it operate efficiently and effectively.

Functional level strategies

Functional level strategies are a further level of strategic concern, but since they are the subject of specific functions like HR, finance or marketing they are not part of a strategy course, but are taught in the courses that relate to their specific functions. Other levels of strategy are met in the literature such as cooperative strategy and international strategy. These are fundamentally specific aspects of corporate strategy, but they may also have competitive strategy implications.

Game Theory

The origins of game theory

Game theory can be traced back to 1944 and the work of von Neumann and Morgenstern. It is generally associated with mathematics or economics. However, it has recently come to play an important part in strategy, in that it requires the strategist to consider the impact of a potential strategy not just on the customer, but on the competitor, who is capable of responding and perhaps neutralising what would otherwise be a good strategic move. As Brandenburger and Nalebuff (1996) put it, it persuades the strategist to operate allocentrically and not merely egocentrically.

Game theory and strategy

Strategy had traditionally concentrated on market analysis, and on core competences, and relating the two together to achieve competitive advantage. It had paid less attention, however, to the roles of suppliers, competitors and 'complementors'. Game theory construes the business arena as one in which, typically, two players try to outwit each other, when the same information and motivation are available to both. Typical examples of business games are The 'prisoners' dilemma' and the 'battle of the sexes'. The prisoners' dilemma is concerned with how to ensure an effective cooperative strategy when short-term self-interest points towards an uncooperative one. The battle of the sexes is concerned with how agreement can be reached when two partners have only partially overlapping agendas. The chapter on cooperative strategy will deal with both games in more detail later in the course.

Game theory has been defined as a systematic way to understand the behaviour of other players in situations where the fortunes of all are interdependent and uncertainty is present. This describes most strategic situations. However, game theory is at its most definitive when considered as a game between two players. Unfortunately most strategy games involve more than two players, which makes game theory difficult to apply in a definitive way in real business situations. As an overall mind-set, however, it is vital to the thought processes of the strategist.

Quick summary

Game Theory

- Game theory can be traced back to 1944 and the work of von Neumann and Morgenstern. It is generally associated with mathematics or economics.
- Game theory has been defined as a systematic way to understand the behaviour of other players in situations where the fortunes of all are interdependent and uncertainty is present.

Summary

Strategy is a matter of central concern to all companies. It establishes how the company aims to achieve its objectives. Whether the strategy is dominantly linear, adaptive, evolutionary or perhaps interpretive, it needs to be addressed critically if the company is to prosper. The two levels of strategy that are the concern of this topic are competitive strategy (how to achieve SCA) and corporate strategy (which businesses to be in and how to run them). In the first half of the course these will be addressed in a general sense and in the second half with an international dimension.

Task ...

Task 1.1

To check your understanding of the material in this topic, try to answer the following questions. If you have any difficulties, you may wish to go back and revise the relevant part of the topic.

1. What is the distinction between competitive strategy and 'corporate strategy'?
2. How important is a sense of purpose to successful corporate strategy?
3. Distinguish between competitive strategy and international strategy.
4. Outline Ansoff's four-stage model of strategy formulation.
5. How does Andrews suggest a firm can best achieve a fit between environmental opportunities and organisational resources?
6. Describe some of the major approaches to strategy formulation
7. Advance some examples of Hamel's (1996) 'rule makers', 'rule takers' and rule breakers'.
8. What are Hamel's nine routes to industry revolution?
9. Explain the importance of game theory to strategy formulation

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Topic 2

Strategic Decision-Making: An Evolutionary Approach

Aims

The aims of this lesson are:

- to tell you more about business history and its importance in the development of strategic management;
- to explain how business history is interpreted;
- to show how different forms of strategic decision-making are important to the evolution of the subject;
- to establish the nature of strategic evolution

Objectives

By the end of this topic, you should be better able to:

- introduce a historical dimension to strategic management;
- critique the notion that strategy can be planned;
- develop a multi-process model of strategic decision-making;
- identify the historical precedents for modern corporate strategies.

Introduction

Business history has emerged from studies and biographies of individual entrepreneurs to become a multi-faceted subject that embraces a wide variety of disciplines from economic theory to industrial sociology. The main aim of business history is to study and explain the behaviour of the firm over extended periods of time and to place the findings in a broader framework of market and institutional considerations (Wilson 1995, p. 1). Business history generally adopts a case study-based approach, from which wider generalisations are drawn concerning the nature of capitalism, industry structures and strategies, and so forth. Ashton (1959) argues that:

> It is in the individual firm, rather than in wider organisations, that we can observe the operation of economic forces at first-hand, with little distortion by politics and ideologies. Decisions reached in the counting house or board room may affect the course of events quite as much as those made in public assemblies. Insufficient attention has been given to them.

T. S. Ashton saw business history as a "grass roots approach to economic history", which should contribute to our understanding of the fundamental processes and stages of long-term economic and social change. Ashton's view of business history, as a sub-discipline of economic history, has been influential and persists today in the minds of many practitioners.

For others, however, the most exciting and intellectually promising development of recent times has been the erosion of the Ashtonian perspective as the constituency of business history has been progressively widened and its status correspondingly enhanced. The ideas of business historians such as Alfred Chandler (1962, 1977, 1990) have been particularly influential in the development of this broader and more innovative interpretation of business history and in developing its linkages with strategic management. These ideas have already been explored in Topic 1. Thus, the business history of the 1990s and beyond owes as much to economics and management as it does to economic history.

Business History and Strategic Management

The relationship between business history and business strategy

We are concerned in this topic with one aspect of the new business history: its relationship to business strategy. In the modern conception, the focus of business strategy is the way a company defines its business and matches its internal capabilities and external relationships. A strategy sets out how the company aims to shape its future through the development of its productive capabilities and by responding appropriately to "its suppliers, its customers, its competitors, and the social and economic environment in which it operates". The strategy provides the intellectual frameworks, conceptual models, and governing ideas that allow a company's managers to identify business opportunities and satisfy its primary purpose: that of adding value – of "bringing value to its customers and delivering that value at a profit". In this sense, to quote Normann and Ramirez, "strategy is the art of creating value".

That business history may make an important contribution to corporate strategy is not generally recognised. Significantly though, two of the most influential works on strategy of recent years do exploit business history as a source of information and ideas, albeit to a limited degree. Michael Porter's The Competitive Advantage of Nations and John Kay's Foundations of Corporate Success each use business history as a means of developing and refining valuable conceptual frameworks and tools for strategic analysis. As Kay puts it:

Quick summary

Business History and Strategic Management

- A strategy sets out how the company aims to shape its future through the development of its productive capabilities and by responding appropriately to "its suppliers, its customers, its competitors, and the social and economic environment in which it operates".
- That business history may make an important contribution to corporate strategy is not generally recognised.

> The analysis of strategy uses our experience of the past to develop concepts, tools, data, and models which will illuminate these decisions in the future.

Both Porter and Kay have, in very different ways, made important contributions to the reformulation of thinking on strategic management that has taken place in recent years. The significance of this reformation is best understood by comparing the essentials of the subject as conceived in the 1960s and 1970s with the dominant ideas of today: we will consider this later in the topic.

Strategic Decision-Making: Managing Complexity – The Planning Approach

Organisations do not exist in predictable environments. Levy (1994) points out that industries and their environments are dynamic and evolving. Their evolution is the result of a complex set of interacting elements, which include firms, governments, labour, consumers and financial institutions, to name but a few. Successful organisations are inevitably dynamic entities evolving through time. Both organisations and organisational environments in a free market economy can be conceptualised in systems terms. Their complexity can be considered in terms of the numbers of interacting components, their variety and the numbers and different types of linkages between them.

The complexity of the business environment

At the organisational level, small firms are not as complex as large, diversified multinationals, but the nature of the business environment is complex for any firm. Even so, it is not impossible retrospectively to identify patterns and trends in the development of economies, industries and organisations. These are reflected in descriptions of such phenomena as trade cycles, booms and slumps, industry and product life-cycles and typical stages in the growth and evolution of the firm, but the dynamics of future changes that produce such trends and patterns are too complex to be predictable.

Long-term forecasting is not a reliable science (Wack, 1985a, 1985b). As Wack points out, it often proves to be inaccurate (1985a, p. 75). In this respect, it may be suggested that formal strategic planning techniques, for example, scenario planning, are of value in so far as they heighten awareness of possibilities, opportunities and threats and explicate the presuppositions that underpin company strategic decision-making. However, any company strategy, whether it emerges in the course of day-to-day operations, or results from a systematic rational strategy formulation process, cannot be pursued unquestioningly without risk. Any strategy that assumes the status of a sacred cow is bound to fail sooner or later in today's rapidly changing world.

Industry structures can influence the behaviour of firms within them. Industry strategic recipes can be identified in many industries, but the relationship between industry structure and firm behaviour is not necessarily deterministic or linear. Firm behaviour can also in the longer term influence industry structure. Innovative firms may change the circumstances of the competitive game in which some of their competitors will thrive while others will suffer decline. In this way they can be considered to have an effect upon the ecology of the industry.

The limitations of a predictive linear model

However, in terms of cause and effect relationships, these influences are not immediate. As De Geus (1988) recognised, in the modern world, cause and effect are often separated in time and space, which makes it difficult to tie down definitive cause and effect relationships. In the complex world of the modern multinational organisation, the usefulness of conventional predictive linear models of the type to be found in the economics literature is called

Quick summary

Strategic Decision-Making: Managing Complexity - The Planning Approach

- At the organisational level, small firms are not as complex as large, diversified multinationals, but the nature of the business environment is complex for any firm. Even so, it is not impossible retrospectively to identify patterns and trends in the development of economies, industries and organisations.
- As De Geus recognised, in the modern world, cause and effect are often separated in time and space, which makes it difficult to tie down definitive cause and effect relationships.
- The traditional strategic planning models of the 1960s do appear naive in the changed world of the 1990s. But as the world has moved on, so too has research in the field of strategic planning, from which the variety of analytical tools and techniques to assist in strategic decision-making, have evolved.

into question. Stacey (1993a) points out that the traditional planning models of strategy are also linear. They are based upon the concept of positive action planning influenced by negative feedback. That is to say, when actual results diverge from planned results corrective mechanisms come into play to rectify the discrepancy.

These models are argued to be oversimplified. This distorts their view of reality, although it should be added that many of the models of modern prescriptive rational process theorists may still be considered to have a place in policy formation. The student of strategic management, confronted by numerous criticisms of strategic planning in the literature, may feel tempted to throw the baby out with the bath water by abandoning the concept entirely. After all, when reputable strategy writers such as Mintzberg (1994) go so far as to describe strategic planning as an oxymoron, surely there must be something in it.

Further developments in strategic decision-making

The traditional strategic planning models of the 1960s do appear naive in the changed world of the 1990s. But as the world has moved on, so too has research in the field of strategic planning, from which the variety of analytical tools and techniques to assist in strategic decision-making, have evolved. Tools and techniques, of course, cannot on their own provide a synthesis of the available information for an unequivocal decision (Mintzberg 1994). It may also be said that in any evaluation of information and requirements for change, values intervene, as you will see in the examples below.

Examples – Hotel chains

Formal planning processes alone cannot provide the company with its strategic direction. For example, some large hotel chains, such as the Holiday Inn, franchise their outlets to independent operators. Others, such as the French Novotel chain, which is a part of the Accor group, own their hotels and regard themselves as operators. Any decision about which strategy to adopt depends upon the values of the senior management team and what sort of company they want it to be.

Examples – Oil refining majors

Similarly, there is over-capacity in world oil refining. Any one of the existing oil refining majors could take a decision to close down its refineries and buy in product from elsewhere. However, such a decision would be irreversible and the question that needs to be asked and answered in relation to the values and culture of the company is: do we want to become a marketing organisation?

Oil majors, with a manufacturing culture, may evaluate such a proposition unfavourably in the light of their existing values. Formal planning techniques can, however, provide a systematic analytical foundation for strategic decisions and in doing so point towards potential risks that intuitive judgements alone may overlook. It can also serve to make the assumptions behind decisions explicit, thereby enabling them to be queried. This can help the company to avoid future strategic errors.

In some companies (Royal Dutch Shell is a well-known and documented example), there is a strategic planning culture that serves the company well as a means of warding off the dangers of complacency. The fact that strategic planning processes form part of a company culture can mean that existing strategies have to be continually questioned and scrutinised. Such processes can encourage management to think strategically and recognise the potential for alternative courses of action that might otherwise go unnoticed. Given that the limitations of strategic planning processes are recognised, they need not become an oxymoron. There is no necessity for them to be inimical to the world of complex relationships described by Stacey in which feedback is both positive and negative.

Your notes

Non-linear relationships and the power of feedback

Some kinds of feedback, perceived as positive by a blinkered management, can lead to a vicious circle of decline rather than a virtuous circle of achievement, and feedback may itself be non-linear. "Non linearity occurs when some condition or action has a varying effect on an outcome, depending on the level of the condition or the intensity of the action" (Stacey 1993a, p. 151).

In chapter 6 of his book Strategic Management and Organisational Dynamics, Stacey argues that every human system comprises non-linear relationships and is powerfully influenced by both negative feedback and positive, amplifying feedback loops. His understanding of organisations is a dynamic one that allows for differences in the ways in which organisational actors think. Such differences in ideological orientation have increasingly come to be recognised as key factors affecting both the competitive performance of the firm and the unpredictable nature of the environment. Stacey's picture of the organisation is one of a complex dynamic system in an unpredictable and complex environment. He outlines some well-known theories of organisational dynamics that can be accommodated to his view and which may be taken to illustrate the inadequacies of conventional linear approaches (Stacey 1993). They are indicative of the fact that mindsets and mental models are central to an understanding of complexity.

Understanding organisations

Strategic problems are not simple or their solutions routine. As firms become larger and more diversified, their strategic problems become more complex. The traditional view of Chandler (1962), for example, or Bower (1972), is that many of these problems can be largely resolved through the adoption of suitable organisational structures. Prahalad and Bettis (1986) acknowledge the need to attend to structural issues in the diversified multinational company. They argue that appropriate structures can "attenuate the intensity of strategic variety" at the level of the business unit manager, but they cannot "substitute for the need to handle strategic variety at corporate level" (Prahalad & Bettis 1986, p. 496). In short, the top management team needs to be well informed and open minded. In this respect, the tendency Prahalad and Bettis (1986) observed, for top teams to develop a dominant logic, is one that can handicap flexibility and innovation. Subsequent research substantiates this fact (Carlisle & Manning 1994).

Weick (1979) approaches an understanding of organisations from a sociological and psychological perspective. Organisations are analysed in terms of the interactions that occur between individuals and groups and the positive and negative feedback loops that are brought into play as these interactions take place. Even at the level of individual actors, relationships are argued to take a complicated and changing form as feedback patterns are not constant. Decision-making is therefore not as coherent and uniformly rational as the conventional planning models of the strategy process would have us believe they should be.

To move beyond the level of the individual, organisations also comprise groups impacting on one another. This network of inter-organisational relationships makes for a particularly complicated set of interactions. With hindsight, Weick's work supports the view that approaches to strategy that treat the organisation as if it were a linear system, misrepresent the nature of cause and effect in organisations. Human perceptions and interpretations cannot be predicted with accuracy, although different scenarios based upon different ways of managerial reasoning might be considered to be determinate. Strategic decisions are not a matter of right or wrong as in mathematics; they are a matter of success or failure in practice.

Your notes

The fall from grace of strategic planning

In Topic 1 we discussed how, in its formative phase as an academic subject, the dominant approach to strategy was that of planning. Formal planning procedures typically grew out of the budgeting process – the key control mechanism in most organisations. The approach was extended to reviewing market and technological trends and subsequently to model building and 'what if' scenario planning. According to Henry Mintzberg (1994), in The Rise and Fall of Strategic Planning, planning was long seen by business leaders as the best way to devise and implement strategies that would enhance industrial competitiveness. Strategic planning had the virtue of nominally matching resources with environmental opportunities and trends in a systematic fashion. It also provided step-by-step instructions for carrying out the strategies "so that the doers, the managers of business, could not get them wrong".

As the title of Mintzberg's book suggests, virtually no one believes in strategic planning as the ultimate solution any more. Mintzberg attributes the fall from grace of strategic planning to three inherent limitations:

1. Planning is by its nature rigid; yet the business world is inherently turbulent and difficult to predict.
2. Planning is a detached process; yet the majority of business opportunities arise through engagement, activity and involvement.
3. Planning is highly formalised; yet to grow and develop in business has always required experimentation and learning by doing.

The three fallacies of strategic planning

In a later volume, The Strategy Safari (1998), Mintzberg et al. describe what they term as "the three fallacies of strategic planning".

Predetermination

The first of these is the fallacy of predetermination. Successful strategic planning hinges on an organisation's ability to predict and control the course of its environment or, at a minimum, to assume its stability (Mintzberg et al. 1998, pp. 66–67). If this is not possible, the implementation of a planning approach to strategy decision-making is nonsensical.

Detachment

The second fallacy of strategic planning advanced by Mintzberg et al. is that of detachment. As already mentioned (Mintzberg 1994), this refers to the separation of strategy formulation and implementation, inherent in the planning approach. Strategy is detached from operations and thinkers are distanced from doers in an organisation (Mintzberg et al. 1998, p. 68). This inevitably leads to problems as the strategic planners become isolated and increasingly view the organisation's activities and resources in an abstract fashion. As Mintzberg et al. argue:

> Effective strategy making connects acting to thinking which in turn connects implementation to formulation. We think in order to act, to be sure, but we also act in order to think. (Mintzberg et al. 1998, p. 71)

The planning approach to strategic decision-making often results in the reversal of this process and an attempt to inform practice with theory, rather than the other way round.

Formalisation

The third fallacy inherent in strategic planning is formalisation. Again, as Mintzberg described in his earlier (1994) work, this inconsistency relates to the authors raising a crucial question: can innovation really be institutionalised? It is important to remember that strategic planning has not been developed as a tool of strategic decision-making and as a support for natural management

processes such as intuition; but rather, as a form of decision-making and as a substitute for intuition (Mintzberg 1998, p. 72). Such an approach can result in a lack of spontaneity, creativity and human judgement in corporate strategy formulation and can also create a strategy process that is unable to cope with complexity or change.

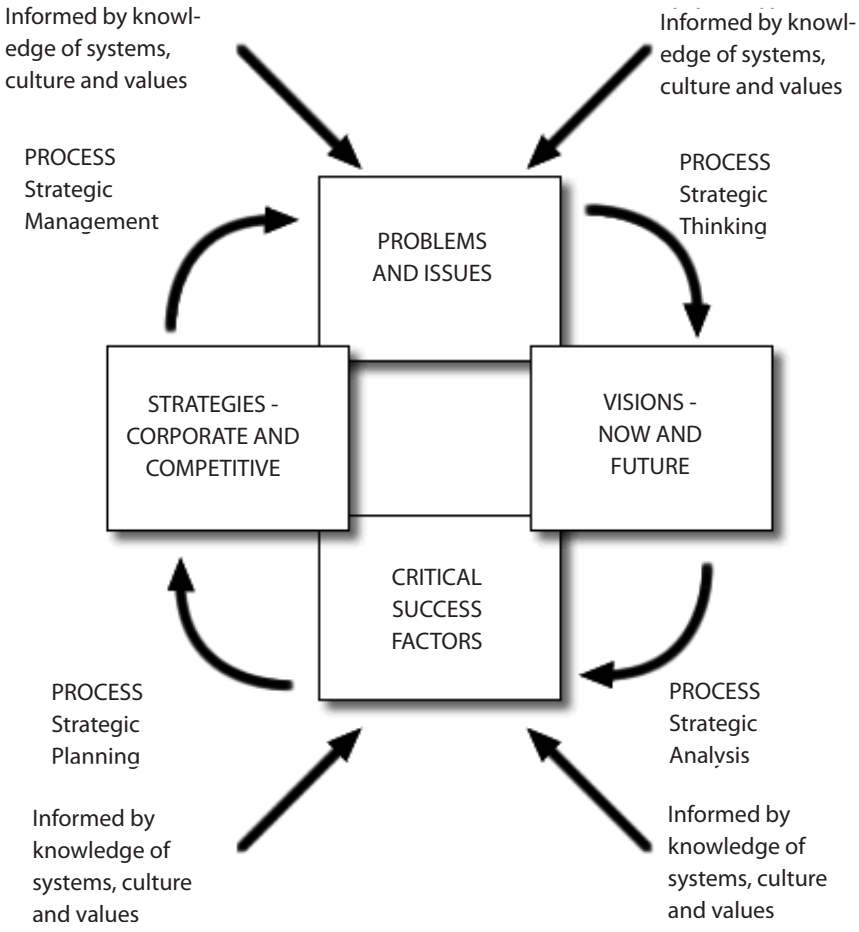
It thus follows that reliance on planning as the dominant mode of strategy formulation may lead to inflexibility, inefficiency and missed opportunities. As a decision-making process, planning is unable to deal with the strategic and structural complexity of the modern corporation.

Your notes

Strategic Decision-Making: Managing Complexity – The Business History Approach

So far so good. Mintzberg would find few strategists who would take exception with the conclusion that you read above. So what should replace rationalistic planning as the dominant mode of strategy formulation?

This question has been answered in many ways over the years as fashions have changed: some concepts and models have come and gone; others have proved more valuable and enduring. The model presented below (Figure 2.1) integrates several contemporary strands of thought on strategic management and gives proper weight to corporate historical consciousness in the decision-making process. Four features of the model are noteworthy.



The view of strategy represented in the model, which embraces many of the ideas that have come to the fore in the last few years, could hardly be more different to that of the planning era described by Mintzberg. To the planner, strategy formulation was linear, rational and detached. It is seen here as circular,

flexible and interactive. The planning mentality emphasised targets, quantification and resource allocation. The new mentality emphasises value creation, vision and the development of capabilities. In the planning era, strategy was largely the province of specialist technocrats. Nowadays it is seen as a central function of directors, senior managers and even middle managers.

Strategic management as an ongoing process

In this diagram, strategic management is represented as an ongoing process. Strategies are not pure: they are neither deliberate (imposed from above) nor emergent (resulting from action).

Products generated by strategic decision-making

Strategic decision-making should generate four sets of products:

1. Awareness of the critical problems and issues confronting the business, which must be addressed as a matter of urgency.
2. Two well articulated visions: the first of where the business is now; the second of where it would wish to be in the future. Where are we now? Where do we want to be?
3. A sharply honed list of critical success factors – those variables that have the most significant impact on performance. What must we focus on to get where we want to be?
4. A clutch of related strategies: for the company as a whole and for each main product group and business function.

The processes of strategic decision-making

Strategic decision-making involves four main processes:

1. Strategic thinking involves business leaders in capturing knowledge of many kinds, from many sources, and of many types (soft and hard), and reflecting imaginatively upon that knowledge. Synthesis is vital to the understanding – visioning – of past events, current realities and future possibilities. Mintzberg observes that his "research and that of many others demonstrates that strategy making is an immensely complex process, which involves the most sophisticated, subtle and, at times, subconscious elements of human thinking."
2. Strategic analysis involves looking outside the company, gathering data and analysing political, economic, social and technological trends. Information on competitors and suppliers reveals the critical factors determining competitive success or failure in an industry.
3. Strategic planning involves the alignment of resources with vision, and the setting of objectives and targets in relation to critical success factors.
4. Strategic management involves taking all the technical, structural, systematic, and human decisions necessary to execute a strategy.

The Value of Business History

Using business history

Much of contemporary strategic decision-making is best understood through the lens of business history. Key decision points in the lives of corporations are rarely arrived at as a result of purely abstract considerations disembodied from the past. Rather, the past conditions and exerts leverage over the present in many subtle yet powerful ways.

Consider, first of all, the processes of strategic thinking and the importance of vision in lending a company impetus and direction. In nearly all of the cas-

Quick summary

The value of business history

- Much of contemporary strategic decision-making is best understood through the lens of business history,
- Jones (1996) labels this approach to strategic decision-making the 'evolutionary perspective' on international business and argues that it offers important advantages.
- The development of British 'overseas banks' from the 1830s onwards provide further historical examples for modern multinational banking. Using the British Empire as their original market base, these banks gradually established a global presence and contributed a great deal to the evolution of modern financial infrastructures around the world.

es examined of mature (as opposed to new start) companies, a true vision of current corporate realities has been as important to progress as the formation of realisable visions of the future. An understanding or direct experience of 'history' is often essential to this process. The international mining house RTZ developed a vision of the future in the early 1950s of a company with worldwide operations based on the ownership of very large-scale mineral deposits in politically stable countries. To all intents and purposes this compelling vision was realised by the 1970s. But this vision did not appear from out of the blue – it was preceded by the vision of a once great company locked into and suffocated by Franco's Spain, which must re-invent itself or die.

The evolutionary perspective

Jones (1996) labels this approach to strategic decision-making the 'evolutionary perspective' on international business and argues that it offers important advantages. He contends that because multinational investment is a cumulative process, the structure (and strategy) of contemporary international business can only be adequately explained by examining its history (Jones 1996, p. 1). Most of the world's leading companies have long-established competitive positions and have retained their market advantage despite technological, social, political and economic change. Jones goes on to argue that more importantly:

> An evolutionary perspective demonstrates the dynamic nature of international business. The structures, strategies, and impact of multinationals have changed considerably over time, and will continue to change in the future. (Jones 1996, p. 1)

The origins of business strategy in international banking

Taking international banking as an example, we can see that modern developments and strategies in this sector often have an historical precedent. Banking was transformed in the post-1960 era as many banks internationalised their activities. In 1960 foreign operations were of marginal concern to US banks for instance, but by the mid-1980s, the assets of their foreign branches amounted to 20 per cent of their total assets (Jones 1996, p. 189). Banks increasingly sought to break free from national regulatory regimes and establish a presence in loosely regulated international, or supranational, financial markets.

Although this change in banking structure and strategy was heralded as a new direction, examples of such activities had existed for several centuries. As Jones argues, "bankers had engaged in the finance of cross-border trade and international lending for centuries, and the history of international banking can be legitimately traced back to the Italian bankers of the Middle Ages …" (Jones 1996, p. 152).

British 'overseas banks'

The development of British 'overseas banks' from the 1830s onwards provide further historical examples for modern multinational banking. Using the British Empire as their original market base, these banks gradually established a global presence and contributed a great deal to the evolution of modern financial infrastructures around the world. These banks also evolved over time from corporate lenders to multinational retail banks, competing directly with domestic banks for local customers (Grubel 1977). The Hong Kong Bank is perhaps the most noteworthy survivor of British overseas banks and is, as you will read below, a clear example in support of the argument that present-day strategies have historical origins.

Case Study: Does the corporation's history matter?

A study of Hong Kong Bank/HSBC Holdings

The Hong Kong Bank was founded in Hong Kong in 1865 with a directorate

representing merchants of several nationalities. It subsequently established branches and agencies in the key ports of East and South-East Asia and Ceylon, with limited service agencies in India and the United States and with an important base in London. In the late 1950s the Hong Kong Bank became both an operating bank and a holding company, having acquired the Mercantile Bank (India) and the British Bank of the Middle East. The regional colonial bank became multinational with the acquisition of Marine Midland Bank in 1980 and Midland Bank in 1992. To facilitate regulatory approval of the merger with Midland Bank, the bank permitted a reverse take-over by a minor subsidiary registered in the UK, HSBC Holdings. In 1993, the Hong Kong Bank remained with its head office in Hong Kong but it was now wholly owned by HSBC Holdings whose chairman would reside in London.

In the late 19th century the Hong Kong Bank was described as a collection of banks operating with a common capital. It was founded in a multinational community to finance a trade (the inter-port commerce of South-East Asia) participated in by companies with diverse national origins. This early structure and strategy corresponded with the bank's corporate strategy a century later. In an interview in 1993, HSBC Chairman, Willie Purves, acknowledged that the bank's strategy hinged on appearing to be a local bank wherever HSBC put down roots. Structurally, he described the bank as a federation of franchises, with different brand names in each market. As such, Purves was remaking the group in the image of the old Hong Kong Bank and implicitly accepting that the basics of the historical culture and strategy are intact.

Source: adapted from Frank H. H. King (1996) Chapter 6 in Godley & Westall (eds) Business History and Business Culture, Manchester, Manchester University Press.

The strategic lessons of business history

William Morris

History can be a more direct source of business ideas and strategic thinking. William Morris, of designer fame, regarded history as a fund of 'living ideas'. His method – applied in almost all fields of his endeavour – was to take the best example of something he could find in the past, absorb the principles of its design and manufacture, and then apply his special talent to the creation of contemporary products of equivalent quality and beauty. The Morris method still works, and it is a tribute to him that his designs and ideas still fertilise the world of business today.

Vision, of course, is nothing unless it is translated into strategy, and good strategies are mediated by a clear understanding of what it takes to make a business succeed – an understanding of critical success factors. William Morris's business went into decline after his death because his successors failed to understand what he had taught: that in Morris & Co.'s niche in the market, quality, beauty and originality of design were all essential (Morris is on record as saying that "beauty is a marketable commodity").

Ingvar Kamprad and IKEA

Three years after the closure of Morris & Co. in 1940, Ingvar Kamprad founded what is today the world's largest company dedicated – as was the Morris enterprise – to 'outstanding achievements' in the field of interior decoration. The Kamprad vision of IKEA, formed since the early 1960s, has been one of a global network of furniture stores in large out-of-town locations selling Scandinavian-styled, flat-pack furniture at low prices. Low price is one obvious critical success factor, but there is a second, which is more profound and much less apparent. IKEA has won a reputation for value that is enduring, and it has forged an exceptionally good and productive set of relationships with its customers. Put simply, IKEA invites its customers to participate in the creation of value – as home designers, assemblers and distributors. Visiting the stores is made into an event that is seen by customers as creative and enter-

Your notes

taining (crèches, restaurants, design settings, advice, etc.). The reward has been an ever-expanding customer base.

Your notes

Important lessons from history: Critical success factors

The ability to take advantage of critical success factors is dependent on the creation and sustaining of organisational capability. There is no more serious lesson of business history. The message is at the heart of Alfred Chandler's massively influential book, Scale and Scope. In this, the author demonstrates that first moving firms that make critical investments in manufacturing, marketing and distribution, to secure economies of scale and scope, win long-term competitive advantages. If these advantages are sustained, these companies go from strength to strength. IKEA is a case in point. The company has built up a strong design team, it coordinates purchases from 1500 suppliers through sophisticated logistical systems; its distribution network is similarly advanced; and all its stores operate the same retailing concept. These capabilities – in design, purchasing, distribution and retailing – have transformed IKEA from a purely Swedish company to a global corporation.

Important lessons from history: The consequences of significant change

There is a further important lesson of business history for strategic management. Alfred Chandler first came to fame by demonstrating that significant changes in strategy frequently demanded equivalent changes in business organisation. More recent findings demonstrate that Chandler was only half right. Major strategic changes are seen frequently to lead to difficulties by challenging established systems, cultures and values as well as structures. This was the case at ICI when John Harvey Jones sought to reduce the company's dependence on bulk chemicals, and focus instead on higher margin products like drugs and speciality chemicals. Only when these problems (which are equivalent to those at the point of Kuhnian paradigm shift) were recognised and solved could the strategy be fully implemented. The ultimate result was the separation of Zeneca from ICI.

The cases that you have just read about demonstrate that business history potentially generates both concepts and evidence that are of value to strategic management. The same, of course, is equally true in reverse: corporate strategy provides concepts and models that are of value in interpreting the past – of satisfying the purpose which business history should serve according to Ashton (1959).

An example from the car industry

The point is easily demonstrated. Why had the British car industry all but collapsed by 1980 from a position of world export leadership in 1950? Why was the opposite true in the case of Japan?

In the British case, strategic thinking was strictly limited; there was precious little vision (save that large firms were better than small ones); there was next to no strategic analysis and an almost complete failure to identify critical success factors (e.g. quality, styling, features). There was little by way of corporate and competitive strategies other than to increase the intensity of the work process. When problems of systems, culture and values arose they were unanticipated and resulted in strikes. The industry entered a spiral of decline. Meanwhile the Japanese industry was bolstered by top-class strategic decision-making. Here critical success factors were identified and addressed and capabilities created and sustained. Corporate and competitive strategies were well articulated and generally understood. Problems of managing change were anticipated and handled in a spirit of cooperation.

These historical examples, sketchy as they are, serve to make three related

points:

- First, that at a very practical level, history does indeed inform strategic decision-making. Not so much in a systematic way, but rather, as Mintzberg suggests, through a complex series of processes informed by historically devised corporate consciousness.
- Second, business history, when informed by concepts and theory, may be thought of as methodology for contemporary strategic analysis.
- Third, and finally, it is clear that the concepts, tools and techniques of business strategy may be profitably employed in the course of historical interpretation.

Summary

The first important point arising from this topic is that strategy is about pursuing an idea and approach and experimenting or innovating it as new challenges and opportunities arise. Strategy is not about detailed planning and rigid projection.

The second point is that history should not be dismissed in an offhand manner by modern business people as successful strategies are often forged through learning from past examples.

Task ...

Task 2.1

To check your understanding of the material in this topic, try to answer the following questions. If you have any difficulties, you may wish to go back and revise the relevant part of the topic.

1. What are the main research aims of business history?
2. What value do formal strategic planning techniques have for organisations?
3. Is the relationship between industry structure and firm behaviour always deterministic and linear?
4. Give an example of a large company where a strategic planning culture has served them well.
5. What approaches to strategy are supported by the work of Weick (1979)?
6. What are the 'three fallacies of strategic planning'?
7. In the business history approach to strategy making, what are the four sets of products that strategic decision-making should generate?
8. What label does Jones (1996) attach to the historical approach to strategy making?
9. How might you describe the late 19th century structure and strategy of the Hong Kong Bank?
10. What does business history teach us about first mover advantage?

Recommended reading

Chandler, A.D. (1962) *Strategy and Structure: chapters in the history of the American industrial enterprise*, Cambridge, MA, MIT Press.

Chandler, A.D. (1990) *Scale and Scope: the dynamics of industrial capitalism*, Boston, MA, Harvard University Press.

Mintzberg, H. (1994) *Planning and Strategy: the rise and fall of strategic planning*, London, Prentice Hall, pp. 5–34.

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Topic 3

Business Strategy: The Market Positioning Approach

Aims

The aims of this topic are:

- to introduce you to the market positioning approach to competitive strategy that dominated in the early 1980s and is associated with Porter;
- to introduce the customer matrix and the Five Forces model, which aid the use of the approach;
- to explain the value of the concept of strategic groups;
- to show how scenario planning helps the strategist out of mental straight-jackets.

Objectives

By the end of this topic, you should be better able to:

- use the customer matrix;
- describe the market positioning approach to competitive strategy;
- discuss the 'inside-out' and 'outside-in' routes to successful market competition;
- outline five steps to environmental analysis;
- describe the Five Forces model of market competition;
- describe strategic group theory, which refines the Five Forces model;
- describe scenario planning;
- describe the theory of generic competitive strategies.

Introduction

Your notes

Competitive or business strategy is the essence of business. A company with a poor competitive strategy will go bankrupt if it does not find a source of competitive advantage somehow. A company with a poor corporate strategy is no more than a good takeover target so long as its constituent SBUs (Strategic Business Units) have good competitive strategies. The basis of good competitive strategy success is simply to offer products or services to a market segment that have or are perceived by potential buyers to have a competitive advantage over those offered by competitors.

A market segment may span geographic boundaries, genders, nationalities and age ranges. The uniting factor is the availability of the product and the satisfaction of consumer need.

There are two critical issues at segment level:

1. The level of the effective demand in the segment; and
2. The ease with which firms can replicate the key competences required to meet the demand.

This topic deals with issue 1 and the next topic with issue 2.

The ease with which firms can replicate the key competences required to meet the demand.

These two issues are the most important in determining the overall nature of a particular market segment. The level of demand in the segment influences the prices charged by firms serving it, relative to other segments; it also affects the relative cost levels in the segment, via economies of scale and experience curve effects.

The ease with which other firms can enter a market affects the balance of power between an individual firm and customers. A greater choice of suppliers gives the customer bargaining power over the firm. Power relationships between firms and customers affect who gets the greater part of total value. If the firm is in a strong position, and is perceived by customers as offering a unique and valued product, it is able to capture a large proportion of the total value available.

Customer needs and the number of customers

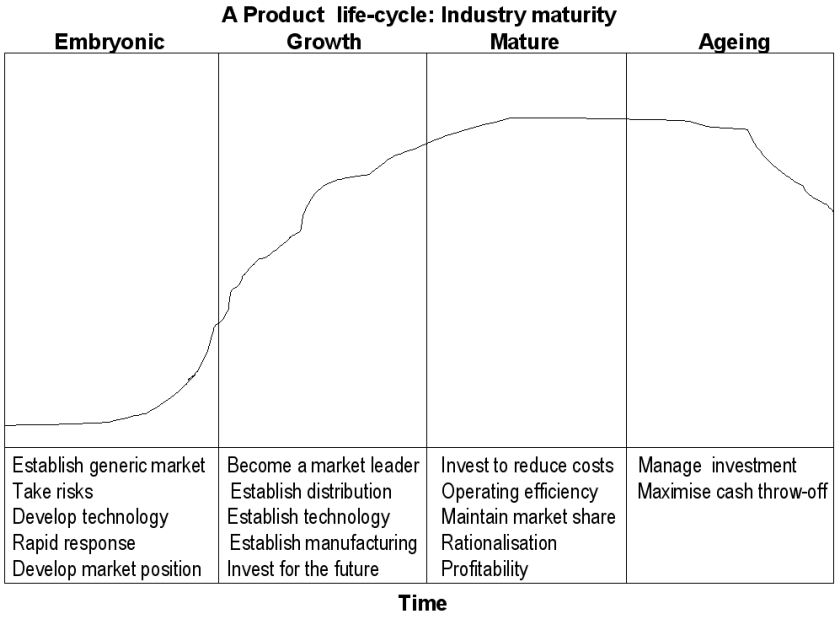
The strength of demand depends upon the factors that influence customer needs in the segment and the factors that influence the number of customers in the segment. There are personal customers and business customers. Typically, business customers are purchasing goods and services as inputs to a business process, such as components, power, computer software or short-term finance. In order to better understand the drivers of demand for business customers, it is necessary to gain insights into their businesses, their needs and how our products and services can meet their needs, and also to anticipate how these needs may change in the future.

Some firms have been particularly diligent in this regard. Major suppliers of computer hardware have been attempting to redefine their businesses from being suppliers of hardware, to becoming providers of systems and solutions to their clients. In personal customer segments, it is necessary to understand the different layers of needs, not just the more straightforward, obvious motivations that drive customers, then to identify what trends (social, demographic and economic) affect these needs. This might then suggest how the needs may change in the future.

Industry Structure Analysis – The Life-Cycle Model

Prior to the arrival of Porter's famous Five Forces model in 1979, much of industry analysis was conducted on the basis of the product or industry life-cycle model as shown below. This model, shown in Figure 3.1, divides the life of a successful product into four distinct phases:

1. embryonic
2. growth
3. mature
4. ageing



Unsuccessful products of course did not progress beyond the embryonic phase. Each phase had its own distinct character, and required appropriate behaviour (strategy) from the companies operating in the product/market if they were to be profitable and build market share.

Embryonic

In the embryonic phase, the mostly new companies were concerned with establishing a generic market for the product, to develop their technology, to be entrepreneurial and to establish the market as a stable one.

Growth

Only in the next phase, that of growth, would the product bear fruit in terms of rapidly growing sales. Even then, distributable profits would be small and the firm needed to reinvest to build capacity to meet the growing demand. In this phase, the successful company would be concerned to establish regular distribution, achieve the 'dominant design paradigm' (Teece 1987) for itself, become the market leader and invest for the future.

Mature

In the mature phase, profits would build as growth began to plateau. The same level of new investment would no longer be required, and the main aim would be not so much innovation as an increase in operating efficiency and productivity. This phase could be likened to the 'cash cow' phase of the Boston Box.

Ageing

Ultimately, the ageing phase overtakes the market and the firm struggles to

Quick summary

Industry structure analysis - the life-cycle model

- Prior to the arrival of Porter's famous Five Forces model in 1979, much of industry analysis was conducted on the basis of the product or industry life-cycle model as shown below.
- Unsuccessful products of course did not progress beyond the embryonic phase. Each phase had its own distinct character, and required appropriate behaviour (strategy) from the companies operating in the product/market if they were to be profitable and build market share

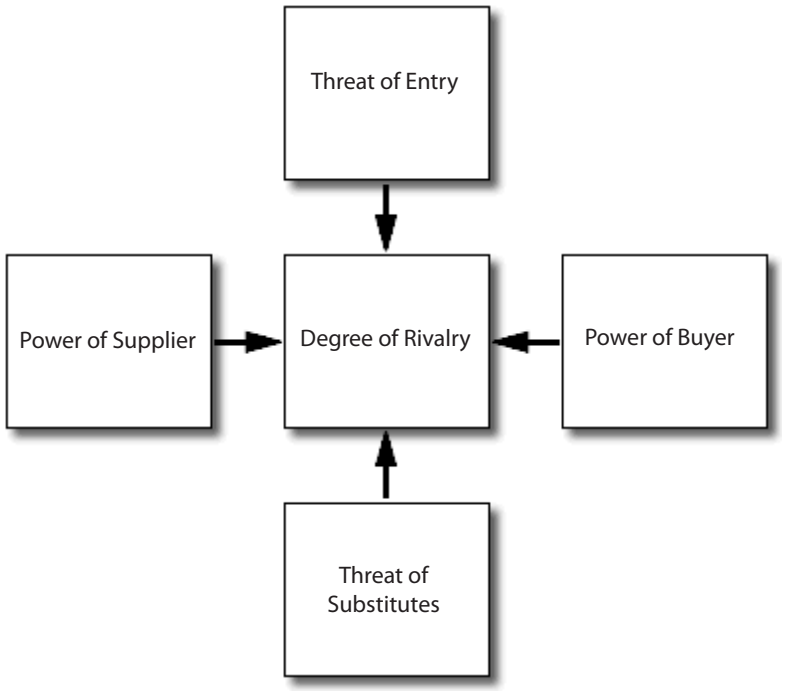
defer its onset and to maximise cash throw-off as it harvests its now largely written-off investment. The powerful market share holders buy up their weaker brethren and the market proceeds to decline.

Industry Structure Analysis – The Porter Five Forces Model

Throughout the 1980s, strategic thinking was strongly influenced by Michael Porter's book Competitive Strategy (Porter 1980), in which market structure is said to play an important part in determining firm profitability. This thinking developed out of Industrial Organisation (IO) theory in which market structure was seen as largely determining strategic conduct (strategy), which in turn was largely instrumental in determining performance. This is the Structure–Conduct–Performance paradigm so influential amongst industrial economists in the 1950s and 60s, and associated with the names of Bain, Mason, Scherer and, more recently, Tirole.

Porter offers his Five Forces model of competition as a means of understanding industry environments and suggests that "competitive generic strategies" (Porter 1985) are adopted in the light of an environmental analysis to achieve a competitive industry position. You can see the model in Figure 3.2 below.

An industry may be considered to comprise a number of competing firms that supply goods and services to satisfy the same or broadly similar customer needs. In order to understand their competitive environments, Porter argues that managers need to understand the various forces that operate in their industry environment. His Five Forces model provides a means of analysing the strength of the influence and power of these forces.



A strong competitive force presents the company with a threat to its position because it depresses profit margins. A weak competitive force on the other hand offers an opportunity to raise margins. There are a number of macro-environmental influences upon these competitive forces, such as political and legal, technological, macro-economic, and social and cultural factors. These are beyond the control of the company. Despite this, the changes they occasion in the relative strengths and weaknesses of the five competitive forces require an adaptive response on the part of the firm.

First of all remind yourself of the Five Forces model by looking again at Fig-

Quick summary

Industry structure analysis - the Porter five force model

- Throughout the 1980s, strategic thinking was strongly influenced by Michael Porter's book Competitive Strategy in which market structure is said to play an important part in determining firm profitability.
- An industry may be considered to comprise a number of competing firms that supply goods and services to satisfy the same or broadly similar customer needs. In order to understand their competitive environments, Porter argues that managers need to understand the various forces that operate in their industry environment.

ure 3.2.

Porter identifies a number of determinants of the strength of each competitive force.

The threat of entry by potential new competitors

This threat is largely determined by the strength of industry entry barriers. These include entry costs and cost advantages, such as the economies of scale enjoyed by established companies.

The bargaining power of suppliers

Powerful suppliers can command high prices. They are most powerful when:

a. Their products have few substitutes.

b. The supplier does not depend on a single industry to supply its customer base.

c. Their products are differentiated so that costs are incurred by customers who switch suppliers.

d. They can threaten forward vertical integration, which would make them the direct competitors of their current customers.

e. Their customer companies cannot threaten backward integration to secure supplies.

The bargaining power of buyers

Powerful buyers can drive down prices. They are most powerful when:

a. Their supply industry comprises many small competing companies.

b. They purchase large quantities.

c. They can switch easily from one supplier to another because products are relatively undifferentiated.

d. The supply industry largely depends upon a particular buyer group for the bulk of its customer base.

e. Buyers can economically purchase from several suppliers simultaneously.

f. Buyers can threaten backward vertical integration to secure their own supplies.

Substitutes

If there are few close substitutes for a product, then companies that supply it can command higher prices.

Rivalry between firms

The degree of rivalry between established firms depends largely upon:

a. The industry competitive structure. Industry structure can range from highly consolidated to highly fragmented. In consolidated industries, competitive moves on the part of one firm have a larger impact on the others. Porter (1980) considers the evolution of industries, the relevance of product life-cycle theory to phases of their development and the forces that tend towards consolidation or fragmentation.

b. Demand conditions. Growth in demand reduces competition by providing scope for expansion. Declining demand intensifies competition as firms compete for market share in conditions of reduced absolute demand.

c. Exit barriers. High exit barriers are a particular threat in a declining industry. They include:

   » High existing levels of capital investment.
   » High exit costs, associated, for example, with severance payments

Your notes

and, in some industries, site clean-up costs.
- » An extreme economic dependence on the industry in question, especially in the case of undiversified firms.
- » Strategic linkages between business units in a diversified firm with businesses in more than one industry. A low return may accrue to a business unit that provides key inputs into another with high returns in a different industry.
- » Sentiment. Not all strategic decisions are rational. Sentimental attachments can lead to an unwillingness to exit.

d. The effects of the interactions between the other four competitive forces and their component parts.

Benefits of using Porter's Five Forces model

The main benefit of using the Five Forces technique is that it provides a structure for management thinking about the competitive environment. Each force can be examined using the check-list. Some aspects will be highly relevant to the industry and some less relevant. Some useful insights into the nature of the industry will usually emerge from such analysis.

It can also be useful if two or more groups of managers carry out an appraisal independently. Differences of perception can then be brought to the surface and discussed, and, where agreement is reached, some confidence can be placed in the judgements.

It is often useful to carry out several industry/market analyses. The first would be for the industry as a whole, subsequent analyses would focus on particular segments, and a third round might consider the industry at some defined point in the future in order to introduce a dynamic element into what so far had been an exercise in analysing the current situation.

The framework can be valuable, then, in many ways. It can help to define strategic segment boundaries; reveal insights about the key forces in the competitive environment; and reveal which forces can be transformed into advantageous ones by operating proactively upon them, such as by creating switching costs, or establishing stronger barriers to entry by building strong brand names.

There are, however, some weaknesses of the model, as you will see below.

Weaknesses of the Porter model

The Porter model suffers from a number of weaknesses:

- It is a static analysis of the present industry structure.
- It is qualitative and hence does not give accurate measurement.
- It is a single point analysis.
- It is difficult to know where the 'industry begins and ends'.
- It is difficult to weight the factors and thereby understand their relative importance.
- It does not allow for risk.
- It does not take account of alliances and networks in industries.

Some of these weaknesses can be overcome by the use of other tools of analysis.

The problems of static single point analysis can be overcome by the use of a PEST (political, economic, social and technological) check-list applied to a current Five Forces analysis and then projected, say, five years into the future.

Scenario planning will overcome to a degree the single point projection, and give some encouragement to think about 'What if?' questions.

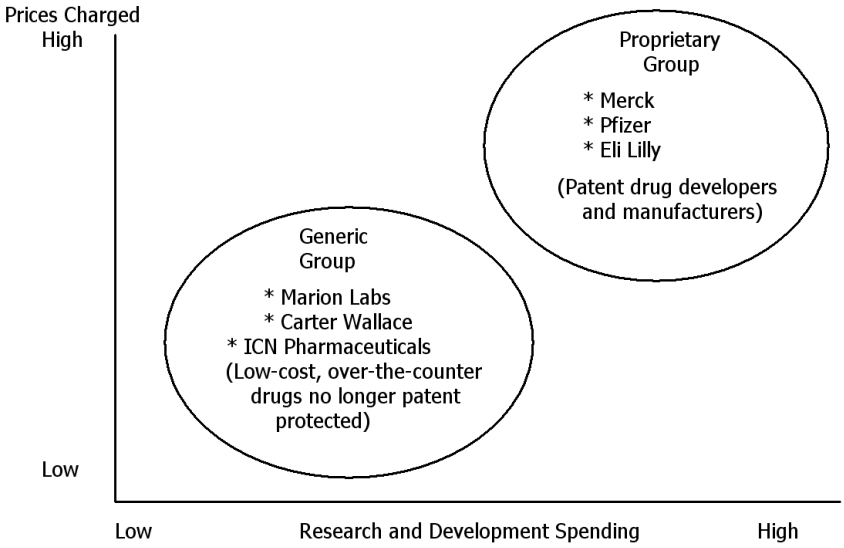
The use of strategic groups, which you will read about below, overcomes some of the problems of industry definition. Generally, the strategic group will provide the scope for the Five Forces analysis. However, care must be taken not to ignore a potential competitor not in the strategic group but giving signs of

becoming a dangerous competitive force in the market, e.g. the Honda motor cycle company in the USA in the 1960s.

Little can be done, however, to overcome the lack of weighting, risk collaboration or the judgemental nature of the tool. But the Porter Five Forces approach is a valuable first-cut approach to an understanding of industry dynamics.

Strategic Groups

Strategic group theory (Mcgee, Thomas & Pruett 1995) provides a refinement to the Five Forces model, which takes account of the fact that, within any given industry, there may be niches, not all of which are served by every firm. In many industries, it is possible to observe strategic groups of companies that follow a similar basic strategy that differs from others in the industry. Hill and Jones (1995) illustrate this within the context of the US pharmaceutical industry in which they identify two core strategic groups: the proprietary drugs companies and the generic drugs companies. For an illustration, see Figure 3.3.



Historically, price competition between generic drugs producers has been intense. In the proprietary group, patent protected products are differentiated products. Porter's five forces may be of different strengths for different strategic groups in an industry and some strategic groups may be more desirable than others owing to their ability to make greater profits. Mobility barriers between strategic groups in an industry may be more or less strong. These include the entry and exit barriers between groups.

Strategic groups have been defined in a number of different ways. However, perhaps the most useful definition is that of groups of companies who are aware of each other as competitors in a particular market, and who are collectively separated from other such groups by mobility or imitability barriers. Such barriers vary widely in nature from group to group, and different companies within a group may relate to them to varying degrees.

These barriers are the structural characteristics of a market that prevent or at least inhibit one strategic group from merging into another. Mobility barriers may include scale economies, proprietary technology, possession of government licences, control over distribution, marketing power and so forth. Different mobility barriers will be dominant for different strategic groups.

The essential importance of the strategic group concept is that competitor analysis needs to be directed towards the other members or perhaps potential members of the group. Rolls Royce, for example, will not spend its time most valuably by carrying out competitor analysis of Hyundai, which is in a

Quick summary

Strategic groups

- Strategic group theory provides a refinement to the Five Forces model, which takes account of the fact that, within any given industry, there may be niches, not all of which are served by every firm.
- Price competition between generic drugs producers has been intense. In the proprietary group, patent protected products are differentiated products.

quite different group, but it would do well to understand Mercedes Benz's capabilities in some detail.

Scenario Planning

When can you use scenario planning?

Over the next few pages we will take a look at scenario planning – what it is, and the different types that exist.

Scenario planning overcomes to a degree the limitations of the Five Forces model when applied to a single point in time and estimation. In many forecasting situations, it is a useful technique to adopt. Scenario planning is most appropriate for industries that have a high level of capital intensity and a relatively long lead time for product development.

Industries that involve a high level of risk also benefit from the scenario approach. Only in such industries is it necessary to take a fairly long-term look into the future. If the lead time for product development is short, it is possible to react to events as they appear, and a 'trading' type of mentality may be more appropriate than a crystal gazing one. If the industry is not capital intensive, an incremental approach can be taken to development, the essence of which is to maintain flexibility. In these circumstances, therefore, time spent on scenario planning may not be well used. Both characteristics should be present in an industry to at least a moderate degree before scenario planning becomes a necessary strategic tool. Thus service sectors like management consultancy, public relations, advertising or market trading may have little need for scenario planning. For the oil, steel or engineering industries, however, the technique is becoming increasingly vital if the chances of major investment mistakes are to be minimised.

Generally, where the risks are high the development of more than one scenario provides some hedge against error, although inevitably such a hedge can be only a limited one. You can still get it badly wrong even with scenario planning.

What are the different types of scenario?

A scenario is a self-contained envelope of consistent possibilities that describes the future. A scenario contains events that the strategist cannot control. If they can be controlled, they represent strategic choices. There are two main types of scenario; the quantitative and the qualitative.

Quantitative

The quantitative method of scenario building is based on mathematical econometric forecasting, using computer models and a number of simulations using different values of the parameters. Probability estimates are attached to each scenario. The relationships between the variables are assessed, and the likely impact on one variable of a change in the value of another. Attempts are made to structure and formalise what must initially be judgemental forecasting of the key parameters. Using such quantitative methods, a large number of alternative scenarios can easily be generated on a computer.

The quantitative method, however, suffers from the weakness that the seeming precision of the models tends to make the scenario planner forget that all models are built on past relationships, which may well not be future relationships. Furthermore, the model is only as good as the initial parameters allow, and these are necessarily judgemental, and thus subject to an indeterminate band of error.

Qualitative

The qualitative approach is most commonly traced back to the 1950s and the

Quick summary

Scenario planning

- Scenario planning overcomes to a degree the limitations of the Five Forces model when applied to a single point in time and estimation. In many forecasting situations, it is a useful technique to adopt.
- Scenario planning is most appropriate for industries that have a high level of capital intensity and a relatively long lead time for product development.
- Industries that involve a high level of risk also benefit from the scenario approach.
- Generally, where the risks are high the development of more than one scenario provides some hedge against error, although inevitably such a hedge can be only a limited one.

work of Herman Kahn. Believers in qualitative methods tend to distrust the value of quantification, considering that well-judged underlying assumptions are much more important than sophisticated methodologies. They contend that the future carries an infinite number of variables and values, and therefore any attempt to select a few and compute their implications is quite pointless. They put their faith instead in intuition and the value of an integrative and holistic approach. They are conscious that the possibility of predicting the future in even a rough and ready way is very remote and therefore believe that the best way forward is to make intuitive guesses structured around known trends, plus selected possible themes for consistent views of the future.

Scenario planning serves three major purposes:

1. It looks into the future and thus attempts to anticipate events and to understand risk.
2. It provides the ideas for entrepreneurial activity by identifying new, possibly unthought-of strategic options.
3. It helps managers to break out of their established mental constraints and become aware of possible futures other than those that merely represent a measured extrapolation of the present.

Scenario planning also enables managers to gain a better understanding of the forces driving business systems, to develop a feel for the direction of those forces, and to understand the logical implications of events already in the pipeline. It can also help them to appreciate the interdependencies in the system and to become able to rule out the impossible, whilst accepting the inevitable. It is, for example, probably impossible for the UK economy to grow at 10% a year like the Chinese economy seems to be doing, and it is probably inevitable that the UK will face the need to support an ageing population over the next quarter century.

The benefits of scenario planning

The major benefits of scenario planning are then:

1. It challenges the conventional wisdom.
2. It demonstrates the possible impact of a lot of 'What if?' questions.
3. It enables contingency plans to be developed for strategically important but low probability events.
4. It helps to clarify the interrelationships between key impact factors that affect the company.
5. Finally, it establishes the mind-set that accepts uncertainty, and finds it less of a threat, and more of an opportunity to profit at the expense of a less far-sighted competitor.

Understanding the forces likely to create the future is crucially important to a strategist. Consideration of the Consumer and Producer Matrices, and how they will change, enables the strategist to look towards the future in a structured way, which we will examine later in this topic.

The PEST check-list is also useful in this process and can help with scenario development. Scenario planning goes some limited way to coping with the problem that exists because the future cannot be known, and strategies have to be selected in conditions of uncertainty. By developing three different scenarios around consistent themes, and analysing them by macro-economic factors and company impact factors, strategists are able to construct a more robust strategy than by the use of single point forecasting. They are also, through consideration of alternative scenarios, able to develop contingency plans to deal with some unexpected eventualities.

Your notes

Porter's Generic Competitive Strategies

Formulating a competitive strategy

Porter's approach to the process of formulating a competitive strategy has been most commonly described as follows:

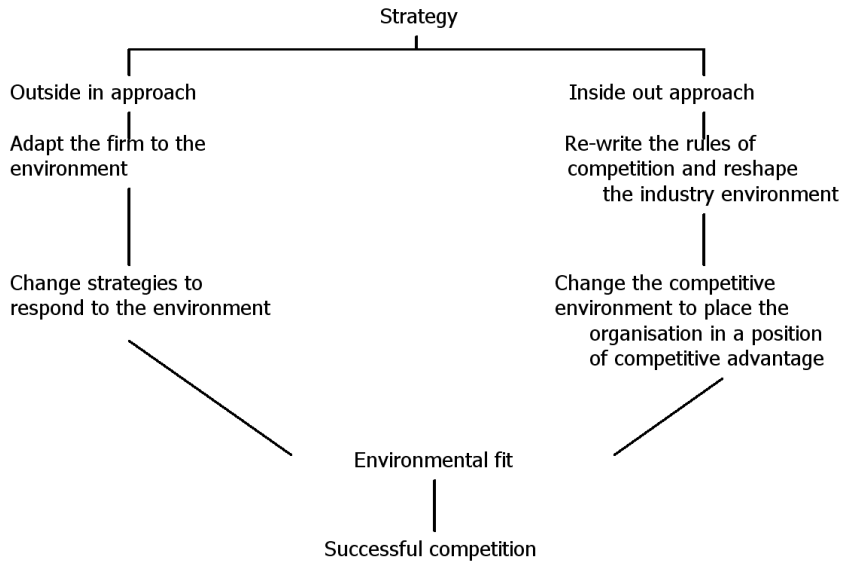
1. Analyse the environment for attractive industry segments.
2. Identify, evaluate and select the appropriate strategies for competing in the chosen industry segments (in Porter's terms these would be low cost, differentiation or focus)
3. Implement the chosen strategy.

The thinking behind this process is that the attractiveness of the industry or market is the main determinant of firm profitability, and therefore that the prime strategic task for the firm is to identify an attractive market or market segment and then focus on it. Given good management, profits are then likely to follow.

As Porter (1980) states, "the essence of strategy is coping with competition". The context of strategy formulation is the competitive environment in which the firm operates. Through its strategies, the firm must achieve some kind of environmental fit. One of the ways in which strategy can provide an environmental fit is to adapt to environmental change. This means it must fit its strategies to changing circumstances. This is one way in which strategy can enable the firm to cope with competition. The other is rewriting the rules of the game, dealt with in the next topic.

Let us now look at the two main routes to successful competition.

The two main routes to successful competition, as outlined by Porter, are illustrated in Figure 3.4.



The first route shown in the diagram is the outcome of an outside-in approach to strategy formulation. This approach stresses the need to adapt the firm to its environment as a strategy requirement. It is exemplified by the positioning school of thought (Mintzberg et al. 1998) and its most important contributor has been Michael Porter (1980, 1985, 1996). The positioning school proposes that successful competitors start with an understanding of the industry environments and then adopt strategies to position themselves favourably within them in relation to their rivals.

The second route is the outcome of an inside-out approach to strategy for-

Quick summary

Porter's generic competitive strategies

- The thinking behind this process is that the attractiveness of the industry or market is the main determinant of firm profitability, and therefore that the prime strategic task for the firm is to identify an attractive market or market segment and then focus on it.
- As Porter (1980) states, "the essence of strategy is coping with competition". The context of strategy formulation is the competitive environment in which the firm operates.

mulation. This is the approach that stresses the need to develop strategies that change the competitive rules of the industry. It is exemplified by the resource-based perspective, within which significant contributions have been made by various writers including, for example, Hamel and Prahalad, and dealt with in the next topic.

'Outside-in' perspective

Both approaches require an understanding of the environmental context of competition. From the outside-in perspective, this is a prerequisite for the adoption of an appropriate strategy to match the firm to its environment. Porter (1985) suggests that in the light of an industry analysis, a generic strategy may be adopted to achieve a favourable industry position. Generic strategies strive to achieve particular kinds of competitive advantage that, it can be argued, are broadly applicable to any situation. Cost leadership, for example, can confer an advantage in any industry. Differentiated products of any kind within an industry may be able to command a premium price. Value added is value added in any competitive context. Regardless of the specific value-adding activities that make up the value chain in a particular business, value is added either by reducing the cost of carrying out those activities or by adding more value in the value-creation process.

'Inside-out' perspective

From the inside-out perspective, an industry analysis is important because managers need to understand the existing rules of the competitive game before they can identify how to change them to the advantage of the firm by a creative deployment of organisational resources and capabilities. This leads to a revised view of the kind of strategy a firm should adopt.

In the literature, these two approaches tend to be treated as separate and even sometimes as if they were mutually exclusive. In practice, there are two sides to every coin and strategists need to be flexible. As an understanding of the environmental context of competition is common to both approaches, we'll now consider this process in more depth.

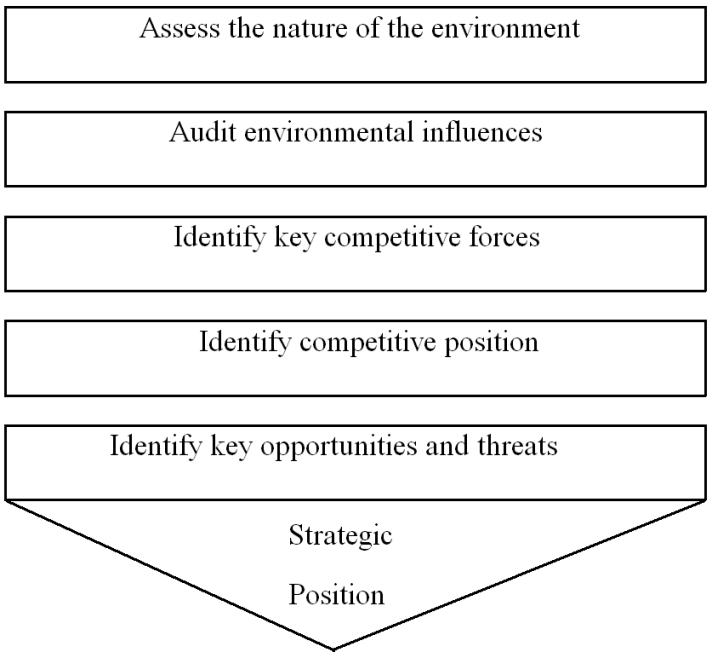
Environmental analysis

Johnson and Scholes (1993) propose that five steps be carried out in conducting an environmental analysis that can lead to such an understanding, as you can see in Figure 3.5.

Porter may be taken to be the primary representative of the outside-in approach to strategic management. His analytical approach (in the 1980s) was primarily directed towards understanding the competitive forces that operate in any given industry environment.

In the light of industry analysis, Porter (1985) suggests that managers should adopt a "generic competitive strategy" to position their businesses within their industry environments. Positioning determines whether or not the firm's profit levels are above or below the industry average and it is assumed that some industries or industry sectors and some strategies are more profitable than others. The basis of superior profit performance is a sustainable competitive advantage that maintains a superior position in the industry. Porter acknowledges that a firm may have a myriad of strengths and weaknesses in relation to its rivals, but suggests that there are only two basic types of sustainable competitive advantage, namely, cost and differentiation. This leads him to suggest three types of generic competitive strategy that can be pursued to achieve such advantages.

Your notes



Porter's generic strategies are:

1. Overall cost leadership, in which a firm strives to be the lowest cost producer in an industry.
2. Overall differentiation, in which a firm seeks to be unique in some way that is valued by buyers.
3. Focused strategies, in which either cost leadership or differentiation are pursued in a more narrowly defined niche or target market than that of the industry market as a whole.

You can see these illustrated in Figure 3.6.

Competitive Scope	Competitive Advantage: Cost	Competitive Advantage: Differentiation
Broad Target Market	Cost Leadership	Differentiation
Narrow Target Market	Cost Focus	Differentiation Focus

Each of these strategies has advantages and risks that can be considered in relation to an understanding of the aforementioned competitive forces:

Overall cost leadership

Advantages

1. Enables firm to remain profitable when rivals have eliminated margins through price competition.
2. Exploits buyers' capacity to drive down prices but only to the level of the next most efficient competitor.
3. Provides more flexibility to cope with input cost increases from suppliers.
4. Raises entry barriers of either an economies of scale type or a cost advan-

tage type, sometimes both.

5. Places a firm in a favourable position vis-à-vis inferior substitutes.

Risks

1. Technological change may render past investments or experience obsolete.
2. Experience may be gained very inexpensively by imitators who may become serious competitors as a result.
3. Cost reduction may be stressed at the expense of attention to market changes (a managerial blind spot).
4. Cost increases, reducing price advantages, may be needed to combat a competitor's differentiation strategy.

Differentiation

Advantages

1. Insulates the firm from rivalry by using brand loyalty to lower customer price sensitivity.
2. Brand uniqueness creates entry barriers.
3. Higher margins can offset supplier power.
4. The uniqueness of the product means that alternatives are not strictly comparable.
5. With customer loyalty the firm is well placed vis-à-vis substitutes.

Risks

1. Cost differentials may become too large to retain customer loyalty.
2. The buyers' tastes may change, and the need for the differentiating factor may fail.
3. Clever imitators can narrow the perceived differentiation.

Focused strategies

Focused strategies may be focused on cost or differentiation and, essentially, the advantages and risks of these types of strategy are similar in their focused segments to those of their overall counterparts. However, it is possible to cite some risks that are specific to focused strategies because they are not industry wide. They are focused at particular buyer groups, market segments or niches, product segments or niches, or geographical markets:

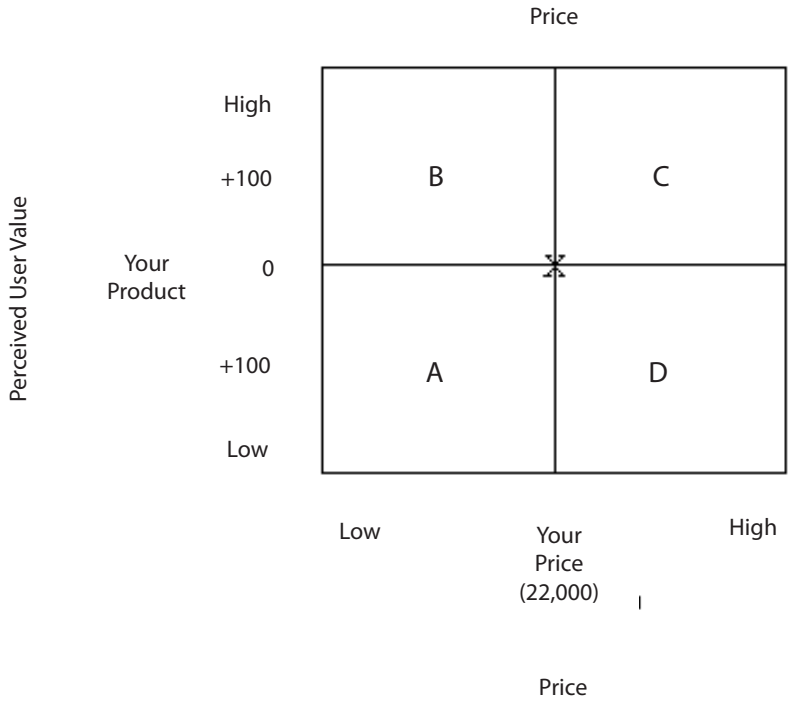
1. Cost differentials (for cost focus) between narrow and broad target firms may widen to eliminate the advantage of serving a narrow market.
2. Other differences between the target market and the market as a whole may narrow to make the target market less easily identified.
3. Competitors may find sub-markets within the target market and out focus the focuser.

Although Porter suggested that companies that followed more than one type of generic strategy risk getting 'stuck in the middle', it is clear that many successful companies can be seen to follow both cost and differentiation strategies. The two are not necessarily incompatible. Furthermore, Porter's strategies are excessively reductionist as prescriptive models, but useful in clarifying the mind in the initial stage of strategy formulation.

Your notes

The Customer Matrix

Those who come to regard the Porter generic strategies as unduly simplistic, and the 'stuck in the middle' warning to be ill-advised, may use the customer matrix (Bowman & Faulkner 1997) as an alternative approach to competitive strategy formulation. You can see this matrix in Figure 3.7.



The customer matrix is a basic device for exploring competitive strategy that takes more potential positions into consideration than does Porter's generic strategies model. This matrix is derived from the perceptions that customers have of the products/services being offered to them, and the prices that they are being charged.

The vertical axis of Figure 3.7 (perceived use value, or PUV) refers to the value perceived by the buyer in purchasing and using the product or the service; the horizontal axis is perceived price (PP). Perceived use value and perceived price represent the two components of 'value for money'.

The customer matrix separates these out to assist us in analysing competitive strategy. They are distinct in that one is received by the customer (PUV) in exchange for the other (PP). Perceived use value is a similar concept to the economist's 'utility'. Perceived price refers to the elements of price that the customer is concerned with. For example, in purchasing a heating system for a house, the customer may be not only concerned with the initial cost of the installation (the price of the boiler, radiators, fitting) but may also be interested in the running costs of the system over the years (fuel costs, maintenance, etc.). PUVs are the benefits the customer gains from the transaction, and PP is the cost incurred by the customer.

Representing the customer on the matrix

In a pure sense, a customer matrix can only be derived from the perceptions of a single individual. We would all have slightly different perceptions of the same collection of, say, family cars. What we would be looking for in terms of perceived use value, or utility, from the purchase of a car would be different from one customer to the next.

What elements of price we pay attention to would also vary. For example, one

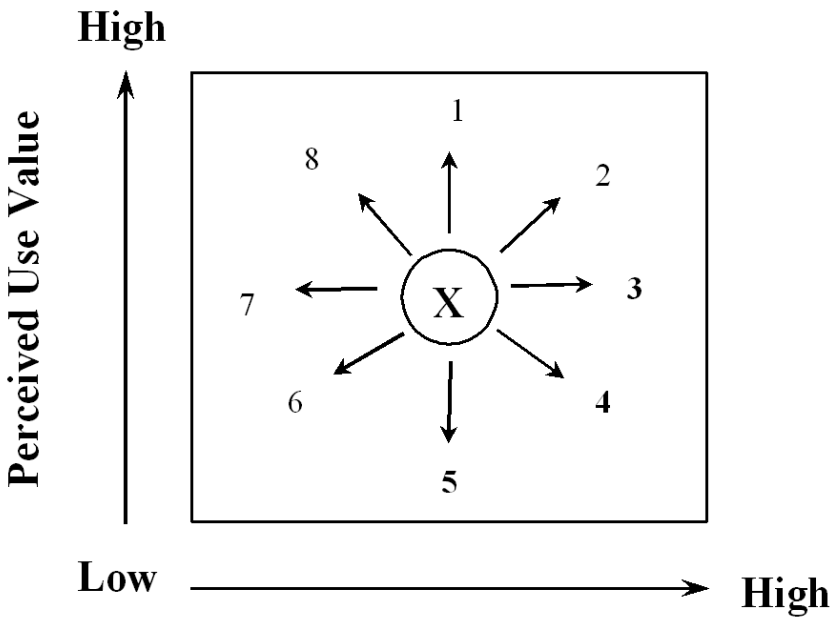
Quick summary

The customer matrix

- The customer matrix is a basic device for exploring competitive strategy that takes more potential positions into consideration than does Porter's generic strategies model.
- The matrix is derived from the perceptions that customers have of the products/services being offered to them, and the prices that they are being charged.

customer might regard insurance and running costs as a vital cost element, whereas another customer would be more concerned with initial purchase price and the likely rate of depreciation over two years of ownership. How we individually assess alternative products will also vary. This means that, in trying to understand customer behaviour, we must be prepared to recognise that there may be important differences between potential customers. People don't all see things the same way, and inappropriate assumptions of homogeneity across large groups of buyers will lead to mistakes in competitive strategy.

Your notes



Point 1, due North

Point 1, due North, involves a strategy of retaining the existing price but increasing perceived use value. This is an effective strategy if it can be carried out without excessive increase in costs, as such an increase in costs would reduce profit margins. If such a strategy leads to a dramatic increase in market share on volume of turnover, then economies of scale may come about and a reduction in unit costs may retain profit margins. The move north: gaining advantage through adding more perceived use value for the same price as the competitors' offerings. The starting point for this strategy must be the target customer, and the target customer's perceptions of value.

Point 2, North-East

Point 2, due East, also increases PUV, but allowing for the increase in costs likely to be engendered by such an increase, it puts up price accordingly. We then have the risk that such a strategy will put the product into a high-value segment of demand, for which the manufacturer is not adequately prepared. The result will be loss of business as the brand name proves itself inadequate to survive in the quality segment.

One other point to note with this move to the north-east is that it may well be shifting the firm's product into a new segment. For example (Bowman & Faulkner 1997), let us assume the new owners of an Italian restaurant wished to move the restaurant up-market. They intended to achieve this by introducing more exotic dishes onto the menu and dropping the more basic pasta main courses, by changing the decor and by increasing the prices by 50%. The price positioning of the restaurant was therefore shifted away from the cheap and cheerful end of the restaurant market. Now, however, the restaurant was being compared to other existing up-market venues. Service levels, location, car parking and ambience were, unfortunately, perceived to be inferior to these 'new' competitors and so the restaurant was forced to close. Whereas in its lower price/perceived use value position these aspects of the

restaurant experience were not critical, they clearly were important to customers in the higher price segment.

If small moves are made in direction 2, however, this strategy can be effective, and can be a gradual way of raising the perceived quality of the product.

Points 3, 4 and 5

Points 3, 4 and 5 represent less value for money and should only be adopted in situations of product scarcity. If demand is strong and supply is a limitation, then any of these positions can be adopted to garner excess profits until other suppliers are drawn into the market. It should be noted, however, that reputations can easily be lost if the public comes to believe that it is being exploited.

Point 6, South-West

Point 6, South-West represents the 'pile it high, sell it cheap' strategy. As in most markets there is greater demand for 'budget' items than premium priced ones. Therefore the company that can control its costs carefully, and source its materials economically, can do well with such a strategy.

Moving south-west (cutting price and perceived use value) is a diagonal move that may well shift the firm into a new market segment. For example, if a car manufacturer located in the middle ground of the car industry (e.g. Ford) took this route, it would be moving to a down-market position. Whereas Ford's competitors might have been GM, Nissan and Chrysler, they would now find themselves being compared by potential customers with Hyundai, Daewoo and Proton. This may be a viable shift as long as the relative cost position of Ford enabled them to operate profitably against these low-price competitors.

Point 7, due West

Point 7, due West is a dangerous strategy. It involves reducing price without reducing PUV. Competitors can follow suit instantaneously, and the market often comes to regard a price reduction as tantamount to a quality reduction. All competitors receive reduced profit margins, and a price war ensues in which there are normally no winners. A price war will only have a clear winner if one competitor genuinely has access to lower costs than the others, and is therefore able to set prices at a level the others cannot match. This is rarely the case. The risks of competing on price include the following:

- The firm may not be able to achieve the lowest costs in the industry. By definition, only one firm can be in this position.
- The first firm to compete by cutting prices is likely to provoke its competitors into matching its lower price position as a defensive measure to protect market share. This could lead to a price war with margins for all but the low-cost players being cut to the bone.
- The emphasis on cost-cutting encourages the management to focus inwards onto the internal operations of the firm. This may mean that little attention is focused on changing trends, tastes and competitive behaviour in the market-place.

This last point can lead to a vicious circle for the firm: the inward orientation results in the firm lagging behind changing trends in the market-place; the firm's products become less competitive as they have lower perceived use value than the competition; and this forces the firm into competing on price, which reinforces the inward cost-cutting orientation. Ultimately, the firm in this situation may find itself having to offer larger and larger price discounts in order to persuade any consumers to tolerate its inferior products.

Point 8, North-West

Point 8, North-West can be a very effective strategy and is often encountered in the electronics industry, as rapidly increasing demand for a new product brings down unit costs and enable prices to be dramatically reduced, thereby increasing demand further. This strategy, however, carries the risk that if it does

not lead to increased demand and reduced costs, then it may lead to losses.

Movements in the customer matrix

Movements in the customer matrix are determined by changes in customer perceptions of price and perceived use value. Shifts of particular products in the matrix can occur even when the producing firm does nothing. If a competitor is able to move its product north by adding PUV then this has the effect of pushing other competitors' products south in the eyes of the customer. Products can be repositioned through changes in customer tastes and preferences, which can alter the dimensions of PUV seen to be important by the customer. This may result in products well endowed with the preferred dimensions of PUV moving further north.

In addition to these spontaneous shifts in the customer matrix, firms can obviously seek to reposition their products in the matrix through deliberate acts. However, markets are in a continual state of flux, and the outcomes of actions by one producer will be moderated by actions and reactions of competitors. So the linkages between a firm's deliberate attempts to position its product in the customer matrix and the eventual outcome are complex and dynamic. The linkages are complex because a firm cannot anticipate precisely how a set of internal actions will translate into movements in the customer matrix. The linkages are dynamic because competitors will not stand still: they will be attempting to effect manoeuvres in the customer matrix themselves. Strategists have employed concepts from Game Theory (Brandenburger and Nalebuff 1996) to explore competitor actions and reactions.

The Strategic Positioning Approach

Strategy as position

Porter argues that for almost two decades, management has been dominated by benchmarking, re-engineering, flexibility, outsourcing, partnering, core competencies and so on as ways of maintaining competitive advantage. Positioning – 'once the heart of strategy' – has been rejected as too static for the contemporary fast-moving markets and rapidly changing technologies (Porter 1996, p. 61).

According to Mintzberg's 'five P's' model, 'positioning' is one aspect of strategy. Specifically, strategy as 'position' refers to a means of locating an organisation in its environment. In this conceptualisation, strategy is the mediating force between organisation and environment, between the internal and the external context. Strategy thus becomes a focus for resource concentration. As positioning, strategy encourages us to look at how firms find their market positions and protect them in order to meet, avoid or subvert competition (Mintzberg et al. 1998, p. 20). This definition of strategy is compatible with most other interpretations: for example, a position can be pre-determined and aspired to through a plan and it can be reached, or even found, through a pattern of behaviour (Mintzberg et al. 1998, p. 17).

Defining strategy as a position allows us to broaden the concept to include as many or as few players as we wish. In other words, position can be defined with respect to a single competitor, it can be considered in the context of a wide array of competitors, or it can be referred to simply with respect to markets or an environment at large. Beyond these explanations, strategy as position can even be envisaged as a means of avoiding competition. A market niche is, after all, a position that is occupied to avoid or minimise competition.

Porter (1996) outlines three sources of strategic positions:

1. Variety-based – producing a subset of an industry's products or services (as opposed to choosing customer segments). This can serve a wide variety of customers but for most it will meet only a subset of their needs,

Quick summary

The strategic positioning approach

- According to Mintzberg's 'five P's' model, 'positioning' is one aspect of strategy.
- Strategy thus becomes a focus for resource concentration.
- Defining strategy as a position allows us to broaden the concept to include as many or as few players as we wish.

e.g. Kwikfit.

2. Needs-based – serving most or all of the needs of a particular group of customers (targets customer segments). This approach might include targeting those customers who are price sensitive, e.g. IKEA or Ryanair.
3. Access-based – segmenting customers who are accessible in different ways. This can mean focusing on, for instance, urban customers, e.g. Warner Cinemas.

Positioning can be any of the above or any combination of them.

A guide to strategic positioning

There exists an extensive literature on the concept of strategy as positioning. The approach adhered to here is based on a synthesis of ideas developed primarily by Henry Mintzberg (Mintzberg et al. 1998), one of the original and clearest exponents of strategic positioning.

Mintzberg's model is a metaphor consisting of a launching device, representing an organisation, that sends projectiles, namely products and services, at a landscape of targets, meaning markets, faced with rivals, or competition, in the hope of attaining fit. This metaphor has not been chosen at random: rather, the military connotations reflect the world view of most writers within the strategic positioning school of thought. The model is used to locate, explain, illustrate and link the various concepts that make up this school (Mintzberg 1998, p. 70).

We will now examine each of these aspects of the model.

The vehicle (organisation)

The organisation, or firm, may be seen as a launching device that performs a series of business functions enabling the development, production and distribution of its products and services into markets. These functions sequence themselves into a value chain, as explained in the next topic.

Design (of product and process) and production are the basic platform from which the market positioning vehicle is launched. Supply and sourcing (including financing) form one support tower, and administration and support (e.g. public relations and industrial relations) form the other.

The launch vehicle has two booster rockets (which fall away during the product's voyage) – one for sales and marketing and another for physical distribution. The business functions are executed by using an assorted group of competencies or capabilities (which you will read more about in the next topic), such as the ability to conduct research or to produce products cheaply, and supported by a variety of resources or assets, e.g. patents or machinery.

The projectile (products and services)

Proceeding along the value chain eventually creates a product or service that is launched at a target market. This can be done in a number of ways, best conceptualised, according to the positioning school, by a set of generic strategies.

A broad range of these strategies exists. As Figure 3.9 illustrates, they can be divided into two groups: those generic strategies based on the nature of the product or service – size, shape, surrounding, etc.; and those based on the sequence of products or services launched – frequency, direction and so forth.

Your notes

Characterise product or service	Elaborate or extend range offered
Low cost/price differentiation strategy high-volume, commodity-type production	**Penetration strategy** target same product more intensely at same market, e.g. via extra advertising
Image differentiation strategy e.g. attractive packaging	**Bundling strategy** selling two products together, e.g. computer software with hardware
Support differentiation strategy e.g. provision of after-sales service	**Market development strategy** targeting same product at new markets
Quality differentiation strategy e.g. more durable or higher performance	**Product development strategy** targeting new products at existing market
Design differentiation strategy i.e. different in function	**Diversification strategy** targeting different products at different markets products can be related or unrelated can be done through acquisition can also be done via internal development of new product/market

Source: adapted from Mintzbert et al. (1998, pp 73 – 74)

The target (markets)

The generic characteristics of markets are again best conceptualised in diagrammatic form – see Figure 3.10 for an illustration. These may be divided into size and divisibility, location, and stage of evolution or change.

Size and divisibility	Location	Stage of evolution / change
Mass large, homogenous	**Geographical**	**Emerging** young, not yet defined
Fragmented many small niches	local regional global	**Established (mature)** clearly defined
Segmented differing demand segments		**Eroding**
Thin few, occasional buyers		**Erupting** undergoing changes

Source: adapted from Mintzberg** et al. **(1998, pp. 74–75).

The fit (strategic positions)

Your notes

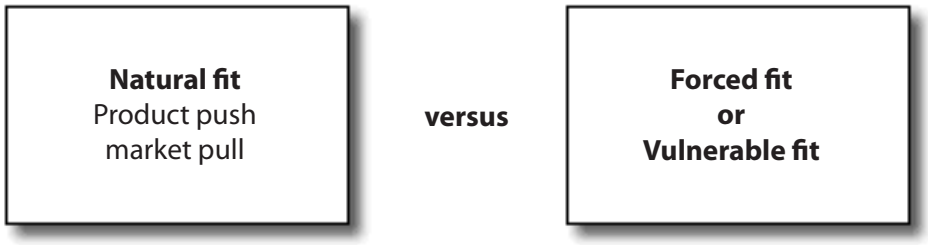
When products and markets (projectiles and targets) come together, we reach the central concept of business strategy, namely 'fit', or the strategic position itself – how the product sits in the market (Mintzberg et al. 1998, p. 76). Successful strategy rests on a whole system of activities – competitive advantage comes from the way activities fit and reinforce one another. Fit locks out imitators and creates a chain that is as strong as its strongest link. Activities complement one another in ways that create real economic value: e.g. one activity's cost is lowered because of the way other activities are performed. That is the way strategic fit creates competitive advantage and superior profitability (Porter 1996, p. 70).

Any discussion of strategic fit or position must focus on both scope and sustainability. Scope refers to the match between the breadth of the products offered and the markets served. See an illustration in Figure 3.11.

Commodity strategy	targets a (perceived) mass market with a single, standardised product
Segmentation strategy	targets a (perceived) segmented market with a range of products, geared to each of the different segments
Niche strategy	targets a small isolated market segment with a sharply delineated product
Customisation strategy	the ultimate in both niching and segmentation – designs or tailors each specific product to one particular customer need

Source: adapted from Mintzberg (1998, pp. 76–77).

Once scope is established, one must turn to the sustainability of the fit – how strong, secure and durable it is in the market. For an illustration, see Figure 3.12.



Natural fit occurs when the product and market fit each other naturally, whether it was the product that created the market or the market that encouraged the development of the product. Natural fit is inherently sustainable for reasons of customer loyalty, high switching costs and so forth. This can be distinguished from 'forced fit' and 'vulnerable fit', where no natural fit exists and sustainability is therefore unlikely due to vigorous competition or loss of customer interest.

Protecting a strategic position

Fit is rarely perfect and not easily sustainable in modern business. In this case, a set of reinforcing and/or isolating mechanisms may be identified, which serves to protect a company's strategic position.

- The first of these is burrowing strategy, which involves driving deeper into existing markets through increased advertising and the consequent strengthening of brand loyalty. A drawback of this approach is the high costs incurred.

- A second strategy for sustainable fit is packing strategy. This involves tightening the fit by adding supporting elements such as efficient after-sales support and service.
- A third approach is fortifying strategy, wherein a firm builds up barriers around the fit, such as seeking tariff or patent protection or creating long-term contracts with customers. These can prove restrictive for all parties involved, though, and may weaken the firm's overall ability to compete.
- A fourth option is a learning strategy, aimed at improving fit through adaptability. In dynamic, highly competitive industries in particular, this is often the most effective option. Learning strategy can be manifest through exploiting the experience curve and learning through doing. It can also be evident through being close to your market, understanding the needs of your customers and responding accordingly. A firm may also pursue learning strategy by taking advantage of complementarities, which emanate from different parts of a strategy that reinforce each other.

Misfit

If there can be natural fit, forced fit and vulnerable fit, there can also be misfit. When pursuing a positioning approach to business strategy, it is useful to be aware of circumstances where misfit may occur. Mintzberg highlights six such occurrences:

1. Capacity misfit – what is offered exceeds what the market can take.
2. Competence misfit – the competencies of the producer do not match the needs of the market.
3. Design misfit – the design is wrong for the market.
4. Sunk misfit – sunk costs such as inflexible machinery and high exit barriers combine to make it difficult for a company to enter other markets.
5. Myopic misfit – the producer cannot see the market, possibly due to over concentration on other markets.
6. Location misfit – the producer is in the wrong place and cannot reach the market – perhaps because some entry or exit barrier is too high.

Rivalry, competition and market contestability

Any discussion of strategic positioning must also discuss how best to contest existing sustainable positions. First movers often gain market advantage and establish sustainable positions. Later entrants are faced with several strategy options to try and position themselves in existing markets: see Figure 3.13. In so doing, they may be trying to share in these markets or displace their rivals and achieve market leadership.

Frontal attack	Concentration of forces, e.g. cost-cutting
Lateral (or indirect or flanking) attack	• Undermining (attracting least loyal customers through, for example, lower prices) • Attacking supporting brand (to dislodge main one) • Battering strategy to attack fortifications, e.g. lobbying for removal of tariff barriers
Guerrilla attack	Series of small 'hit and run' attacks such as sudden heavy discounting move
Market signalling by feint	Scaring off potential competitors through, for instance, pretending to expand operations

Niche strategies	Carving out small territories – 'picking up the crumbs'
Collaborative Strategies	Forming price fixing or market allocating cartel with existing competitors

Source: adapted from Mintzberg (1998, pp. 80–2).

Mintzberg concludes that the truly creative strategist shuns all of the aforementioned categories, or reconstructs them in innovative ways, to develop a novel strategy that cannot be neatly generalised or emulated.

Example of strategic positioning – Southwest Airlines

Strategic positioning is usually described in terms of customers. US low-fare pioneer, Southwest Airlines, serves price- and convenience-sensitive travellers, for example. The essence of strategy is in the activities – choosing to perform activities differently or to perform different activities to rivals.

For instance, Porter provides evidence that Southwest Airlines tailors all its activities to deliver low-cost, convenient service on its particular type of route (Porter 1996, p. 64). Southwest has staked out a unique and valuable strategic position based on a tailored set of activities. On the routes served by Southwest, a full service airline could never be as convenient or as low cost (Porter 1996, p. 64). Collins and Porras argue that genuinely successful companies understand the difference between what should never change and what should be open for change, between what is truly untouchable and what is not (Collins & Porras 1996, p. 66). Southwest is an example of such a company – regularly innovating and constantly differentiating themselves from the competition, but resisting the urge to tamper with the fundamental features of their strategy formula.

The Southwest model is not easily transferable. Continental and United Airlines both attempted to copy the Southwest model for their low-cost US subsidiaries. They were able to duplicate the route structure and other observable and quantifiable elements but they failed to emulate the Southwest culture – or organisational capabilities – the key to its success.

Deepening a position involves making the company's activities more distinctive, strengthening fit and communicating the strategy better to those customers who value it. Companies need to resist the temptation to target new customers or markets in which the company has little special to offer. The moral of the positioning strategy story is, be distinctive at what you do best rather than simply tackling potentially higher growth areas, where you take on more competitors and your uniqueness declines. This is where low-cost companies especially need to tread cautiously. The urge to expand rapidly and develop new markets is difficult to resist.

Case study: Southwest Airlines

"Competitive strategy is about being different": US low-price pioneer, Southwest Airlines, offers short-haul, low-cost, point-to-point service between midsize cities and secondary airports in large cities. Southwest avoids large airports and does not fly great distances. Its customers include business travellers, families and students.

Strategic positioning is usually described in terms of customers: Southwest Airlines serves price- and convenience-sensitive travellers for example.

The essence of strategy is in the activities – choosing to perform activities differently or to perform different activities than rivals: e.g. Southwest Airlines tailors all its activities to deliver low-cost, convenient service on its particular type of route. Through fast turnarounds at the gate of only fifteen minutes, Southwest is able to keep planes flying longer hours than rivals and provide frequent departures with fewer aircraft. Southwest does not offer meals,

Your notes

assigned seats, interline baggage checking or premium class of service. Automated ticketing at the gate encourages customers to bypass travel agents, allowing Southwest to avoid their commissions. A standardised fleet of 737 aircraft boosts the efficiency of maintenance.

Southwest has staked out a unique and valuable strategic position based on a tailored set of activities. On the routes served by Southwest, it would be very difficult for a full service airline to be as convenient or as low cost.

Source: adapted from Porter (1996, pp. 61–78).

Your notes

Summary

This topic has examined the market positioning approach to the development of competitive strategy. It has also discussed some of the most important tools for helping the strategist adopt this approach.

In choosing a competitive market positioning strategy, a key consideration for company strategists is how to configure the value equation so as to best meet customer needs and demands. For many companies, this means striving to achieve the lowest possible prices for their products or services. For others, it means providing a high-quality product or service at a reasonable price.

Task ...

Task 3.1

To check your understanding of the material in this topic, try to answer the following questions. If you have any difficulties, you may wish to go back and revise the relevant part of the topic.

1. What does Porter (1980) describe as the two routes to successful competition?
2. Map Johnson and Scholes' five steps to environmental analysis.
3. What are Porter's five forces and what are the weaknesses of the model?
4. What is scenario planning?
5. How does the customer matrix model work?
6. What is a strategic group?
7. Sketch some of the advantages and disadvantages of differentiation strategy (in the context of Porter's generic strategies).
8. What are Porter's (1996) three sources of strategic positions?
9. Discuss Mintzberg's strategic positioning metaphor.
10. List six circumstances where strategic misfit may occur.
11. How might you best deepen a strategic position?

Resources

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Topic 4

The Resource-Based View

Aims

The aims of this topic are:

- to introduce you to the resource-based view (RBV) of the firm;
- to describe the producer matrix that attempts to show the competitive strength of companies from a resource viewpoint;
- to identify competencies and capabilities and emphasise their importance in achieving competitive advantage;
- to show how the RBV has supplemented the market positioning approach as a business strategy tool;
- to introduce the Prahalad and Hamel 'stretch' concept of strategy.

Objectives

By the end of this topic, you should be better able to:

- expand on your understanding of the 'inside-out' (resource-based) approach to strategic management;
- discuss the distinctive capabilities approach to competition;
- examine the concept of core competences;
- establish how capabilities and competences are mutually reinforcing;
- provide guidelines for identifying and developing core competences and distinctive capabilities;
- consider the notion of strategy as resource 'stretch and leverage';
- assess how core competences can contribute to sustainable competitive advantage.

Introduction

In the previous topic, we emphasised that the essence of strategic management is coping with competition. Positioning strategies are one way of coping with competition, through adapting a firm's structure and strategy in response to extra-firm needs, demands and opportunities.

However, there is evidence (see Rumelt 1974, 1991; Buzzell & Gale's PIMs data 1987) to show that variation of profit levels in firms within industries is at least as great as that between industries. Furthermore, the undoubted profit record of the Hanson Group and others, the fundamental strategy of which frequently involves investing in apparently unattractive industries, but running the companies efficiently, casts further doubt on the contention that high profits necessarily have to be made in highly attractive industries.

It can also lead a firm that believes it has identified an attractive opportunity, such as cable television, to embark on an investment in that opportunity area. However, the firm may not pay sufficient attention to the question of whether running a cable television company actually builds upon something the firm has experience in doing well, and in which it can therefore reasonably expect to have some competitive advantage.

A second path to successful competition therefore exists. This is commonly referred to as the 'inside-out' approach to strategic management. This is the approach that stresses the need to develop strategies that change the competitive rules and norms of the industry. It is exemplified by the resource-based perspective, wherein a company endeavours to deploy its organisational resources and capabilities creatively so as to change the rules of competition to its own advantage. The idea of strategy as stretch and leverage, to be outlined later in this topic, exemplifies the 'inside-out' perspective on strategic development.

The Resource-Based View

Since the late 1980s, the emphasis for competitive strategy formulation has moved from the market positioning approach associated with Porter to the resource-based view associated with a number of current writers including Grant, Prahalad and Hamel, and Teece. This view emphasises the point that firms achieve and sustain prominence as a result of their abilities and competences, not just through astute market positioning. This topic will primarily deal with competitive advantage accruing from exploiting unique resources (distinctive capabilities) and core competences. We will critically discuss the need to change with time as a company's competitive position and dominant strategies change.

The resource-based theory of competitive advantage (Wernerfelt 1984; Prahalad & Hamel; 1990 Grant 1991) suggests that competitive advantage is best sought by an examination first of a firm's existing resources and core competences.

This is followed by an assessment of their profit potential in relation to the congruent opportunities presented by the market, and the selection of strategies based upon the possibilities this reveals.

The task is then to fill whatever resource or competence gap is identified by the inventory-taking of existing resources and competences, in relation to the perceived profit potential of a given opportunity.

From this analysis emerges a set of decisions to build competences internally, to form alliances with other firms with complementary competences or to acquire a firm with such competences.

Quick summary

The resource-based view

- Since the late 1980s, the emphasis for competitive strategy formulation has moved from the market positioning approach associated with Porter to the resource-based view associated with a number of current writers including Grant, Prahalad and Hamel, and Teece.
- This view emphasises the point that firms achieve and sustain prominence as a result of their abilities and competences, not just through astute market positioning.
- The resource-based theory of competitive advantage suggests that competitive advantage is best sought by an examination first of a firm's existing resources and core competences.

Investing where core competences lie

The process that you have just read would discourage a firm from investing in an enterprise that was not strongly related to its core competences. Only strategies based upon existing competences could, it would hold, lead to the acquisition and maintenance of sustainable competitive advantage.

Thus a would-be athlete wondering what event to specialise in, would be more likely to succeed by considering his or her qualities first, before considering the attractiveness of the event. If he is five foot six in height and weighs 200 pounds, neither the high jump nor the marathon seem likely events in which he might expect to excel, however hard he trains. By selecting throwing the hammer or the javelin, however, he might well, given training and technique, achieve eminence.

Similarly, a company is only likely to excel in areas where it is already highly competent, and for which a strategic opportunity has arisen. If it lacks the basic core competences, it may become acceptably proficient, but is unlikely to achieve competitive advantage over firms already prospering in the industry.

Comparing the market structure approach and the resource-based approach

In contrast to the market structure view of profit potential, the resource-based theory suggests that above-average profits arise in a firm because it is able to make use of certain resources and core competences better than its competitors, and because these competences mesh better with the current key competences required for success in the industry than those of its rivals.

The market structure approach assumes the ultimate arrival in markets of 'normal' conditions of equilibrium, i.e. a balance of supply and demand at a price acceptable to both buyers and sellers, in which above-average profits will have been competed away, and appropriate rational strategies will have led to the end-game of a commodity product, produced by a small number of the most efficient firms each with low costs and minimal differentiation. Indeed, some industries do display these characteristics, e.g. the personal computer hardware industry and many other electronic goods, but not all do so, and generally not those in which long-run profits are to be made.

The resource-based approach, however, has a radically different view of likely outcomes. By contrast, it assumes a state of disequilibrium as the norm: that firms differ essentially from each other for reasons of history, of differing asset endowments both inanimate and human, and through the development of distinct capabilities. At given moments, industries will display characteristics that make certain factors key to superior profitability for firms possessing them. The firms able to achieve above-average profits will be those whose competences match most closely the key strategic industry factors. These competences may be called the firms' strategic assets (Amit & Schoemaker 1993). However, they need to be deployed with an appropriate strategy in order to capitalise on the above-average profits that may potentially be available.

Working in an uncertain world

Unfortunately, managers have only 'bounded rationality' (Simon 1957) and are frequently faced with conditions of high uncertainty and complexity (Williamson 1975). They also face the problem of resolving potential organisational conflict within the firm arising from the differing personal agendas and ambitions of the firm's executives. The selection and implementation of the most profitable strategy, even by firms possessing the core competences most appropriate in relation to the industry's key requirements, is therefore fraught with risk and limited probability of a successful outcome.

The supposed predictability in terms of market evolution of the market-based approach, developed from classical economic theory, is thus replaced by the strategic uncertainty of firms, even with the most appropriate core compe-

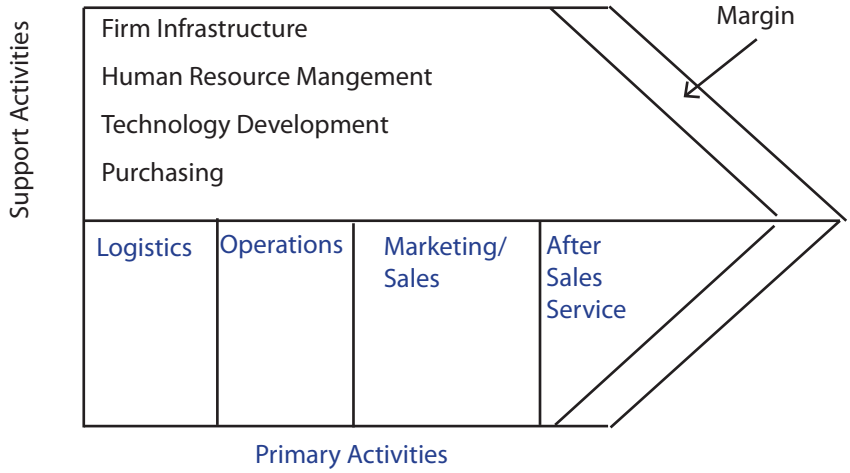
Your notes

tences, groping in the fog of unknown futures. Such a description of the 'real' world is not without credibility. However, even with these limitations to the probability of success, if the game is to be played, the search must be for the most valued core competences, and for the key to how to use them most profitability.

The Value Chain

Although Porter's prime contribution to competitive strategy is generally seen as embodied in the marketing approach, and hence the 'outside-in' view of strategic opportunities, his 1985 book Competitive Advantage presages the modern resource-based view (RBV) approach, through its internal analysis of the firm's value chain. The value chain has proved to be a helpful tool for analysing a range of strategic issues.

Value chain analysis involves breaking down the company's activities into individual primary and support activities. For an illustration, see Figure 4.1.



Each activity can then be analysed in three ways:

- Concept – how the activity is carried out.
- Cost – on a product cost basis.
- Assets – what assets in a balance sheet sense are used for the activity?

When the three forms of the value chain have been constructed, they can be examined to identify where costs could be saved, where make or buy decisions could be changed, where particular activities could be done differently, and how the firm's value chain differs from that of its competitors. In this way, insights can be gained into how the activities of the company can be carried out more efficiently and effectively.

The value chain is divided into primary activities, such as inbound logistics, and support activities, such as firm infrastructure. Each activity is linked to a number of the others. Wherever there is a linkage, there is a possibility of cost reduction by aiding the 'flow' of the activity, e.g. by 'just-in-time' manufacturing to save on the costs of inventory.

Costs can be saved by facilitating the linkage, moving from make to buy or vice versa or finding a different and more economic way of performing the activity or configuring the value chain. The value chain is useful in identifying the necessary activities in a firm's repertoire, but less useful in identifying core competences. The value chain model can, however, provide a useful starting point for the construction of the Producer Matrix to be described later in this topic.

Quick summary

The value chain

- The value chain has proved to be a helpful tool for analysing a range of strategic issues.
- The value chain is divided into primary activities, such as inbound logistics, and support activities, such as firm infrastructure.
- Costs can be saved by facilitating the linkage, moving from make to buy or vice versa or finding a different and more economic way of performing the activity or configuring the value chain.

Kay's competence analysis

Your notes

The only area that the organisation has direct control over is its own resources. Researchers such as Hamel and Prahalad or Kay argue that resources are particularly important in the development of corporate strategy. Within resource analysis, the area of core resources, skills and competences may be difficult to quantify in terms of added value, but is fundamental to strategy development. It relates particularly to research undertaken in the late 1980s and into the 1990s that seeks to explore a basic strategic question:

- "How is it possible for companies with a small share of the market to gain a significant share of an industry?" For example:
- "How did Canon photocopiers make headway against the dominance of Xerox?"
- "How did Airbus Industrie take market share from Boeing?"

Part of the answer lies with their resources and how they use them competitively. Let us examine this under separate headings but in the realisation that there is some overlap.

Resource-based theories of strategy do not deny the importance of competition but they lay greater emphasis on the internal resources of the organisation. The term 'resources' is often used in the literature to include the ability to use the resources, i.e. competences. At other times however it refers purely to the resources themselves. One way of using the definitions is to see the resources as the inert entities upon which work has to be done. Competences are, then, the ability to do that work competently and capabilities are the sum of a number of competences leading to, say, the development of a capability in R&D or in marketing. However, the academic literature is by no means consistent in the use of these terms.

Kay (1993) argues that important company resources in strategy development fall into three categories:

- Architecture
- Reputation
- Innovation

These contribute to the distinctive development of a company's strategy. Contracts and informal relationships provide a company with three ways of developing 'distinctive capabilities' – to make a company's resources distinctive from its competitors.

A fourth company resource is described as 'strategic assets', i.e. the inherited assets that a company may have. An example would be British Airways' hereditary control over the majority of landing slots at Heathrow Airport. Due to the static nature of strategic assets and the inability to shape them strategically, they will not enter into the resource-based analysis developed in this topic.

Architecture: network of relationships and contracts both within and around a firm. Its importance lies in the ability to create knowledge and routines, to respond to market changes, and to exchange information both within and outside an organisation. Long-term relationships with other organisations can lead to real strategy benefits that competitors cannot replicate: for example pharmaceutical companies such as Glaxo and Merck negotiate with governments on new drug price structures.

Reputation: allows an organisation to communicate favourable information about itself to its customers. Particularly concerned with long-term relationships and takes lengthy periods to build. Once gained, it provides a real distinctiveness that rivals cannot match. Examples: reputation for good quality work, delivered on time and to budget, can be important for construction companies. Reputation for quality service that is punctual and reliable. Railway companies can win or lose here, for instance.

Innovative ability: the skill to produce new ideas and initiatives. Some com-

panies find it easier to innovate than others, due to their structures, procedures and rewards. Highly important area of strategy and one in which a company can create a real distinctive capability

Figure 4.2 illustrates these three areas of distinctive capabilities in practice, with the example of the US company, Eastman Kodak.

Architecture	Links with suppliers, distributors, and customers in the photographic and media businesses World-wide network of companies and affiliated organisations Ability to develop film fast and cheaply: organisational skills required
Reputation	Brand name Quality products and services
Innovation	Some recent innovations such as digital imaging but weaker here

Source: adapted from Lynch (1997 p. 135).

All three areas of distinctive capability require years of development. Architecture and reputation are easier to define than they are to develop in terms of options.

Strategic Architecture

Lynch (1997) argues that an organisation generally has three sets of relationships:

1. with its employees inside the organisation;
2. with suppliers, distributors and customers outside in the environment;
3. possibly with groups of collaborating firms inside and outside the immediate industry.

If the objective of the corporation is to build capabilities to compete in the innovative contest, then organisational structures alone cannot provide an enabling mechanism.

For this reason, the attention that a number of writers, e.g. Kay (1993) and Hamel and Prahalad (1990), have paid to the question of strategic architecture should be noted. They started to think about strategic architectures instead of organisational structures. As Kay (1993, p. 77) explains, the strategic architecture of the firm is more than just a formalised structure. If all it consisted of was a formalised structure, it could be copied readily by rivals to achieve exactly the same strategic advantages. However, there is evidence to testify to the fact that structures alone do not achieve this. The literature contains numerous examples of organisations that have implemented structures considered to be successful elsewhere, only to find that they fail to live up to expectations.

What is strategic architecture?

Kay defines the strategic architecture of the firm as a structure of relational contracts that are both internal and external.

The internal architecture consists of a network of "relational contracts between the firm and its employees, and among the members themselves" (Kay 1993, p. 78). Such internal relational contracts cannot develop stability where employment is of a temporary nature. They only pertain to employees who are contracted on a permanent basis. The obverse side of the coin is, of course, that stability cannot be achieved if employee turnover is too high.

According to Kay, external architecture "is found where firms share knowledge or establish fast response times, on the basis of a series of relational contracts between or among them" (Kay 1993, p. 80). Relational contracts of this kind can

Quick summary

Strategic architecture

- If the objective of the corporation is to build capabilities to compete in the innovative contest, then organisational structures alone cannot provide an enabling mechanism.
- Kay defines the strategic architecture of the firm as a structure of relational contracts that are both internal and external.

involve fairly major commitments, as in the case of the garment manufacturing industry in which some manufacturers commit a large portion of their output to one of the British retail majors, such as Marks and Spencer. Within the context of such arrangements, the sharing of product knowledge and flexibility of response are facilitated even though both sides to the agreement can be exposed to the risk of opportunism on the part of the other party.

Your notes

Networks

Networks are groups of individuals within a firm, or groups of firms, that have relational contracts with one another. External networks may consist of a number of geographically concentrated groupings or clusters (Porter 1990) of firms, which can share, draw upon and contribute to a common knowledge and skill base and make spare capacity available to one another. Small enterprises in some industries in such networks can pose a serious challenge to the activities of major multinational corporations (Kay 1993, p. 81). This is because the personal relationships created in a firm of their small size enables them to maintain a level of motivation and commitment and creative flexibility that larger firms find difficult to emulate.

Small firm characteristics in larger companies

Fairtlough (1994) has considered the possibility of maintaining some of the smaller firm characteristics that you have just read about, in the context of larger companies. He has put forward the idea of establishing creative compartments that can emulate small firm characteristics.

Compartments are departments or business units that are large enough to command the resources necessary to carry out their activities, but small enough to enable their members to maintain close vertical and lateral communications with one another. They achieve a level of belonging and trust that can foster the free flow of information, ideas, learning and creativity. The idea is one based upon Fairtlough's personal experiences of managing business units within the large corporation context of the Anglo-Dutch multinational, Royal Dutch Shell. He has also deployed the idea with some success in the context of expanding biotechnology firms. As with many other good ideas, it has associated risks, which emanate from the fact that organisations are made up of different-minded people.

Creative compartments have proved to be a valuable means of generating loyalty, commitment and an openness in the culture, which facilitates trust and communication. They can be a means of mobilising employees around the kind of strategic intent that is, in the context of both organisational learning (Senge 1990) and strategic innovation (Hamel & Prahalad 1990), deemed to be important. But within the multinational context, this sort of approach runs the risk of generating the kind of inter-departmental rivalry and competition, combined with autonomously oriented managerial mindsets, which may not be in the best long-term interests of the corporate whole. However, one can easily see its merits in the context of the kind of federated enterprise that, for example, IBM has become.

Architecture and competitive advantage

In some countries, the external architecture of the firm has become an important source of competitive advantage. Kay (1993) cites Japan as an example. Continuity and stability in supplier/assembler relationships are common, for example, amongst Japanese automobile manufacturers.

Kay has contrasted this arrangement with that which is more typical of the USA. In the USA, customised components are usually manufactured by wholly owned subsidiaries of the assemblers. In Japan, they are often made by members of an external supplier network, termed Keiretsu. The firms concerned are prepared to run the risk of committing themselves to dedicated production facilities and transaction-specific assets. The power of Japanese Keiretsu de-

rives in part from the high degree of information exchange between member firms and their ability to promote transactions that will benefit from relational contracting. Such transactions include financing, overseas distribution and joint ventures (Kay 1993, p. 83).

Distinctive capabilities and competitive advantage

Distinctive competences are generated from organisational resources, which is why core competence theorists are sometimes to be found categorised as writers who take a 'resource-based' view of the firm. Resources may be tangible, as in the case of human and technological assets, or they may be intangible, as in the case of reputations, market information and knowledge.

The development of distinctive competences alone is insufficient to ensure competitive success. Amit and Schoemaker (1993) draw attention to the fact that the development of competences needs to be linked to a clear strategic vision. Hamel and Prahalad (1990) point out that employees need to be mobilised around such a vision or, to use their term, a 'strategic intent'. In other words, distinctive competences may be considered to be corporate resources, but they also need to be put to productive use at the level of individual competing business units. See Figure 4.3 for examples of industries that have used capabilities to yield competitive advantage.

Industry	Distinctive capability	How it yields competitive advantage
Italian knitwear	Reputation Architecture	Fashion assurance Designer label Response to fashion
Airlines	Strategic assets	Airport hubs Route licences
Retail banking	Strategic assets Reputation Architecture	Branch network Customer base Assurance solvency Customer relationships Employee commitment

Source: adapted from John Kay (1993, p. 289).

The idea of competing on corporate capabilities is a related inside-out resource-based view of the corporate strategy process. Whereas competences are basically product- and/or market-related advantages, capabilities concern processes (Stalk et al. 1992). The capabilities-based approach presumes that competitive success depends upon transforming the company's business processes into strategic capabilities. These capabilities will consistently provide superior value to the customers than the goods or services of competitors. Companies create capabilities by investing in a support structure that links together and transcends traditional strategic business units and functions.

Core Competencies

A core competence is a group of production skills and technologies that enables an organisation to provide a particular benefit to customers. Core competences underlie the leadership that companies have built or wish to acquire over their competitors.

> The core competences of the organisation lie in the collective learning in the organisation, especially how to co-ordinate diverse production skills and integrate multiple streams of technologies. (Hamel & Prahalad 1990)

Core competences require managers to think more carefully about which of

Quick summary

Core competencies

- A core competence is a group of production skills and technologies that enables an organisation to provide a particular benefit to customers.
- Core competences require managers to think more carefully about which of the firm's activities really do – or could – create unique value, and which activities managers could more effectively buy externally.
- Core skills are a basic fundamental resource of the organisation.

the firm's activities really do – or could – create unique value, and which activities managers could more effectively buy externally (outsource). Competences involve activities that tend to be based on knowledge rather than on ownership or management of assets.

Core competences are important in the development of strategy because they are usually unique to the company and therefore important in delivering sustainable competitive advantage.

Core skills are a basic fundamental resource of the organisation. For example, the Japanese electronics firms, Sharp and Toshiba, identified flat-screen electronic technology as an opportunity that they expected to see grow. Both companies invested significantly in this skill, given its widespread use in products such as televisions, video cassette recorders and personal computers.

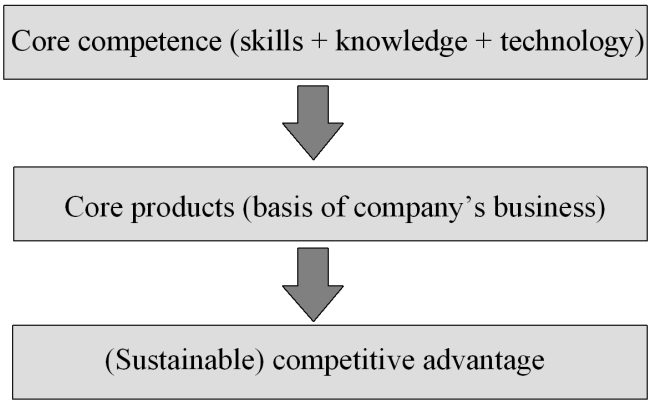
The combined core competences and skills of a company such as Eastman Kodak are silver halide technology, photographic film, digital imaging and photographic services including developing (Lynch 1997, p. 135).

Prahalad and Hamel (1990) offer a different conception of the large multi-business unit corporation – they see it as being like a tree. The trunk and major limbs are core products, the smaller branches are business units; the leaves, flowers and fruit are end products. The root system that provides nourishment and stability is the core competence. You can miss the strength of competitors if you look only at their end products, in the same way as you miss the strength of a tree if you look only at its leaves.

Their view of corporate strategy, which has been further elaborated in their 1994 text, Competing for the Future, is neither based on the idea of a corporation as a portfolio of relatively independent business units, nor on the notion that activities shared in common add value to the corporate whole. It is founded upon the concept of distinctive organisational competences that develop over time. Core competences relate to the particular skills and/or technologies that underpin the corporate product line. The individual business units both draw upon and contribute to the development of corporate competences and this should provide the focus for corporate strategy formulation.

What is a core competence?

For these writers, the role of the corporate centre is to ensure that organisation-wide development of core competences is fostered. Core competence is the common thread that runs through all the business units – for further explanation see Figure 4.4 below. They offer three criteria for the identification of a core competence (Hamel & Prahalad 1990)



1. Firstly, it must have the potential to provide access to a wide variety of markets.
2. Secondly, it should make a significant contribution to customer perceptions of the value or benefits of the end product.
3. Thirdly, because a core competence is the result of continuous improve-

Your notes

ment and organisational learning, it should be difficult for rivals to emulate or copy. This means that corporate strategy must ensure that practices, procedures and routines are established to support, spread and develop competence on an organisation-wide basis. As they put it themselves, "top management must add value by enunciating the strategic architecture that guides the competence acquisition process" (Hamel & Prahalad 1990).

What are the major features of core competences?

Areas that distinguish the major core competences are:

- Customer value – competence must make a real impact on how the customer perceives the organisation and its products or services.
- Competitor differentiation – competence must be competitively unique. If the whole industry has the skill, it is not core (unless the company's skills in the area are really special).
- Extendable – core skills need to be capable of providing the basis of products or services that go beyond those currently available.

Kay (1993) also affords a central place to the notion of core competence. He suggests that there are four categories of primary competence:

1. Technological innovation. However, this may not be easily sustainable in the long run, as technological innovations can be difficult to protect from copying, particularly in global markets.
2. Architecture. Like Hamel and Prahalad (1994), Kay notes the importance of developing a strategic architecture. Kay sees architecture in terms of a distinctive structure of relationships either within the corporation or between it and its suppliers or customers. This is something that is not so readily copied.
3. Reputation. Reputations cannot be built up overnight. For example, it might take years for a competitor with a poor quality reputation to acquire a reputation for quality. This does not, however, mean to say that rivals with a poor quality reputation will not eventually rectify this problem.
4. Strategic assets. These provide favoured access to markets or factors of production.

David Sainsbury, Chairman of the leading UK retailer, has said that he believes the concept of core skills and competences has real merit. However, he also comments that core skills are easier to apply to large rather than small companies, who may not have the depth of management talent. The ideas have been most thoroughly developed for electronics and related markets. The concept may need to be adapted for others.

Capabilities and Competencies

There is some overlap between distinctive capabilities and core competences. Core skills and competences add up to a group of skills and technologies that allow a company to gain long-term advantage over competitors. They need to be identified early in the strategy process. They may take many years to develop, perhaps before all the business opportunities have been fully recognised.

A core competence is one of several resource areas that can provide important strategy options (another is cost reduction).

Resource capabilities need to offer some form of distinctiveness over competitors. One method of generating options is to measure the resources of an organisation against the criteria of architecture, reputation and innovation.

To aid the development of core competences, ten guidelines are shown in Figure 4.5. There is a distinction between core competences and distinctive

Quick summary

Capabilities and competencies

- There is some overlap between distinctive capabilities and core competences. Core skills and competences add up to a group of skills and technologies that allow a company to gain long-term advantage over competitors.
- A core competence is one of several resource areas that can provide important strategy options (another is cost reduction).
- Resource capabilities need to offer some form of distinctiveness over competitors.

resource capabilities but they are combined here as there is an overlap between the two concepts in organisations.

Figure 4.5. Guidelines for developing core competences and distinctive resource capabilities

1. What technology do we have? Is it exclusive? Is it at least as good as that of competitors? Is it better?
2. What links are there between the products that we manufacture or services that we operate? What common ground is there?
3. How do we generate value added? Is there anything different from our competitors? Looking at the main areas, what skills are involved in adding value?
4. What people skills do we have? How important is their contribution to our competences? How vital are they to our resources? Are there any key workers? How difficult would they be to replace? Do we have any special values? What is our geographical spread?
5. What financial resources do we have? Are they sufficient to fulfil our vision? What is our profit record (or financial record in not-for-profit organisations)? Is the record sufficiently good to raise new funds? Do we have new funding arrangements, tax issues or currency matters?
6. How do our customers benefit from our competences and resources? What real benefits do they obtain? Are we known for our quality? Our technical performance against competitors? Our good value for money (not low cost)?
7. What other skills do we have in relation to our customers? What are the core skills? Are they unique to our organisation or do many other companies have them? How might they change?
8. What new resources, skills and competences do we need to acquire over the next few years? How do they relate to our vision?
9. How is the environment changing? What impact will this have on current or future core skills and resources?
10. What are our competitors undertaking in the area of resources, skills and competences?

Source: Richard Lynch (1997, p. 473).

Let us now look at two case studies to see how core competences work in business.

Case Study 1: Sony Corporation – Building Success on Capabilities and Competences

In a 1995 speech, the strategy manager for Sony Europe explained that Sony's success was derived from a combination of many things. He listed these as:

1. Key drivers – he perceived three key drivers that combined to form Sony's core competence. Research alone would not have given it its pre-eminence in the market place. He suggested that the Sony name was probably as well known as Coca-Cola. The three drivers he identified were: research, venture/entrepreneurial spirit and global reach.
2. Key innovations – he suggested that in each decade of its existence, Sony has capitalised on a single major innovation: e.g. in the 1980s the compact disc and in the 1990s games, multi-media and personal computers. This illustrates the steady exploitation of its core competence, which built a new breakthrough product each decade to enable the organisation to change the basis and source of its revenue and profit.
3. Key strategic initiatives – he saw four strategic initiatives which, togeth-

Your notes

er with the key innovations, contributed to the company's success. These were: changing its name to Sony, improvements in manufacturing, overseas manufacturing and globalisation (with the inclusion of three non-Japanese directors on the board).

4. Competitive strengths – he explained that it retained its competitive strength through brand image, miniaturisation, global reach, hardware and software, free spirit (dynamic and risk taking), and its genius founder.
5. Sony culture – while Sony is well managed, its research and innovation staff are allowed more latitude and freedom than their colleagues in other parts of the organisation.
6. Future challenges – he suggested that the company had used its three key drivers to migrate from one market to another by moving from consumer electronics to non-consumerism (telecommunications, etc.) and from electronics to entertainment, and from global to local presence without losing its global identity.

Source: adapted from Ambrosini (1998, p. 8).

This first case study helps put core competences in context. It shows how Sony, as a company, was successful at using its core competences – research, venture/entrepreneurial spirit, and global reach – to create breakthrough products. It then exploited these by carefully considered strategic initiatives and the exploitation of its competitive strengths. It has learnt to leverage established, proven products into new markets and it is not afraid to take a risk in order to maximise its position and release new market potential (Ambrosini et al. 1998, p. 7).

Case Study 2: News Corporation

Starting from a base in Australian and British newspaper publishing, News Corporation is developing a worldwide television network. Until recently, the world television industry has been characterised by relatively low levels of competition. This was largely due to a high degree of state control and regulation. The advent of satellites, cable TV and digital broadcasting has changed this situation and television is becoming an increasingly global industry. News Corporation has been at the forefront of this globalisation process. The company's success hinges upon its ability to change the rules of competition through creative deployment of its resources and capabilities. Lynch (1997, p. 470) argues that the core competences of News Corporation revolve around the firm's entertainment and news gathering skills. More specifically, the company has enhanced its core competences and resources through such means as adopting satellite encryption technology before its competitors, developing a range of global satellite and cable channels for global coverage, and identifying revolutionary and imaginative new media opportunities. Framed in terms of distinctive resource capabilities, News Corporation has an advantage in all areas:

- Architecture
  Has built range of companies that are all focused in the areas of news, sport and entertainment. This makes the company quite distinctive from competitors such as Disney or Time Warner.
- Reputation
  Clear image, based on its newspapers in particular. Aggressive and open style has set it apart from its rivals.
- Innovation
  First company to identify satellite encryption technology as being an important aspect of business strategy.

Source: adapted from Richard Lynch (1997, pp. 466– 470).

It is important to recognise that a firm may not at present have all the competences it needs to fulfil its strategic vision, e.g. News Corporation needs to develop further skills and competences if it is to develop its TV activities in India.

Organisations need to consider the acquisition of new core competences.

Core competences in the hands of business judgement

The main problem of core competence theory is that no precise tests exist to select and establish the core competences of an organisation. A strong element of judgement is required to identify and group them correctly. Even if core competences are identified correctly, it is unclear how they should be developed further for new products or services. This again leaves a considerable amount to business judgement.

From Drucker to Hamel and Prahalad, the development of strategy options based on resource considerations is reasonably well established. There was a period in the 1970s and 1980s when the focus shifted to market-based opportunities, but the resource-based approach has now regained its deserved role as a means of generating options.

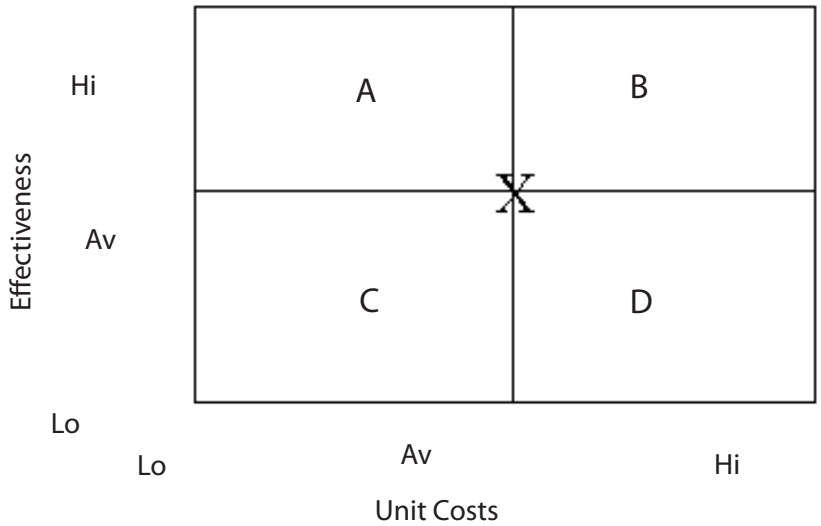
It is particularly relevant when market opportunities are limited, either because the market is only growing slowly or because the organisation itself has very limited resources that are better devoted to internal activities: for example, public sector organisations with limitations placed on their resources by government may find that resource-based options provide more scope than market-based opportunities.

Where competences are narrowly specified, a movement in the market may make them no longer capable of achieving competitive advantage. With this in mind Teece, Pisano and Schuen (1997) define the concept of dynamic capabilities. These are capabilities that are of a meta nature, and of value even if market needs shift considerably. Examples of this might be the capability to innovate frequently, the ability to learn quickly or the capability of handling complex management tasks efficiently.

The Producer Matrix

The producer matrix is a strategic analysis tool that attempts to rate the resources and capabilities of competitor companies on two axes: one is effectiveness (competences) and the second is factor cost.

Some form of benchmarking is necessary to carry out this rating. The customer matrix described in the previous topic shows how a firm's products are rated in value for money terms in relation to competitors' products. However, the producer matrix gives a graphical picture of the firm's strengths in terms of the competences required to deliver value to customers, and the level of its unit costs, in relation to those of its competitors. The customer matrix illustrates the customers' judgements, whereas the producer matrix (illustrated in Figure 4.6) illustrates the firm's ability to manoeuvre in the customer matrix



Quick summary

The producer matrix

- The producer matrix is a strategic analysis tool that attempts to rate the resources and capabilities of competitor companies on two axes: one is effectiveness (competences) and the second is factor cost.
- Some form of benchmarking is necessary to carry out this rating. The customer matrix described in the previous topic shows how a firm's products are rated in value for money terms in relation to competitors' products.

Using the producer matrix

Your notes

Using the resource-based perspective, the problem posed for the strategist is how to achieve a superior and sustainable position on the customer matrix described in the previous topic, through the appropriate use and development of the firm's competences. The producer matrix illustrates the relationship between relative unit cost (efficiency) and key value-creating competences (effectiveness) that the strategist must try to manipulate to improve the firm's position on the customer matrix. The competences on the vertical axis may be called key competences as they are most concerned with enhancing value. The horizontal axis refers to the relative unit cost position of the competing firms.

A firm may have great skills in producing a product for which there is little demand so, when assessing the value of a firm's resources, some account needs to be taken of the context within which the firm is operating. Most contributors to the resource-based view of the firm recognise this problem, but they either tend to assume a resource is 'valuable' (and they then focus their attention on problems of other firms copying these resources), or they define valuable resources in rather vague and generalised ways.

Key competences and core competences

Bowman and Faulkner (1997) distinguish between key competences and core competences. Key competences are those required by any firm to be a serious and successful player in a particular market. Core competences are what the firm happens to be good at doing. Hence key competences are derived from an understanding of the requirements to compete in a particular market arena, whereas core competences are firm specific. Clearly, a firm's core competences may coincide with the key competences required to compete in a given market-place. Where this happens, we would expect the firm to perform well. But also probable is a situation where a firm's core competences have drifted out of line with the key competences required, and unless the firm can develop new competences, or move to another market where its competences may be more effective, it will perform poorly.

First of all remind yourself of how the producer matrix looks – then we will analyse it in more depth.

So this approach enables us to anchor or benchmark an assessment of the firm's core competences against some external criteria; the key competences required to compete in a given market. The vertical axis in Figure 4.6 rates the firm's endowment in the key competences required to compete in a given market. The horizontal axis refers to the firm's unit costs. So, a firm that had core competences that were in line with the key competences required would be in a position high up the vertical axis. If this firm also had low unit costs in relation to its competitors, it would be located towards the north-west corner of the producer matrix (position X in Figure 4.6).

If the firm improves its competences, but competitors improve their equivalent competences even more, the firm will go down, not up, the vertical axis, and will become less competitive. Of the four competitors shown on the diagram, the one in the north-west quadrant is capable of delivering the highest performance in current circumstances, i.e. highest delivery of key competences at lowest unit cost. The south-east quadrant competitor (D) has the worst potential with high unit costs and low key competence endowment. The north-east (B) and south-west (C) quadrant competitors may be balanced in relation to each other from a potential performance viewpoint. A is only able to deliver key competences at high unit cost, and C is able to be low cost, but at the expense of its ability to deliver the key competences.

The link between the customer and producer matrices

Your notes

An understanding of both the customer and the producer matrices is vital to achieving competitive advantage, since their linkage is indirect. Competitive advantage can only be achieved as a result of movement on the customer matrix, since that advantage comes at a point of resolution between the buyer's perception of use value and of price. Yet the firm can only act directly on its producer matrix, by either increasing its competences in order to attempt to increase PUV, and/or by lowering its costs through improving efficiency, to put itself in a position to exercise flexibility on price. Competitive advantage is a customer-determined characteristic, and the actions of the producer can at best attempt to achieve it uncertainly through movements in the producer matrix.

A shift northwards on the customer matrix may come about spontaneously due to a change in consumer tastes, without any core competence improvement at all. Moreover, a firm may move westward on the producer matrix by reducing its costs, but may judge that market conditions suggest a supply constraint, and may thus opt to increase its margins by raising prices; thus causing an eastward move on the customer matrix.

Reducing costs

Reductions in relative costs can be achieved in five ways:

1. exploiting economies of scale
2. economies of scope
3. experience advantages
4. managerial efficiencies
5. low factor costs

Over the next few pages, we shall examine each of these in more detail.

1. Economies of scale

Economies of scale are the reductions in unit cost that are achieved by a firm increasing the scale of its activities. These economies accrue where the firm is able to spread fixed or overhead costs over a greater volume of sales, and where the scale of the firm's activities permits it to enjoy other cost advantages (e.g. it is better able to bargain with suppliers to get lower prices for its inputs).

There is some empirical evidence to suggest that these scale advantages may not be widespread, and, in any event, one would not expect these economies to be universal (for example, the extent of the advantages accruing to larger scale production will vary according to the technology used in the industry). There is a view that new methods of production (e.g. flexible manufacturing systems, and 'just-in-time' systems) may be much more important in determining relative costs than the scale of production. Firms that are able to exploit these new methods may achieve lower unit costs on a relatively smaller scale than rivals (see 'Managerial efficiencies' later in this topic).

A related concept is economies of sequence. Here, cost advantages accrue from linking sequential processes. An obvious example would be locating a hot rolling mill next to the steel blast furnace to avoid the costs of reheating the steel.

2. Economies of scope

Economies of scope derive from core competences. If a firm has been able to build up a competence (e.g. brand development skills) and if it is able to deploy this competence across several product markets, then it enjoys economies of scope. So scope economies are realised where a firm's core competences match the required key competences in a number of product markets.

3. The experience curve

Pioneering work by the Boston Consulting Group demonstrated a strong link between experience and unit cost reduction. Over time, firms accumulate experience in making or supplying products. If the firm learns from this experience, it should be able to deliver products at lower costs by, for example, finding the most efficient ways to assemble components (using method study and value engineering). Firms that have a high relative market share accumulate experience at a faster rate than their competitors. If they translate this advantage into lower unit costs, then, assuming they charge similar prices to their competitors, they should be more profitable.

4. Managerial inefficiencies

Firms that are not subject to strong competitive pressures may suffer from 'X-inefficiency'. This economist's term refers to the increases in costs that can occur if firms are protected from the full rigours of a competitive market. X-inefficiency can result where firms are essentially in a monopoly supply position, where there is a cartel or where a firm is protected from competition (by, for example, import restrictions). Absence of competition leads to a slackness in the way the firm is managed, leading to increases in input costs (e.g. labour), excess capacity, administrative slack and the persistence of inefficient production processes.

Some economists would argue that X-inefficiencies will exist unless there are pressures from the market-place that force the firm's management to take action. This 'survival of the fittest' argument assumes that the firm can only react to external pressures, and in the absence of these pressures, unit costs will inexorably rise.

However, a more managerialist view would suggest that firms are capable of achieving efficiency through the exercise of good management practice. Over the past decade, a wide variety of management prescriptions have been proffered that could help a firm lower its costs, and which are not directly connected to scale or experience effects: for example total quality management practices, business process redesign, delayering, downsizing, just in time, materials requirements planning, Kanban, etc. These cost advantages can accrue where the management of a firm actively and continuously seek to drive costs out of the productive process. Even when a firm may face benign market conditions, the exercise of managerial efficiency will yield even higher levels of profit. Note that other sources of cost efficiency (from scale, scope and experience effects) still require the active intervention of knowledgeable management if they are to be realised. None of these volume- and scope-related advantages accrue automatically. Managerial efficiencies offer cost advantages over and above the volume-related effects.

5. Factor costs

Some firms will enjoy cost advantages over their rivals because they have access to cheaper resources. Many of these advantages are locational: lower wage costs; proximity to bulky raw materials; cheap power sources; low social costs (taxes, etc.); and having a low valued currency. Some of these factor cost advantages can be considered as managerial efficiencies, such as where a firm has deliberately located an assembly plant in a low wage country, but others accrue through no proactive behaviour on behalf of the firm's management. However, factor cost advantages can outweigh all the hard-won benefits exploited from scale, scope and experience effects.

So, in order to assess the profit outcome of a competitive strategy, it is necessary to assess the impact of the strategy on these five cost drivers. It is difficult to identify relationships that can be generalised, that occur between competitive strategy options, the cost drivers and the likely profit outcome. Each situation needs to be assessed on its own merits.

Competitive imitation

Hygiene 'order qualifying' value dimensions enable the firm to be in contention for a sale. They do not, however, motivate customers to buy their particular offering. Motivator dimensions of value, on the other hand, are those that are not only valued by customers but are specific to the firm. These dimensions help to explain why several firms are able to coexist in a particular market.

As firms strive to increase or hold their sales in a given market, a process of competitive imitation ensues. As one firm offers new perceived use values or higher levels of existing value dimensions, they attract more customers. This forces competing firms to match these higher levels of perceived use value. This process of competitive imitation has the effect of converting motivator value dimensions into hygiene value. Features that were once unique to one competitor become order qualifying dimensions offered by all firms.

The key competences required to compete in a given market are delivered through a complex set of activities undertaken by the firm. Some of these activities are crucial to the firm's ability to deliver exceptional performance of key competences. Other activities are nevertheless essential, but they do not feed through to exceptional competence performance.

The aim for a firm must be to create a bundle of activities capable of producing a unique product that is difficult to imitate. Grant (1991) suggests that to sustain competitive advantage, strategic resources and competences need to score well when screened for four characteristics, namely:

1. Appropriability
2. Durability
3. Transferability
4. Replicability

Grant argues that the key task of the strategist in internal analysis is to identify the firm's core competences and strategic resources and to screen them against these four defining dimensions of sustainability.

Over the next few pages, we shall examine each of these dimensions in more detail.

Four defining dimensions of sustainability

1. Appropriability – This is concerned with the degree to which the profits earned by a particular strategic asset can be appropriated by someone other than the firm in which the profits were earned. The lower the appropriability of the asset the more it may be able to sustain profits for the firm.

An asset is difficult to appropriate if it is deeply embedded in the firm. The problem arises because of the fact that firms own fixed assets, but not the skills of individuals. Thus, for example, if in a soccer team a star develops with high goal scoring ability, he owns that skill and is empowered either to take it to a competitor, or to use it to gain, in salary or other benefits, a high percentage of the profits from the owners of the team he represents.

Similarly, certain film stars are able to appropriate to themselves a substantial percentage of the profits of films in which they appear, as they are able to convince the films' producers that without their star name the profits would not be achieved. In the business world, certain well-known chief executives of major corporations are similarly successful in appropriating high compensation to themselves with these arguments.

If, however, the profits can confidently be ascribed to the routines and team excellence developed by a wide range of managers and staff within the company, then the profits cannot be so appropriated, as the loss of any individual will not be perceived as affecting profits to any large extent. When a firm has been performing excellently over a period of time, the competence may even

transcend individuals or teams, and become a competence of the firm itself in an 'organisational learning' way. Low appropriability of the strategic asset therefore means high profit sustainability.

2. Durability – This characteristic of a strategic asset applies not so much to its physical durability, but rather to its durability as a source of profit. The more intangible aspects of durability are therefore more important here.

Shortening product and technology life-cycles make most assets less durable than they were, even a decade earlier. However, if tangible assets are proving to be of declining durability as sources of sustainable profits, the more intangible distinguishing characteristics of firms do not necessarily suffer in this regard. Firms' routines and team methods can and do survive passing generations of products. Firms' reputations do not decay with the years, so long as they do not visibly decline in their essential perceived innovative, productive and high-quality characteristics.

Similarly, leading brand names prove remarkably durable. As products come and go, such household names as Kelloggs, Nestlé, DuPont and Xerox continue with undimmed reputations in the public's eyes. Any one of these can, however, all too easily prove to have reputations of perishable durability, given no more than a year of poor performance. However, it is clear that the more durable the core competence, the higher the profit durability.

3. Transferability – The easier it is to transfer the core competences and resources, the lower the sustainability of their competitive advantage. Some resources are obviously easy to transfer, e.g. raw materials, employees with standard skills, machines and to some extent factories, where the transferability may be through change of ownership rather than physical transportation. In this sense, such assets are of less strategic significance, due to the ease with which they can be bought and sold.

Once more the essential characteristic of a strategic asset is the degree to which it is firm-specific, embedded within the fabric of the firm, within its culture and its mode of operation. Such capabilities represent the profit sustaining assets of the firm. The less transferable these assets the greater their strategic profit sustaining quality.

4. Replicability – If the competence or resource cannot easily be transferred, it may be possible by appropriate investment or simply by purchasing similar assets for a competitor to construct a nearly identical set of competences. If this is possible, the original firm possessed no real durable competitive advantage. Equilibrium theory operates here, and a profitable company will find its profits competed away, as new entrants replicate its resources and competences, and produce similar products, thereby reducing price through competition, and moving the product inexorably towards commodity low-profit status. The easier the replicability, the lower the strategic importance of the resources and competences in question.

So, competences that qualify as strategic assets with profit-sustaining capacity need to have high durability, low appropriability, transferability and replicability. It should be noted that this taxonomy could be collapsed from four into two, i.e. durability and the various forms of imitability.

Hence Grant, and others in the resource-based field, would argue that advantage can be sustained if the firm has competences that not only deliver valued products, but that the resources involved in delivering these competences must be difficult for other firms to imitate. It can be argued, however, that no firm has sustainable competitive advantage for ever. All advantages are transitory, and ultimately all resources can either be imitated or by-passed, i.e. they cease to be uniquely required to deliver value. Then, the issue shifts away from the prevention of imitation towards the continual development of new sources of advantage, which is a continuous process that firms neglect at their peril. Perhaps the only really sustainable advantage is the ability to learn faster than one's rivals.

Your notes

Resources, systems and know-how

Your notes

Activities combine to deliver key competences. Activities themselves are combinations of three factors: resources, systems and know-how, each of which typically has different characteristics.

1. Resources are the basic factors of production involved in the creation of a product or service. Thus, materials, machinery, technology, location, premises, labour, brands and reputation may all be regarded as factors of production that are necessary before a product or service can be manufactured or performed.
2. Systems are the methods by which the resources are brought to life, i.e. coordinated and deployed in the value activity. Systems are usually explicit and well understood, and they can often be codified into written procedures.
3. Know-how is the term used to represent the individual or group capability to work the systems. It is present in individuals and can be embedded throughout the organisation, but it is not codified. As soon as it becomes so, it has to be reclassified as a system.

Resources

Thus, resources generally are tangible and visible (with a few exceptions like reputation). At their simplest, they are land, labour and capital, the traditional factors of production of classical economics, but this list may be extended (note, for example, Porter 1990). They are, however, generally inert and, to be activated, need the systems to put them to work. To be called a system, however, a process needs to be able to be codified and subject to reduction to a set of rules, manuals, standards and modes of inspection and audit for efficient operation. They cannot be activated unless operated by an individual or team of individuals with know-how. This is immediately obvious if you sit a computer illiterate person, i.e. without relevant know-how, in front of a personal computer well equipped with all the relevant software systems and set him or her a task. Without the help of someone with know-how, he or she is likely to make little progress.

Systems

Resources are generally imitable but in rare cases may not be, for example a diamond mine or a very strong brand name. Systems by definition tend to be imitable since they are rule dominated and can be explained and described in manuals. However, if the system is understood but not made explicit in the form of procedures or manuals, then this for a time at least protects it against imitation.

Know-how

Nevertheless, the lowest level of imitability is generally to be found in the know-how category. At an extreme, only Stradivarius proved capable of making violins to such a standard that they would still be sought after by concert virtuosi hundreds of years after their manufacture. Try as he might to pass on his know-how to his apprentices, so much of the knowledge was 'tacit' that he succeeded in teaching them to make only excellent violins, not superb ones.

However, in general as time passes there is a tendency for know-how to migrate into systems and then often to basic resources. Thus the know-how of the expert is observed and turned into a system by an acute analyst and system designer, and, with the passage of further time, this system may become a basic resource encapsulated in machinery or software, now no longer unique and inimitable. Therefore, firms need to continually invest in activities that deliver motivator value.

So, firms need firstly to understand what customers perceive as value. They

then must recognise those activities that deliver motivator value dimensions (the qualities in the product or the service that excite customers). But, in order to sustain a more enduring advantage, the investments should enhance know-how, as this is the most difficult component for other firms to imitate.

Filling competence gaps

Once a target market segment has been clarified, it is necessary to understand what the dimensions of perceived use value are to these customers. Then, the key competences required to deliver this package of value at low cost need to be identified. The firm's relative endowment in these competences finally needs to be assessed. This will reveal the nature and extent of any competence gaps that are preventing the firm from competing more effectively.

In the event of a firm's core competences not matching the key competences required, the firm must seek to acquire or develop the additional resources, systems or know-how either by internal development, by strategic alliance or by acquisition. The caveat here, however, is that the resources or skills sought must be only a small proportion of the existing resources, or the risk exists that the newly acquired competences will so outbalance the existing ones as to change the nature of the firm, and thereby reduce the effectiveness of the existing competences. So long as the acquired competences are restricted to this small proportion of the whole, the firm can continue to develop its competences effectively and incrementally. Thus a firm, or an alliance more than one firm, seeks to develop a range of core competences that potentially enable it to match the key competences necessary to succeed in its chosen markets.

The customer and producer matrices

The customer matrix at a general level can be used to represent the overall company strategic stance: for example Rolls Royce, very up-market and expensive, Škoda, rather down-market and budget-priced. However, to be usable for specific strategy formulation, the matrix needs to be constructed for a particular product/market situation. It represents the firm's position relative to its competitors in relation to PUV and perceived price. Any movement on it refers to the same product in the same market.

The producer matrix, however, is concerned with key competences and cost efficiency competences as they apply to a particular product group and market, but may well reflect the firm's overall competences in a variety of areas to a greater degree than the customer matrix can.

Strategy as Stretch and Leverage

The inside-out approach also seeks to achieve a fit between the organisation and its environment, but its emphasis on how this should be achieved is different to that of the outside-in approach. The positioning school, which was cited to exemplify the outside-in approach, stressed the need for the firm to adapt to the changing environment.

Inside-out approaches are resource-based schools of thought in that they seek to achieve successful competition through the superior deployment of resources and the development of superior competences and capabilities. They stem from a consideration of the question posed by Rumelt (1991) as "how much does the industry matter?" Firms cannot simply choose to change their industries at will. Existing resource deployments impose constraints. However, whatever may be the fortunes of any given industry at any given time, some firms within it perform better than others in that they are more profitable and/or sustain higher levels of market share.

Whilst not wishing to deny the fact that operating in particular industries may constrain the choices available to a firm both in terms of entering another and in terms of viable strategy options, some writers have concluded that there has

Quick summary

Strategy as stretch and leverage

- The inside-out approach also seeks to achieve a fit between the organisation and its environment, but its emphasis on how this should be achieved is different to that of the outside-in approach.
- Inside-out approaches are resource-based schools of thought in that they seek to achieve successful competition through the superior deployment of resources and the development of superior competences and capabilities.
- The resource-based perspective is therefore one that starts with a consideration of a firm's resources, strengths and weaknesses.

Your notes

been too much emphasis in the literature upon the influence of the industry on firm performance and that "the firm matters, not the industry" (Stopford & Baden-Fuller 1992).

The resource-based perspective is therefore one that starts with a consideration of a firm's resources, strengths and weaknesses. Competitive advantages are secured by developing superior capabilities or competences that cannot readily be emulated by rivals. A good strategy is one that develops and maintains distinctive capabilities, competences, resources and resource deployments, which can be used to change industry standards. In other words, good strategies do not merely adapt organisations to their environments; they change the rules of competition and re-shape the industry environments of the firm.

Hamel and Prahalad (1993; 1994) consider that effective strategy achieves stretch and leverage (fit) – see an illustration of this in Figure 4.7.

Figure 4.7. The lead edge of strategy: fit or stretch

Aspect of strategy	Environment-led 'fit'	Resource-led 'stretch'
Underlying basis of strategy	Strategic fit between market opportunities and organisation's resources	Leverage of resources to improve value for money
Competitive advantage through …	'Correct' positioning: differentiation directed by market need	Differentiation based on competences suited to or creating market need
How small players survive …	Find and defend a niche	Change the rules of the game
Risk reduction through …	Portfolio of products/businesses	Portfolio of competences
Corporate centre invests in …	Strategies of divisions of subsidiaries	Core competences

Source: reproduced from Johnson and Scholes (1993, p. 26).

Leveraging involves making the most productive use possible of limited resources. Because resources are limited, Hamel and Prahalad see leveraging as an essentially creative response to scarcity. In general, they suggest that there are two methods of achieving this creative response.

1. The first is to cut resources without cutting output. As they put it, "reducing the buck paid for the bang". In other words, output does not change but the resource input required to achieve that output is reduced.
2. The second general approach to leveraging resources is to increase the output achieved with existing given resources thereby enabling the firm to get "a much bigger bang for the buck".

The concept of stretch is discussed by Hamel and Prahalad in relation to the need to bridge the gap between aspirations and resources. They suggest that, frequently, great ambitions entail great risks in organisations because ambitions are constrained by accepted orthodox ways of doing things. However, if top management have an ambition, formulated as a strategic intent and can accelerate the process of knowledge accumulation, the risks entailed by the pursuit of an ambitious strategic goal are reduced.

What they describe can be regarded as a process of speeding up the process of incremental change by accelerating the acquisition of information and

know-how. In their view, "the job of top management is not so much to stake out the future as it is to help accelerate the acquisition of market and industry knowledge". To cite Hamel and Prahalad (1993),

> On the one hand, strategy as stretch is strategy by design, in that top management has a clear view of the goal line. On the other hand, strategy as stretch is strategy by incrementalism, in that top management must clear the path for leadership meter by meter.

The international Swedish-based furniture retail company, IKEA, is a good illustration of how successful strategies can be accounted for both in terms of 'fit' and 'stretch' (see case study 3). The two concepts are not necessarily mutually exclusive and may – in particular cases – even be mutually reinforcing.

Case Study 3: IKEA – Successful Strategies through both Fit and Stretch

The success of IKEA can be put down to:

The identification and exploitation of a substantial market segment concerned with price but wanting reasonable quality goods.

The structure of the furniture industry traditionally, which requires customers to wait weeks or months for deliveries; IKEA fulfils a need for immediate availability.

Building on the increasing trend of out-of-town shopping as a leisure pursuit and the availability of transport for customers.

Their international expansion has sought to build on market opportunities as they emerge throughout the world.

However, the success can also be seen as the exploitation of the developing competences of IKEA:

The early development of stores selling kit furniture has been refined over the decades to build an image of convenience and quality that, itself, has set standards and, in this way, created a market.

Their buying and merchandising systems have also been developed to guarantee good design and good quality but at reasonable prices; and in turn these skills have been used to extend product ranges and develop the capabilities of suppliers.

They have cleverly built the customer as an extension of their merchandising, reducing costs of distribution but making their products immediately accessible.

Source: adapted from Johnson and Scholes (1993).

IKEA can then be used to show that strategies do not develop successfully because of 'fit' or 'stretch'. Trying to decide which came first for IKEA – the market opportunity or the capabilities – is a futile exercise. The company has taken advantage of both: the market has informed developing competences and developing competences yielded market opportunities.

Hamel and Prahalad (1989) base their ideas on investigations of global corporations in the USA, Europe and Japan. They found that less successful competitors followed conventional 'outside-in' strategy prescriptions. They argued that the perspective that seeks to match the organisation to its environment curtails ambition to existing available resources. They found that the more successful companies leveraged their resources to achieve ambitions. They were innovative in finding ways to achieve their ambitions and used their resources in creative stretching ways to build up core competences. These companies did not conform to the traditional planning image, but they had a clear strategic direction or strategic intent and organisational members shared this intent.

Achieving Sustainable Advantage

Hamel and Prahalad (1993, p. 84) view strategy as comprising both incremental improvements and rapid advances on the part of a company. They view strategy as comprising both operational effectiveness and risk-taking innovation. However, operational effectiveness does not necessarily translate into sustainable profitability.

The three key strands of value creation may be identified as revenue enhancement, cost reduction and reduction of asset intensity.

1. McKinsey management consultants (1995) argue that for airlines, enhanced revenues will flow from better management of key capabilities such as pricing, capacity, networks and schedules.
2. Moreover, better cost management means that in addition to making general productivity improvements, the airline will address the issues of crew costs and of further outsourcing.
3. Finally, asset utilisation is improved when airlines adopt a system-wide perspective on their fleets, i.e. reducing the variety of aircraft and splitting off non-core service functions such as maintenance and ramp services.

Overall, McKinsey places considerable emphasis on operational efficiency and focusing on core competences. Porter argues that strategy consists of neither operational improvement nor focusing on a few core competences (Financial Times, 19 July 1997). Real sustainable advantage comes rather from the way in which the activities of a company fit together. He bases this argument on the premise that core competences can be duplicated and that resting a company's success on a few core competences can lead to destructive competition. Successful companies, according to Porter, fit together the things they do in a way that is very hard to replicate. Strategic fit is reinforced by successful market positioning and the willingness of a company to make hard choices in terms of its cost structure and customer focus.

The concept of 'core competences' derives from the work of Hamel and Prahalad (1990; 1994). The authors define core competences as 'the collective learning in the organization, especially how to co-ordinate diverse production skills and integrate multiple streams of technologies' (1990, p. 82).

The core competences approach does not work well in the airline industry because airlines have broadly the same competences (Couvert, Airline Business, November 1996, p. 61). Their staff, equipment, distribution systems and so forth tend towards a standard mean for most airline companies. Couvert argues that there are three key questions in any evaluation of an airline's strategy for sustainable competitive advantage:

1. 'Where are you now?
2. How did you get there? and;
3. Where are you going?'

He argues that virtually everyone is competing by doing very similar things in very similar ways. Building on the work of Collis and Montgomery (Collis and Montgomery 1995), Couvert contends that the solution is to adopt a resource-based view of the company, recognising that an airline's routes are its main asset. He further argues that organisational capabilities are an important source of competitive advantage for airlines. Ultimately, the primary physical source of advantage in a successful airline is the combination of its route structure and its history/culture, that is, the way it developed or its organisational capabilities (Couvert 1996, p. 63).

In practice, managers need to consider the question of strategy from both inside-out and outside-in standpoints. In this context, the core competence and capabilities approaches can be related to the building of competitive advantage from both perspectives – see Figure 4.8 for an illustration. Hill and Jones

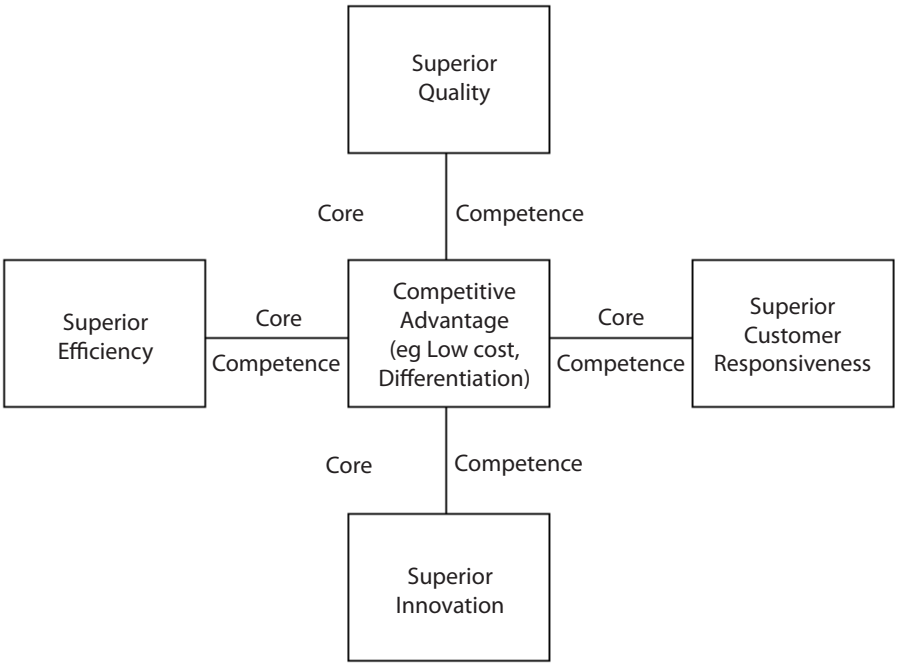
Quick summary

Achieving sustainable advantages

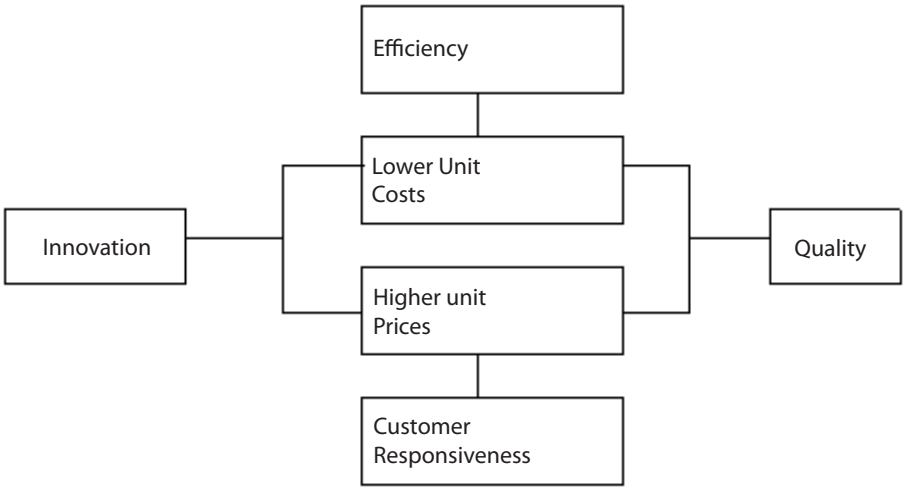
- Hamel and Prahalad (1993, p. 84) view strategy as comprising both incremental improvements and rapid advances on the part of a company.
- McKinsey places considerable emphasis on operational efficiency and focusing on core competences.
- Porter argues that strategy consists of neither operational improvement nor focusing on a few core competences

Your notes

(1995) suggest that there are four generic building blocks with which to build a competitive advantage, each of which can provide a basis upon which to found a low cost and/or differentiation competitive advantage.



It can be suggested that building a core competence in relation to quality, efficiency, innovation and/or customer responsiveness can lead to competitive advantages such as cost and differentiation advantages. Similarly, distinctive capabilities that are reflected in practices, procedures, processes, and routines can produce cost and/or differentiation opportunities. Efficiency, quality, customer responsiveness, and innovation are building blocks for competitive advantage within the Porter positioning school because they have an impact on the ability of the business to lower its unit costs and/or charge higher prices. See Figure 4.9 below for an illustration of these building blocks.



Getting to sustainable advantage

Efficiency leads to lower unit costs, and customer responsiveness allows the charging of higher prices, while superior quality and innovation can lead to both lower unit costs and the ability to charge higher prices. Distinctive competences and organisational capabilities are the foundation upon which these generic building blocks themselves can be based. In short, distinctive competences and organisational capabilities can provide the foundations upon which competitive advantages of differentiation, cost or both can be built by individ-

ual business units through the adoption of appropriate competitive strategies. Particular core competences and organisational capabilities shape strategies. But certain strategies can build core competences. The relationship between strategies and core competences is therefore interdependent.

To consider briefly the implications of competing on competences and capabilities, it may be said that neither of these endowments can guarantee sustained success unless they are subject to a process of continual revision. The Porter approach to strategy implies that there will be intermittent periods of change. The portfolio approaches also imply this. However, competing on competences and capabilities implies that change will be ongoing. The conventional view of strategy has been that strategy is normally about the maintenance of stability. Organisations cannot withstand internal permanent revolutions and change cannot be the norm. However, in the modern increasingly turbulent world this is questionable.

Your notes

Summary

In the previous topic, we examined the market positioning approach to strategy formulation. This topic has identified another perspective – the resource-based view. The resource-based view (RBV) or core competence approach stresses the importance of developing special skills and capabilities that are unique and hence are able to give a degree of sustainable competitive advantage. It needs, however, to be combined with an appreciation of market opportunities to prove capable of being translated into profitable enterprise.

Task ...

Task 4.1

To check your understanding of the material in this topic, try to answer the following questions. If you have any difficulties, you may wish to go back and revise the relevant part of the topic.

1. What are the three main elements of an organisation's distinctive capabilities?
2. Describe Kay's concept of 'strategic architecture'.
3. Define what you understand by the term 'core competence'.
4. How might a company identify its core competences?
5. What is the overlap between distinctive capabilities and core competences?
6. What do you understand by strategic 'stretch and fit'?
7. Are the concepts of 'stretch and fit' mutually exclusive?
8. In what cases might the core competences approach not work well?
9. What are the four generic building blocks with which to build a competitive advantage (Hill and Jones 1995)?
10. Does the concept of competing on capabilities and competences imply that strategic change will be ongoing in an organisation?
11. How does the Producer Matrix relate to the Customer Matrix?.

Resources

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Topic 5

Corporate Strategy

Aims

The purpose of this topic is to:

- to introduce corporate strategy;
- to illustrate the corporate strategy triangle of selecting, promoting, resourcing and controlling;
- to show how corporate strategy can add value from the centre;
- to introduce the parenting fit matrix;
- to emphasise how rarely the centre actually does add value.

Objectives

By the end of this topic you should be able to:

- determine the major forms of corporate responsibility;
- explain how to promote the corporation;
- describe how to select a management portfolio of businesses;
- identify the alternative methods of resourcing the business;
- identify the key methods of controlling the corporation;
- define what 'parenting' involves;
- identify the alternative ways that the corporate centre of a multi-business corporation can add value;
- recognise the risks involved in not clearly seeing how to add value.

Introduction

Corporate Strategy is concerned with the strategy of the multi-business corporation. Collis and Montgomery (1995) state that the Fortune 500 companies, which account for about 40% of the GNP of the USA, on average are active in over 10 separate business areas. In organisations with a number of different businesses, the distinction between corporate and competitive strategy is at its most clear. In such circumstances, to understand how to achieve corporate advantage as well as competitive advantage is a very important exercise.

What then is a corporate strategy? It is sometimes defined as a statement answering the questions:

'Which businesses should we be in, and how should we run them?'

There is probably no better short answer than this. However, a fuller statement of a corporate strategy would probably range a little more widely, and include the following (Bowman and Faulkner 1997):

1. A vision and/or mission for the corporation, including a set of objectives.
2. A portfolio of market sectors and businesses in which the corporation chooses to operate.
3. A portfolio of resources, skills and competences in which the corporation aims to be excellent when compared with its rivals.
4. A corporate organisation structure, systems and processes with which to coordinate the activities of the corporation.

The major distinct areas of a corporate strategy's domain may be summarised as promoting, selecting, resourcing and controlling the businesses within the corporation, as well as the more general responsibility for 'parenting'. Above all, the corporate strategy needs to identify clearly how and where the corporate centre will add value, both by what it does well, and by how it is able to assist the business units to achieve a higher performance within the corporation than they could alone.

Goold et al. (1994) even go so far as to say that the corporate centre must be able to demonstrate that it adds more value to its businesses than any other potential parent, or it is legitimately at risk of a take-over on efficiency grounds. In fact, corporations are not quite at this level of risk, since there are considerable costs involved in ownership transfer and reorganisation, so the benefits of proposed new ownership need to exceed that of present ownership by a considerable margin before ownership transfer becomes appropriate.

An effective corporate strategy is created by the selection of the optimal mission, businesses, competences, structures and systems for the corporation. This topic sets out to define corporate strategy, and suggests how an appropriate corporate mission can be determined and corporate competences developed to support it, including promoting the organisation both internally and externally; selecting the business portfolio; the corporate risk profile; acquiring the necessary resources to succeed; and controlling the corporation.

Promoting

Under the heading of 'promoting' fall a number of frequently used and equally frequently misused tools including the Vision Statement and the Mission Statement, plus corporate objectives and ultimately specific corporate targets. There is a tendency for these terms to overlap in usage and for some of them to descend into banality in content. Let us examine the two types of statements, and corporate objectives, in more detail over the next few pages.

Quick summary

Promoting

- Under the heading of 'promoting' fall a number of frequently used and equally frequently misused tools including the Vision Statement and the Mission Statement, plus corporate objectives and ultimately specific corporate targets.
- Read many corporate mission statements and you will hear that the firm aims to give the customer excellent value, and to treat its employees well

Mission statements

Read many corporate mission statements and you will hear that the firm aims to give the customer excellent value, and to treat its employees well. A litmus test of a mission statement might usefully ask whether a statement of its opposite would still make sense. For example, 'give poor customer value and treat employees badly'! – in this case, such a mission statement is unlikely to be adopted, at least formally, by a company. If the mission statement identifies succinctly the firm's core values, objectives and method of operation, then it provides a useful focus for stakeholders both internal and external.

These statements tend to be used hierarchically, such that the corporate mission or vision statement provides the umbrella statement within which the more detailed SBU (Strategic Business Unit) statements must fit. The corporate mission statement needs to perform as an umbrella statement for the corporation as a whole, under which the SBU mission statement can nest relevantly and congruently.

Vision statements

Vision statements tend to be short and pithy, sometimes referred to as 'bumper stickers'. One of the most famous is that adopted by Komatsu in the 1970s, namely 'Encircle Caterpillar'. This has the merit of being brief, memorable and of encapsulating what the Komatsu top management regarded as the key issue facing the company at the time.

A clear vision defines the rules for acting incrementally and opportunistically. A manager facing an unexpected situation can take a decision after asking the question 'Will such an action further the company's vision?' Vision statements often embody the core values of the founding entrepreneur, and say something about the inspiration behind the company that would not be obvious from a reading of its business plans. Steve Jobs of Apple set out a vision for his young company: "one person – one computer". John Lewis stores capture a vision with their declaration "Never knowingly undersold".

Although good vision statements, when read aloud, may sound incredibly simple, this is not the case for firms without a clear vision. In such circumstances, to adopt an advertising copywriter's clever phrase does nothing to create a vision. In the field of politics, George Bush Sr admitted to being uncomfortable with the 'vision thing', and nothing could be done to disguise this. Visions come from within, and the chosen words merely define them. The words cannot create the vision where none exists.

A vision is an image of a better future, however defined; it is a state to which the company aspires, and therefore can, at least logically, be achieved. What happens when Komatsu succeed in encircling Caterpillar? Clearly a new vision needs to be adopted if the company is not to sink beneath the competitive waves enthusiastically telling stories of past triumphs. For an ongoing sense of purpose, the mission statement is needed.

Objectives

The process of setting objectives for the corporation and subsequently for the business units is the process of translating the corporation's strategies into specific and if possible measurable objectives, the achievement of which will signal that the corporation's adopted strategies are working successfully.

Objectives are frequently financial, but need not be so. They need not even be measurable, but obviously it helps the monitoring process if they are. The following are typical objectives that a corporation might set for itself, in order to provide behavioural signposts regarding the implementation of strategy as illustrated in Figure 5.1 (Bowman and Faulkner 1997).

Your notes

Figure 5.1 Measurable corporate objectives

- To achieve a 15% overall return on capital employed.
- To grow the corporation in sales terms to double its current size within five years.
- To become market leader or number two in every industry in which it competes.
- To reduce administrative overheads from 20% to 15% of sales.
- To increase export from an average of 10% of total sales to 25%.

Source: Bowman and Faulkner (1997, pp. 187–196).

Less measurable objectives might be as illustrated in Figure 5.2:

Figure 5.2 Less measurable objectives

- To gain a corporate reputation for product quality.
- To improve company morale.
- To be more innovative.
- To increase commitment throughout the company.

Source: Bowman and Faulkner (1997, pp. 187–196).

Following on, if corporate logic is significantly about leveraging competences and creating synergy, the corporate objective-setting process should reflect this. Sophisticated objectives would therefore recognise sharing, cooperation and cross selling, and would monitor the benefits of centralised activities.

Some attempt can be made to measure even the less measurable objectives. For example the percentage of returns is some measure of product quality and the level of company morale may be gauged partly by the level of staff turnover, although in times of recession this may not be a very reliable measure. One risk of too great an emphasis on measuring progress towards objectives is that it is a well-observed characteristic of organisational life that people concentrate on performing well in areas that they know will be measured, often to the detriment of other, sometimes more important but less easily measured, factors.

One set of objectives might well involve the operationalisation of the key statements in the mission statement. For example the item in the M&S statement regarding providing comfort for customers, might be translated into an objective to have a certain number of easily accessible seats for customers in every M&S shop as a principle of corporate policy, not at the discretion of the shop manager (Bowman & Faulkner 1997).

Having defined what the corporation is trying to achieve, the corporate centre is responsible for communicating this to all interested parties – the press, the City, the government, the Unions, customers, suppliers and of course employees. This involves a whole range of activities including corporate advertising, public relations events, City lunches and interviews to journalists. Poorly implemented promotional activity will damage a firm's share price however impressive its audited performance.

Selecting: The Business Portfolio

What businesses to be in is a fundamental issue for the corporate board. Since the early 1970s, the issue has been addressed most commonly by employing one or more of the strategic consultancy company portfolio matrices:

- The 'box' of the Boston Consulting Group

Quick summary

Selecting: the business portfolio

- What businesses to be in is a fundamental issue for the corporate board. Since the early 1970s, the issue has been addressed most commonly by employing one or more of the strategic consultancy company portfolio matrices

- The Directional Policy Matrix of McKinsey
- The Life-cycle Matrix of Arthur D. Little

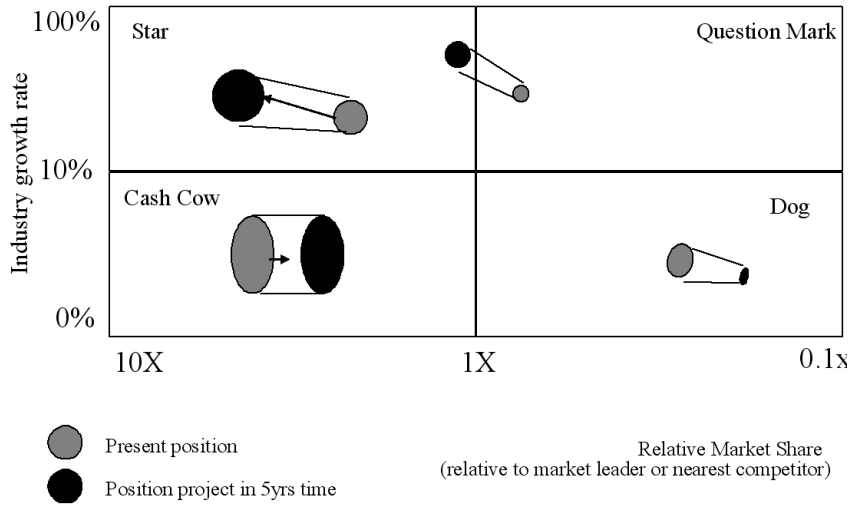
Your notes

However, none of these matrices explicitly takes into account the resource-based theory of the firm, or makes a rigorous attempt to determine the firm's key or core competences in order to discover the area in which the company is most likely to succeed.

The three most common portfolio matrices are described on the next few pages, and some of their respective limitations identified.

The Boston Box

The Boston Box was the earliest of the matrices to be developed and, being perhaps the easiest to understand, is probably still the most popular in the business world. As shown in Figure 5.3, it has four quadrants and two axes: market growth and relative market share.



It is suggested somewhat simplistically that the faster the market growth the more attractive the market, and the higher the market share relative to that of the market leader, or if one is the market leader to the next largest competitor, the stronger the position of the strategic business unit. This leads to the designation of business units that are market leaders in fast-growth markets as 'stars'; market leaders in slow-growth markets as 'cash cows'; non-market leaders in fast-growth markets as 'question marks' or 'problem children'; and non-market leaders in slow-growth markets as 'dogs'.

The portfolio philosophy underlying the matrix is of a balanced cash portfolio. Cash cows generate the funds to enable investment to be carried out in the stars and the question marks, whilst not requiring much investment themselves. Question marks require attention in order to help them to gain relative market share and so turn them into stars, and dogs should be divested, though it is not obvious why they should not be developed into cash cows.

This neat view of the world includes a 'virtuous' sequence, whereby a question mark is developed into a star, and ultimately with a maturing market declines into a cash cow generating profits to fuel the next generation of stars. As a warning homily, the disastrous sequence is also depicted in which the star loses market share to become a question mark and then, with a maturing market, declines into the status of a dog, fit only for divestment.

The theory underlying the concept of the Box is that of the experience curve. This concept, supported empirically by research in a number of industries, holds that unit costs go down as aggregate volume increases. Thus, to gain the market leadership position is to gain a cost advantage over the competition and hence a potential strategic advantage.

PIMS research (Buzzell & Gale 1987) supports this theory. Clearly then, the faster the market grows and the greater the level of market leadership, the higher the cumulative volume and the greater the reduction in unit cost of production. The horizontal axis measures relative rather than absolute market share, since a company with 20% of the market when no other competitor has more than 5% is in a far stronger position than one with 20% but facing three competitors, who each also have around 20%.

Weaknesses of the Boston Box

The Boston Box has the attraction of its simplicity, but it suffers from a number of weaknesses, and should be used with caution. The two axes attempt to relate the attractiveness of a market to the inherent strength of the business unit. However, market growth rate is only a very approximate surrogate for market attractiveness. Porter's Five Forces model described in Topic 3 illustrates the complexity of the market attractiveness concept in which market growth has only one part to play in one of the identified key forces affecting market attractiveness. Whether growth is important also depends on whether the business unit concerned has strategic advantage in the key competencies that enable the growth to lead to improved results for the company.

Relative market share is also an uncertain surrogate for company strength. Market share can be bought easily by pricing below cost, without the possession of any real internal strength. It also refers to the past, not the future, and could be said to be more the result than the cause of business unit strength. Economic research frequently correlates high market share with high profitability, hence strength, but correlations do not, of course, indicate the direction of causality. Does business strength lead to high market share, or high market share lead to high business strength?

Further flaws

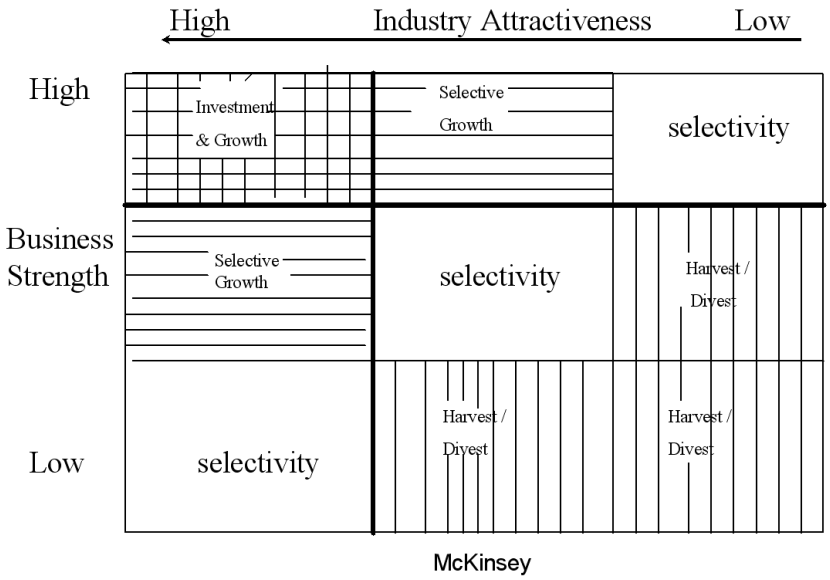
The Boston Box does not allow for declining markets, applies mostly to fast-moving consumer goods companies and certainly does not fit easily with industrial goods markets, since market shares are often very difficult to ascertain in such highly differentiated markets. It is also difficult to apply with confidence to fragmented industries or to industries in which the experience curve and scale economies give small unit cost advantages. It is also not evident why profitable companies in slow growth industries who are not market leaders should be divested. Many may still make good profits without requiring large investment funds. Indeed, in many industries it would not be difficult to find examples for the concept of the 'cash dog' as Hanson is well aware. Furthermore, even slow growth industries exhibit investment opportunities in particular segments or niches, and many well-focused companies in this box may well be acceptably profitable, for example Imperial Tobacco. This company is not the market leader and its industry is in decline. However, it was very profitable year on year during the Hanson Group ownership.

The McKinsey Directional Policy Matrix

The McKinsey Matrix attempts to overcome some of the weaknesses of the Boston Box by selecting more realistic multi-dimensional axes to represent industry attractiveness and business strength. For an illustration see Figure 5.4 below.

McKinsey are careful not to be over prescriptive regarding the dimensions of industry attractiveness or of internal business strength. Indeed, they emphasise that the relevant factors will vary from industry to industry. However, if the matrix had been developed after the publication of Porter's Competitive Strategy and Competitive Advantage books, it is probable that the Five Forces industry attractiveness model would be recommended as a means of assessing the SBU's position on one axis, and the value chain for assessing position on the other axis.

This matrix has its axes in reverse to those of the Boston Box. They are, however, conceptually similar in that the box where high industry attractiveness meets high business strength leads to a recommendation of investment with the objective of growth, similar to that of the 'star'. Correspondingly, low attractiveness/low strength, as with Boston's 'dog' leads to the recommendation 'harvest/divest'. The other boxes follow similar logic.



McKinsey

Although the McKinsey matrix purports to be an investment matrix in contrast to Boston's cash matrix, the distinction is more a formal than a real difference in that the box with the most attractive combination of market position and internal strength is identified as the most attractive one in both matrices. Similarly the 'dog' on the Boston Box lies also in the right-hand corner of the directional policy markets.

Weaknesses of the McKinsey Matrix

The major weakness of the McKinsey Matrix is that there is no easily applied means of establishing the appropriate weightings for the many dimensions of attractiveness and business strength, and this enables practitioners or consultants to bias weightings to meet their already established ideas if they are so inclined. It can in the wrong hands, therefore, be more of a demonstration tool than an analytical model capable of giving surprising insights. This same criticism can, however, also be levied against the Porter Five Forces model.

The Arthur D. Little Life-cycle Matrix

A third variant of the portfolio matrix is the Arthur D. Little Life-cycle Matrix (ADL). Following the customary internal axis, it chooses competitive position as its measure of the firm's strength, not a far cry from McKinsey's business strength axis, although measured somewhat differently. Its other axis is quite different, however. It selects market maturity as its external measure. For an illustration see Figure 5.5.

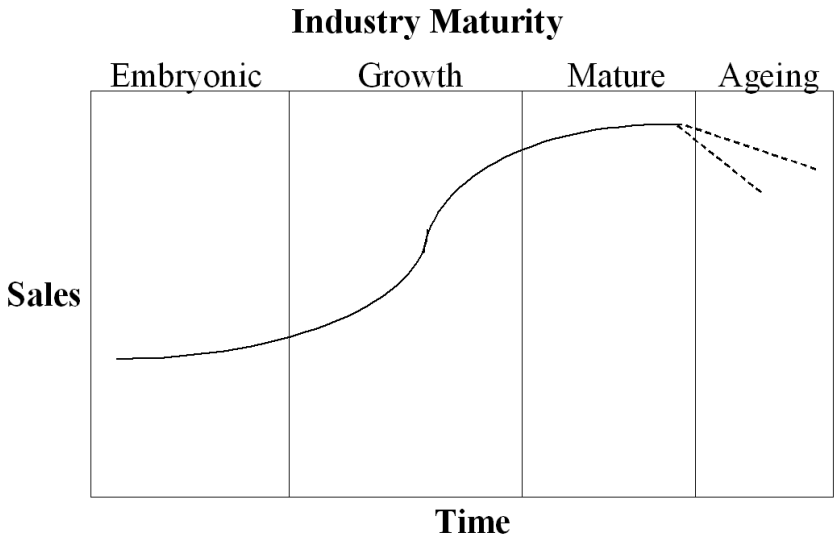
This requires it to aver that there are appropriate strategies for any stage of maturity, and therefore that no particular maturity is 'good' or 'bad'. Indeed, diversified conglomerates seem to prefer that their acquisitions be in mature rather than growth markets, since this often means greater stability and lower demand for investment funds.

Problems with the ADL matrix

Very deterministic rules are applied to this matrix for the calculation of competitive position and market maturity, leading to a positioning on the matrix that in turn leads to the recommendation of a very limited range of 'natural' strate-

Your notes

gic thrusts. A problem here exists in that, if every business unit in a particular matrix position adopts the same strategic thrust in a given market, it is difficult to see how competitive advantage will be gained. In business, as in life generally, the winner is often the competitor who does something unusual, rather than the one who applies rigorously a formula known and available to all.



Other problems attached to this matrix are the following, as mentioned in Topic 3 in relation to the overall life-cycle model. It is possible through the use of the ADL methodology to determine the maturity of the market concerned. It is not possible, however, to determine how quickly the maturing process will take place, or indeed whether it will take place at all. Some products/markets mature very fast, like personal computers; others do not seem to mature at all, like houses, staple foods or non-fashion clothing; whilst others (due to fashion, technology breakthroughs or strong marketing activity) reverse maturity, like watches or sports shoes. As a predictor of the ageing of markets, the matrix is of little use. Its value for strategy guidance must be similarly limited for the same reasons.

Problems with the three matrices

All three matrices have basic flaws that apply to each of them individually. They also have some limitations that apply to them all collectively. All assume that each business unit has no synergistic relationship with any other. Indeed, if this were not the case, it would not be possible to regard the positioning of an SBU on a matrix as implying any particular strategic implications, without considering carefully any relationship one SBU might have with any other, be it supplier, distributor, joint economy of scope achiever or whatever. Strictly speaking, therefore, the portfolio matrix approach to corporate resource allocation can only be used effectively where no synergies are sought between the units. Yet one of the major justifications for the existence of a corporation, over and above that of separate business units, is the belief that such synergies can be realised, and thereby give competitive advantage to the business units benefiting from them. Such matrices are also by their nature examples of comparative statistics and do not enable accurate insights necessarily to be gained into enduring future trends. But perhaps this is to expect too much.

Further criticism of the matrices

However, there is a more fundamental criticism. In purporting to provide an aid to corporate chief executives in their difficult resource allocation decisions (involving deciding which products/markets to concentrate on), the matrices pay little, if any, attention to the growth of risk with increasing unfamiliarity. Neither do they consider the wisdom of getting involved only in new busi-

nesses, whose key factors for success relate closely to the corporation's already demonstrated competences. Indeed, all three matrices can be used to justify totally unrelated acquisitions based on no clearly existing competences within the corporation whatsoever. As Collis and Montgomery (1995) point out:

> The problem with the portfolio matrix was that it did not address how value was being created across the divisions … The only relation between them was cash. As we have come to learn, the relatedness of businesses is at the heart of value creation in diversified companies.

Other criticisms of the portfolio matrices are that they assume that corporations have to be self-sufficient in capital, and should find a use for all internally generated cash, and they were silent on the question of the competitive advantage a business received from being owned by a corporation compared with the costs of owning it.

Diversification and Strategic Risk Options

The selecting task of the corporation does not stop at the SBU level. It is also of importance when the corporation is deciding whether to go into a new product/market or develop a new set of competences. This section of the topic addresses the problems encountered when a firm assesses that it cannot necessarily expect to achieve its financial and other objectives operating with its current products in its current markets. It must venture beyond known product/market boundaries and possibly develop or acquire new competences. This involves increasing risk.

We set out a model for assessing the varying levels of risk involved in different diversification moves. Whilst it is not suggested that use of the model necessarily describes accurately the relative levels of risk of particular situations, it is claimed that the model can generate useful insights in this regard, and lead to the posing of questions that will reveal when 'the exception that proves the rule' has been encountered. Thus, there may be situations where an alliance involves more risk than an acquisition and where internal development is a higher risk than a joint venture, but in most cases this will not be the case.

A firm may not be able to achieve competitive advantage in its current product/market segment. In such a case, it will need to consider other options, for example marketing the same product to a different market. Once product/market options have been listed and researched in relation to the size of the opportunities, the strength of the competition, and the necessary key competences to succeed, each needs to be assessed for relative risk.

Strategic risk of this nature comes in two major types:

1. The risk of losing one's investment or being significantly damaged as a result of the alliance, i.e. vulnerability. This is a type-1 risk.
2. The risk of not achieving the objectives set out for the alliance. This is a type-2 risk.

The risk cube only addresses type-1 risk. The aim of the analysis is to identify the option that will achieve acceptable objectives (i.e. low type-2 risk) with the lowest level of type-1 risk

The risk cube model

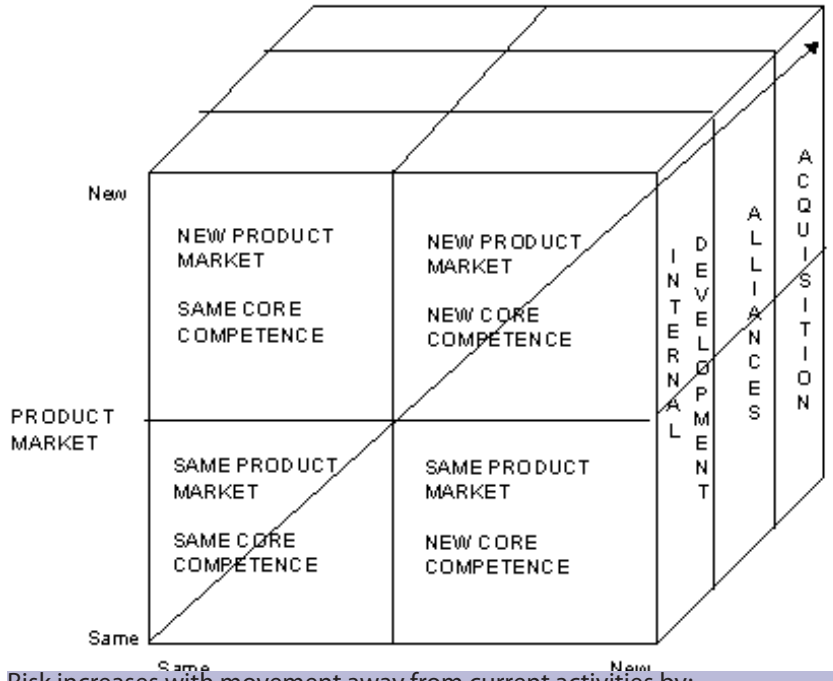
The risk cube (you can see an illustration in Figure 5.6) illustrates the options open to the strategist, with the ascending arrow going into the back of the cube representing increasing type-1 risk. Hence the activity with the lowest type-1 risk option is to continue to operate in the familiar product/market segment using the firm's existing demonstrated competences, and to attempt to grow by internal development.

Quick summary

Diversification and strategic risk options

- The selecting task of the corporation does not stop at the SBU level. It is also of importance when the corporation is deciding whether to go into a new product/market or develop a new set of competences.
- Whilst it is not suggested that use of the model necessarily describes accurately the relative levels of risk of particular situations, it is claimed that the model can generate useful insights in this regard, and lead to the posing of questions that will reveal when 'the exception that proves the rule' has been encountered.
- A firm may not be able to achieve competitive advantage in its current product/market segment. In such a case, it will need to consider other options, for example marketing the same product to a different market.

Your notes



Risk increases with movement away from current activities by:

- Product market
- Core competence
- Corporate activity

The Partners' Risk Profiles are Important in Determining Strategic Choice

However, a strategy to continue operating in the existing product/market segment with the existing competences may not get acceptable results, i.e. type-1 risk may be low but type-2 risk is high. The product/market may be saturated and/or the competences obsolescent or at least in decline. In this event, the next options to be considered, in ascending type-1 risk terms, are to use new competences, for example technologies (e.g. transistors for radios instead of valves) in the present product/market, or to use the existing competences in a new product/market. Only in exceptional circumstances should the excessively high-risk option be considered of marketing an unfamiliar competence application in an unfamiliar product/market.

The type-1 risk element of these moves is increased if the firm attempts to make any of the above moves by methods other than internal development. Joint development involves operating with a partner with whom one is unfamiliar, and over whom one has very limited control. This increases the level of uncertainty and hence of risk. Development by acquisition increases type-1 risk even further, since it involves purchasing an unfamiliar company, which is likely to have been marketed in such a way as to maximise the price the seller is able to achieve. On conclusion of the acquisition, therefore, the purchaser will not only need time to establish the real value of the assets purchased but may be in control of a top management team substantially demotivated or depleted as a result of the ownership transfer. This option is likely to be the highest type-1 risk option, as well as the most expensive one. If the acquired company operates with unfamiliar competences in products/markets unfamiliar to the acquirer, the highest risk option of all has been taken.

Options can be analysed in terms of direction and of method. Both factors involve risk.

- Thus, under the heading of direction, we will consider which product/markets to operate in, noting that risk increases the further away the markets, products and competences get from those in which the company is currently active.

- Under the heading of method, we will encompass internal development, joint development or alliance, and acquisition: categories, once again, generally in ascending levels of risk. Clearly, it is not rational to adopt a greater level of risk to achieve a desired objective, if that same objective is attainable by taking less risk.

So, in general, the lowest type-1 risk option is to continue to operate in the familiar product/market segment using the firm's existing demonstrated competences, and to attempt to grow by internal development. It should be noted that it is not helpful to think of a product as distinct from a market. A product/market combination represents the suggested solution to a particular consumer need. Once a product is targeted at a different market, it becomes a different product in the sense that the consumer will analyse it by means of different dimensions of perceived use value (PUV). Thus, a family car targeted at the sports car market may be found defective, since it will be measured by PUV dimensions such as performance, styling and acceleration. Yet in the family car market, it will be measured by such dimensions as fuel economy, comfort and luggage space and may well score highly.

A product in empirical terms is how it is described, a bundle of attributes attempting to meet a need. In the example, therefore, description of the product cannot be separated from description of the market it is attempting to serve. In different markets, it will also meet different competitors against which its relative strength will vary. The analysis is therefore most usefully carried out using product/market segments as unique entities for analysis, rather than thinking of products as objective objects distinct from markets.

Let us now examine in more detail the options illustrated in each of the quadrants in the risk cube model that you saw above.

Same Product/Market–Same Competence

Within the base quadrant Same Product/Market–Same Competences, the possible strategic actions can be classified thus:

1. Continue with strategy unchanged
2. Withdraw from product/market
3. Consolidate in core business
4. Penetrate existing product/market further

All fall within the same box, i.e. the bottom left-hand front box of the model. They can each be analysed by using the existing perceived use value, competitor positioning, price and competences data as the basis for considering alternative strategic moves.

Continue with strategy unchanged

Continue with strategy unchanged, as a strategic option is by no means necessarily an inappropriate strategy in all circumstances. In circumstances where an acceptable level of profit is being achieved, the firm's market share is good, it has a clear competitive advantage sustainable in the medium term, its product range is still in the growth phase of the product life-cycle, and no imminent turbulence in the market can be discerned – the continuance of the existing strategy is clearly correct. However, this should not lead to complacency, a failure to scan the market closely for possible change or a failure to invest in the development of new products, which could lead to future problems.

Withdrawal from existing product/market

Withdrawal from existing product/market as a strategy is appropriate in a number of circumstances. In a declining product/market when a firm's market share is poor and shows little possibility of substantial improvement, a timely withdrawal may minimise future losses. Where the firm has no competitive advantage, and cannot foresee attaining one, it is better to withdraw early

than to incur heavy losses and to be forced out later. Other circumstances in which withdrawal is an appropriate strategy are where the resources can be deployed more profitably elsewhere, but only where exit costs are acceptably low. Where they are high, this must be taken into consideration before adopting a withdrawal strategy.

A further set of circumstances are those where the industry is strongly cyclical, and withdrawal in order to re-enter later at a better point in the cycle shows good judgement. Thus, an astute housing company will build its land bank when prices are at the bottom of the cycle, and sell it off when a boom develops only to repurchase during the next down-swing. Such strategies apply also to foreign exchange, metals, commodities and other speculative industries.

A consolidation in current product/market

A consolidation in current product/market strategy involves the reduction of a firm's activities to its profitable core. During the up-swing of a business cycle, a firm is likely to consider expanding into new areas of activity, accepting that they will not necessarily be instantly profitable but, given good judgement and investment, should become so in the future. Correspondingly, with the onset of recession, it is appropriate for a firm to consolidate its position in the areas where it has its greatest strength, normally its profitable core business. This involves concentrating its investment in the core areas, and withdrawing from low or unprofitable activities.

Other activities associated with a consolidation strategy are likely to be severe cost-cutting and downsizing (particularly of central overheads) and, for the market leader, acquisition at low prices of smaller competitors in order to push market share from strong to dominant. High capacity utilisation is valued in consolidation mode far more than a varied high turnover over a wide range of activities.

Market penetration of existing product/market

Market penetration of existing product/market as a strategy is particularly necessary when market growth is slowing, or markets are actually declining. In the event that growth of a given market is strong, competitors can achieve fast growth without increasing their market share. However, when the market matures and growth slows, only a strategy of market penetration can enable a firm to increase its sales. Market penetration can be achieved by any combination of perceived price reduction and increased perceived use value. Thus, the buyer will purchase the firm's product rather than a competitor's because it is believed to offer better value for money.

New Product/Market–Same Competence

A product/market development strategy is the next lowest risk option. This involves conducting a new PUV analysis for the new application for the upper left-hand quadrant on the face of the risk cube, coupled with a new competitor analysis. It may also be necessary to determine firstly whether the firm's core competences are those required in this segment, and whether the firm's relative competitive position with regard to its competences, and those of competitors operating in this segment, are different to those in the base core segment.

A strategy of this kind can be carried out in a variety of ways and firstly by extending market segments. If, for example, Mercedes is primarily targeted at the over 45s, the easiest and lowest risk strategy extension is to develop small variants targeted at the 35-year-old.

A second possibility is to extend the marketing to new geographical areas. A product sold purely nationally can be extended to other markets after a little market research to determine acceptable price levels and possible taste differences.

A third variant is to discover new uses for existing products, such as the

Your notes

extension of the home games computer to the word processing personal computer.

Your notes

Same Product/Market–New Competence

The strategy of competence development is higher risk than any of the other strategies discussed so far. Whilst overtly only concerned with unfamiliarity in the product area, it is also inevitably operating in a new market area, i.e. one for the new competence application.

The strategy can be carried out in a number of ways with varying risk, by:

1. Competence extension
2. Licensing-in or franchising a new technology
3. Developing a new competence through R&D

Competence range extension

Competence range extension is the lowest risk of the three strategy variants. The only risk attached to this strategy is of the cannibalisation of revenue from the existing competence applications range. This is of course possible, and the risk attached to it increases the further the range is extended. It is, however, the natural first resort for a firm wishing to increase its sales without changing a winning formula by more than a marginal amount, hence with a relatively low-risk profile.

Licensing in new competence

The licensing-in of a new competence, perhaps through technology transfer, has the advantage that the licensed technology has by definition been successful in the product/market of its origin. The risk attached to this strategy is that demand in the prospective licensee's market is different from that in the technology's market of origin, and the possibility that the new competence will not succeed outside its original home country. The benefit to the licensee is that the technology has already been successfully tested from an effectiveness viewpoint, and that no expenditure is needed on R&D. The licenser may even be persuaded to support the application with some marketing expenditure to spread the brand name. Many international product recipes (including specific competences) from Coca-Cola to McDonalds and Body Shop have been successfully licensed or franchised to the benefit of both licenser and licensees.

New competence through R&D

The riskiest competence development strategy variant is that based on the firm's own R&D. It is reputed that no more than one in a hundred of R&D developed competences is actually successful in a major way when an attempt is made to convert them into successful product/market applications. Only companies with a strong financial position, very strong competence in research and particularly development, and a very effective marketing department should risk embarking on totally new competences or technologies. In general, such a strategy is expensive, very risky and potentially unprofitable. The First Follower strategy is often the one to pursue here, although it should be noted that there are strong advocates of the 'first in the market' school as this may be the way to establish a large installed base and thus ensure repeat sales, and prescription by purveyors of linked products (compare Microsoft in computer software).

New Product/Market–New Competence

To embark upon the development of new competences and their application to new product/markets is tantamount to setting up a new company, always a very risky business especially in unfamiliar territory. Thus, if a traditional watchmaking company, seeing the market for coiled spring watches decline, were

to launch into microchip technology but, having done so, to immediately attempt to get established in the fashion Swatch watch segment, the company would be taking very grave risks with the business. Not only would the company's new developing competence in the microchip technology be based on fragile foundations, and hence increase risk, but its very slight knowledge of the fashion watch market area would compound this risk. New Competence–New Product/Market moves should only be made if there are judged to be no lower risk moves available.

The viewpoint of risk

The risk cube enables strategists to assess the comparative risk of different options involved in selecting a specific product/market–competence strategy as a means of pursuing a strategic direction. In general, the risk is higher the greater the unfamiliarity of the firm with the challenges facing it.

Strategy options should initially be considered from the viewpoint of risk. The further they require the company to stray from the business area in which it has competence and confidence, the greater the risk in most cases. A riskier strategy should not be adopted if a less risky one would achieve the chosen objectives equally well.

It must be stressed that the model should not be used without careful reflection. There may be situations, for example, where it is much higher risk to remain in the Same Competence–Same Product/Market quadrant than to move. This will certainly be the case if the existing product/market is in decline (the old buggy-whip example) and/or the competence becomes obsolete (e.g. valve radios). The model does no more than pose risk questions that require careful analysis. It does not mechanistically answer them.

A company's initial concern must be to achieve as strong a position as possible using its existing proven competences in existing product/market situations. If this gives inadequate results in terms of company objectives, the firm will need to consider the higher risk options of moving to different product/markets and/or possibly developing different competences. These moves involve higher risk, since they mean moving into unfamiliar territory.

Development method

The questions of whether to make the moves you have been reading about by internal development, by alliance or by acquisition also need to be considered, since all but internal development also involve the unfamiliar, and thus involve a raising of the company's risk profile. When the identified options have been analysed and compared, the choice of the preferred option can be made by rating each option against the criteria of suitability, feasibility and acceptability (Johnson & Scholes 1993). The preferred option needs to rate acceptably highly when measured against all three criteria.

The firm needs to decide at this stage how to put together the necessary resources and competences to have a chance of achieving competitive advantage in its selected product/markets. There are only three possible answers to the question 'How?', namely by:

1. Internal development
2. Joint development
3. Acquisition

Clearly, internal development generally involves the least risk, as it has the greatest level of control and of familiarity with the firm's existing competences. However, if this option is not possible, perhaps for reasons of resource deficiency or the need for speed in getting a new product/market launched to meet an opportunity, without having appropriate internal competences to do this, the riskier options of alliance or acquisition must be considered.

Some form of alliance with a partner overcomes many of the problems of lack of resources and competences. New products from one company can be married to sales forces with spare capacity from another, and the time from product to market dramatically shortened. Companies strong on technology can collaborate with partners strong on marketing to their mutual benefit. The wide variety of joint development forms provides a varied menu of possibilities from which partners can select in order to optimise their development possibilities. Joint development is appropriate where sustainable competitive advantage can be achieved together but not separately. A weak competence can be transformed through an alliance by the addition of the partner's core competences.

Your notes

The scope of the corporation

The selection task is also of concern to the corporation at the level of activities. Such questions as 'Should we do our own production or focus solely on being a marketing company?' are central to the selecting task of the corporation, and not only of interest to the SBU.

At a simple level of description, economic activity takes place in companies, in markets or through voluntary cooperative behaviour. Markets operate through the price mechanism, and come about because different economic agents value items or activities differently. If I buy a car for a given price, it is because I value the car more than the money I have to pay for it, and the seller values the money more than the car.

Companies, on the other hand, operate by means of an instruction-giving hierarchy. I carry out a given task because my boss requires me to do so and this is a condition for receiving my wages. The instruction needs to be very unreasonable before I would consider refusing to obey it. My career progress and even my job depends upon recognising the power of the hierarchy and behaving accordingly.

Cooperative behaviour takes place because partners recognise that, by working together, they can realise objectives they both value more readily than they can by working independently. This form of activity involves identifying overlapping agendas, and developing consensus to pursue a jointly determined course of action.

These three fundamental modes of carrying out transactions are rarely totally distinct in economic activity. Markets take place between companies as well as between individuals and are to be found inside companies operating alongside hierarchically organised activities. Cooperative activities take place between companies and within them and, even in cooperative alliances, some activities are market based.

The questions critical to an understanding of the boundaries of organisations include:

- When is it most appropriate to organise economic transactions in companies, by markets or cooperatively?
- Within an overall value chain, which activities should a particular company do itself, buy in or do with partners?
- What determines the optimal size of a company, in terms of its vertical and horizontal scope?

The major concerns of corporate strategy are to add value to the direction of the corporation by selecting the right markets to be in, resourcing them appropriately and controlling the resources efficiently. The question of what activities the corporation should carry out itself, which ones it should buy in and which it should carry out with partners, addresses the fundamental corporate task in a central way. It is not until we have decided which activities we should buy in, carry out directly or do with partners that we can address the basic questions of resourcing, and control of those resources. For example, a corporation may be ill advised to manufacture a piece of undifferentiated

hardware from raw materials when it can buy in a similar quality product at lower costs and with considerably less effort.

Resourcing: The Self-Sufficient Approach

The corporate centre's primary task of deciding which product/markets it should operate in and, within those product/markets, which activities it should carry out directly and which it should subcontract or buy in determines the scope and boundaries of the corporation. Decisions of this nature inevitably add to or reduce the value of the corporation according to the wisdom of the judgements made.

Equally important, however, is another set of decisions of the corporate centre, which involves deciding how to provide the resources necessary to operate in the chosen segments. This resourcing task involves providing the resources to the existing SBUs for their investment and development, providing some services directly from the centre, identifying and implementing synergies between the SBUs and developing the corporation through merger, acquisition and the creation of strategic alliances with other companies.

Let us now look more closely at achieving synergies and providing specialist services.

Achieving synergies – or providing specialist services

The corporate centre of larger companies will provide specialist services like IT, HR and possibly strategic planning. It will probably also try to identify and help in the achievement of any synergies that may potentially exist between the SBUs, thus aiding the achievement of economies of scope.

The identification and realisation of synergies can be an important part of the value-added contribution brought about by the corporate centre. The SBU concept upon which the multi-divisional form (the 'M form', see Chandler 1962) of diversified company organisation structure is based works on the assumption that SBUs are self-contained businesses. This drives out synergies by definition. Many corporations using the SBU principles in general are less rigorous in applying it in practice, and breach its pure form, when they recognise the existence of large opportunities for scope economies and other synergistic relationships between SBUs.

In principle, the opportunity to examine potential synergies rises directly with the acquisition by the corporation of new business units. Two units may have a common supplier, a third a common customer, a fourth may allow manufacture with common plant and so the opportunities increase. It is important, however, that the benefits from the realisation of these synergies exceeds by a significant margin the costs involved in achieving them. The use of a value chain analysis for each business unit in the corporation will identify many of the possible areas of synergy.

Synergies may exist in all value chain activities.

- Marketing synergies may exist through the spreading of the corporate brand name over a wider range of products; through shared advertising and promotion; through the use of the same distribution network and sales force for a wider range of product; through cross-selling by executives in different SBUs; or through sharing the back-office administration associated with the sales and marketing function.
- Procurement synergies may exist through shared purchasing leading to greater volume discounts; production synergies through shared production facilities, shared quality systems and shared maintenance departments.
- 'State-of-the-art' technologies may also be valuably spread over a range of business units to corporate advantage.
- Less tangible synergies may also be realised, for example through the use

Quick summary

Resourcing: the self-sufficient approach

- The corporate centre's primary task of deciding which product/markets it should operate in and, within those product/markets, which activities it should carry out directly and which it should subcontract or buy in determines the scope and boundaries of the corporation.
- Equally important, however, is another set of decisions of the corporate centre, which involves deciding how to provide the resources necessary to operate in the chosen segments.

by more than one SBU of a similar strategy; the targeting of similar customers; and the use of valuable corporate contacts of use to a range of business units.

The cost of realising synergies

On the negative side, there are of course inevitable costs of both a financial and a motivational nature in attempting to realise synergies between SBUs. On the financial side, there are the costs involved in setting up and maintaining the coordination systems necessary to realise the synergies; this means champions, task forces, management time, committees and the compromises that are needed when one SBU is measured by its results, and yet required to take actions that may benefit another SBU and not itself in the interest of the corporation as a whole.

Motivational costs may thus be an important consideration in selecting which synergies to go for. The achievement of intra-SBU synergies inevitably leads to a degree of diffused profit responsibility, loss of focus, reduced flexibility, and a blurring of the cause–effect relationship. It is difficult to know whether you are right to sell off a poor-performing business when it is intertwined in a complex way with the rest of the corporation, sharing production plant, salesforce and maybe R&D.

Making sure synergies are appropriate

It is important therefore to attempt to realise only the synergies that are clearly sensitive to economies of scale, scope or learning, and at the same time represent a large amount of operating costs or assets of the corporation. Putting it the other way around, potential synergies should be ignored if their realisation incurs more costs than benefits, if they are small items of expenditure or if they are not very clearly subject to scale or scope economies, and if the benefits would be difficult to realise.

Only the corporate centre can make the achievement of these synergies possible, as there is an understandable tendency for executives allocated to an SBU to put the interests of that SBU before that of the corporation as a whole. However, optimising actions within each SBU may lead to sub-optimisation of outcomes for the corporation, in that it ignores the potential benefits from inter-SBU synergies. The pursuit of and achievement of appropriate synergies is therefore an important area where the corporate centre can add value.

The other resourcing area of mergers and acquisitions, and strategic alliances will be dealt with in Topic 9.

Controlling the Corporation

A corporate centre that has carried out its primary tasks of selecting which business areas to operate in and has then resourced the various businesses in the corporation appropriately, will also need to face its third primary task of how to control the enterprise. This involves the coordination and configuration of the corporation, by which we mean organising who does what and where and then making sure that it all happens efficiently.

The popularly recommended structure of the multi-business corporation has changed in recent decades from the earlier form of a holding company with the centre allocating resources but having little involvement in the businesses, to the 'M form', or multi-divisional structure, in which the corporate centre takes strategic decisions and the strategic business units take operational ones. In this way, the perpetual issue of centralisation versus decentralisation is resolved at least in principle, although, of course, the debate continues to rage as contingent circumstances determine differing interpretations of this simple formula.

Quick summary

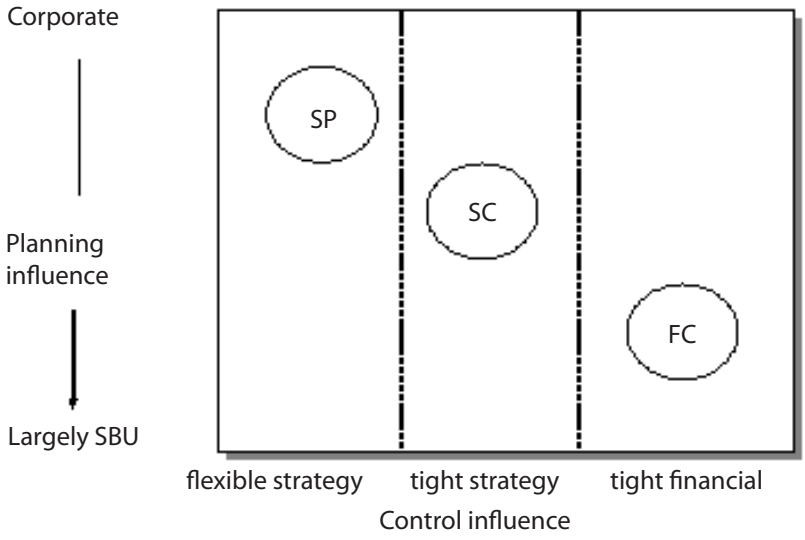
Controlling the corporation

- A corporate centre that has carried out its primary tasks of selecting which business areas to operate in and has then resourced the various businesses in the corporation appropriately, will also need to face its third primary task of how to control the enterprise.
- The popularly recommended structure of the multi-business corporation has changed in recent decades from the earlier form of a holding company with the centre allocating resources but having little involvement in the businesses, to the 'M form', or multi-divisional structure, in which the corporate centre takes strategic decisions and the strategic business units take operational ones.

Your notes

In the real world of actual company structures, company forms are generally complex and unique to each corporation, at least in their detail. The balance between centralisation and decentralisation is constantly shifting to meet varying specific circumstances and changes in the internal power balance. Research by Goold and Campbell (1987), however, helps to crystallise certain predominant forms.

To attempt to discover the most appropriate structure for the multi-business corporation, the researchers investigated 16 UK-based major companies. They discovered that there was no one 'right' way to organise in the views of the companies, but three distinct organisational paradigms did emerge from the research, when the involvement of the centre and the SBUs was analysed from the viewpoint of strategic planning and operational control. The three different styles were named Strategic Planning, Strategic Control and Financial Control and each was found to be regarded as the most appropriate in different sets of internal environmental and external circumstances. Figure 5.7 gives an illustration.



Each of these styles is used in different sets of circumstances, and there are ways of choosing the style that suits a business best.

The Strategic Planning style

The Strategic Planning style was generally used in corporations that operate in one industry, for example BP in the oil industry.

- The company has a core business philosophy, the corporate centre is experienced in the industry, and works with middle management to develop strategy.
- Typically, the corporation is closely integrated with few bought-in services, and has a culture of strong leadership from the top.
- A matrix structure is likely to operate, as the corporation will have a large number of staff departments at the centre able to provide specialist expertise to the business units.

This style is very flexible in its mode of operation, but often fraught with internal politics since clear performance measures related to individuals are difficult to apply in objective terms.

The Strategic Planning style is seen as most appropriate for businesses where there are close links between product groups, and where the investment decisions tend to involve large sums in relation to the size of the company and to have long pay-back periods. Effective power comes very much from the top, and this is appropriate, since top management have typically spent many

years in the industry and worked their way up. The corporate centre typically has large staff departments that ensure that the corporation operates as a seamless whole.

The Financial Control style

In contrast to Strategic Planning, the Financial Control style involves very little operational interaction between the corporate centre and the SBUs.

- The portfolio of businesses may have no necessary connection between them in a market or product sense. Indeed, this is perceived to be of little importance, since the existence of potential synergies between them is generally not seen as an important issue.
- However, they may all have been bought to a common formula, for example, mature industry, undervalued assets suffering from undisciplined management.

The corporate centre is peopled by financial controllers, investment appraisers and deal makers who see their role as exerting tight financial control on the SBUs, and to work with the portfolio, buying and selling companies to maximise shareholder value. The Hanson Group is a good example of a successful exponent of the Financial Control style. In this style, the SBU general managers are chosen because they are highly motivated by the opportunity for recognised successful performance and the rewards this brings. They develop their own strategies and carry them out. If they are successful, they are well rewarded; if not, they tend to move on, or indeed the business unit may even be sold.

Investment decisions tend to be relatively small with short pay-back periods, so it is rare for a high technology company requiring large amounts of R&D expenditure to fit comfortably into a financial control group. That GE is run in a Financial Control style is thus perhaps one of its limitations, as it makes long-term decisions involving large amounts of R&D with uncertain results very difficult to make.

An essential feature of this organisational style is that the SBUs are easy to decouple in the event of a business sale. However, because of the difficulty of realising many of the scale and scope economies that arise in large integrated companies, such a style is unlikely to cause a successful international major corporation in mainstream industry markets to evolve. Its thinking is likely to be short-termist, and cost leadership is likely to be a dominant strategy.

The Strategic Control style

This style is midway between the Strategic Planning and the Financial Control styles and for this reason is both less stable, but possibly also more flexible, and more likely to be adopted in the more varied systems required by the increasingly turbulent economic situations of the global economy. It is close to the paradigm of the 'M form' organisation, in which the centre is responsible for strategy and overall resource allocation, and the divisions for operational matters.

The Strategic Control style is normally used where the portfolio of SBUs can be grouped into divisions under some classification, such as retail division, electronics division or, perhaps, financial services division. It might be thought that divisions should be configured where groups of SBUs exhibit similar core competences, but this is not necessarily the case in the evidence provided by the research.

The strategic role is adopted by both the centre and the SBUs, with the centre exercising its corporate strategy role and thereby setting parameters for the competitive strategy determination of the divisions and SBUs. Synergies in this organisational form are sought at divisional level but much less at corporate level, due to the relatively autonomous power of the divisional 'barons'.

The style does, however, have its limitations, as you will see on the next below.

Your notes

The limitations of the Strategic Control style

Although this is a most popular organisational form for the multi-business corporation, it has problems with focus: it is difficult to prescribe where the power lies and where the value added is expected to come from. In two separate companies adopting this form, can be found a situation where the corporate CEO has been reduced to a holding company role while the divisional heads exercise all the real power in running the corporation and, contrastingly, a situation with a powerful corporate CEO and divisional heads acting as little more than highly paid messengers.

As a result, the risk is always high that Strategic Control style companies will break up, and their divisions will seek separate stock exchange quotations, as it is demonstrated to the satisfaction of the shareholders that insufficient value is added by the centre to justify its cost. This has happened in the UK in a number of major corporations, notably RACAL, ICI and Courtaulds.

A major advantage of the Strategic Control style, however, is that it is ideally configured to form parts of Handy's (1992) 'federated enterprises' of the future. Under this concept, parts of companies, such as divisions or even SBUs of Strategic Control companies from a number of multi-business corporations, create alliances or federated enterprises to meet a market need in the expectation that when that market need ceases to exist, the part can easily uncouple and recouple with others in a new configuration. Such a concept potentially overcomes many of the inflexibility disadvantages found in the integrated traditional multinational organisation.

Selecting an appropriate style

The adoption of one or other of the three primary forms of multi-business organisation styles is, in Goold and Campbell's view, dependent upon two primary forces: an environmental and a personal force.

Strategic Planning

In certain circumstances, for example, the Strategic Planning style is appropriate, such as where the core business is in one industry and clear synergies exist from running an integrated corporation. Furthermore, being a winner in this industry involves using judgement to make large-scale investment decisions fraught with considerable uncertainty. The people running such a corporation, however, need therefore to be very experienced in the industry in question and, temperamentally, the chief executive needs to be a person willing and keen to get involved in the business and not just its balance sheet, profit and loss account and share price.

Financial Control

In companies operating the Financial Control style, the personality of the chief executive and the inner team is perhaps even more important. The chief executive needs to have an accountant's frame of mind and to be a deal-maker and good negotiator. It is perhaps best if the chief executive does not become too attached to any of the businesses to be bought as this will inhibit enthusiasm for selling them, should this be the best course of action to maximise shareholder value. In fact, both Lords Hanson and White were reported as only visiting their individual companies most reluctantly for just this reason.

As a result of the corporate heads' personalities and views of their role, the SBU portfolios of such companies are likely to be extremely varied by product and industry, but to have the common characteristics of little synergy between them, and to be immediately available for divestment should a buyer come along at the right price.

Strategic Control

For the Strategic Control style, the circumstances are less clear. The top executives need to be of both a financial and a strategic frame of mind and corporate skills are needed at both the centre and the divisional levels. The portfolio also needs to have some internal logic, in that divisions should ideally contain SBUs with some synergies between them or share similar core competences.

Your notes

The Goold and Campbell analysis of alternative styles for running a corporation is valuable since it focuses on three clear alternative paradigms, and thereby emphasises some of the key factors influencing organisational choice. The paradigms are rarely met in a pure form and most actual multi-business organisations exhibit characteristics of one but with aspects of another. In fact, the researchers were able in their research to fill in the other boxes in their planning–control matrix, but chose to focus on the three styles described, as they most fully differentiated themselves from each other, and embodied clear philosophies and their organisational implications.

Outcome and behaviour control

Control relates not merely to systems but also in a significant way to the monitoring philosophies adopted in a company.

Lorsch and Allen (1973) suggest that:

> the internal characteristics of an effective organization are contingent upon the work it must perform in dealing with its environment.

This is basic contingency theory and is fundamentally supportive of Chandler's contention (1962) that a firm's organisation structure should be selected in order to best carry out the corporation's chosen strategy. It is nowadays recognised that there is a degree of iteration in this process, in that corporations already have organisation structures, and the strategies they are able to carry out are to some degree also dependent upon the limitations imposed by those structures. Notwithstanding this caveat, few would dispute that the organisation needs to be so adjusted to be capable of carrying out the chosen strategy most effectively. If this is so, the corporate management planner needs to develop a control philosophy as well as a structural style.

In addition to selecting a style as suggested above, the corporate centre needs to so configure and coordinate the organisation as to reduce agency problems to a minimum. By an agency problem, we mean the tendency of managers to be motivated by factors other than the ultimate optimisation of the performance of the corporation. They may be motivated to maximise SBU performance, sometimes to the detriment of corporate performance, or even more narrowly to maximise personal satisfactions at the expense of both SBU and corporation.

In order to do this, the corporate centre needs to adopt a philosophy that will become central to the corporation of monitoring and controlling its personnel either by outcome or by behaviour. Whichever of these methods is adopted, the life of the corporation for its executives will be very different.

What are outcome control and behaviour control?

Outcome control involves measuring an executive by what he or she achieves, without concerning oneself too closely with the time or method spent achieving it. Thus in a university, outcome control of a tutor's performance at teaching would be measured to a large degree by the performance of the pupils in examinations and other tests of knowledge and ability.

Behaviour control is quite different. In this form of monitoring, a tutor's performance would be evaluated by having an inspector sit in on classes periodically with a check-list of factors to look for in the tutor's behaviour. In this case, the teacher could be graded highly even if the relevant pupils failed their exams.

Organisations dedicated to outcome control are relatively uninterested in the number of hours an executive is present in the office, and adopt an incentive system strongly biased towards the achievement of measurable results or outcomes. Under a behavioural control system, the executive's manner, political skills, actual decision processes and ability to gain a reputation as a 'good company player' are the keys to success. Under such a system, an executive may reach high rank with only minimal achievement if his or her 'face fits'.

Behaviour control is more likely to be adopted in Strategic Planning style companies, where the link between decisions and actual corporate performance is difficult to determine, in part because so many people have a hand in all major decisions. Outcome control, on the other hand, is more closely associated with Financial Control style companies, where actual financial results determine people's fate.

Where are outcome and behavioural control used?

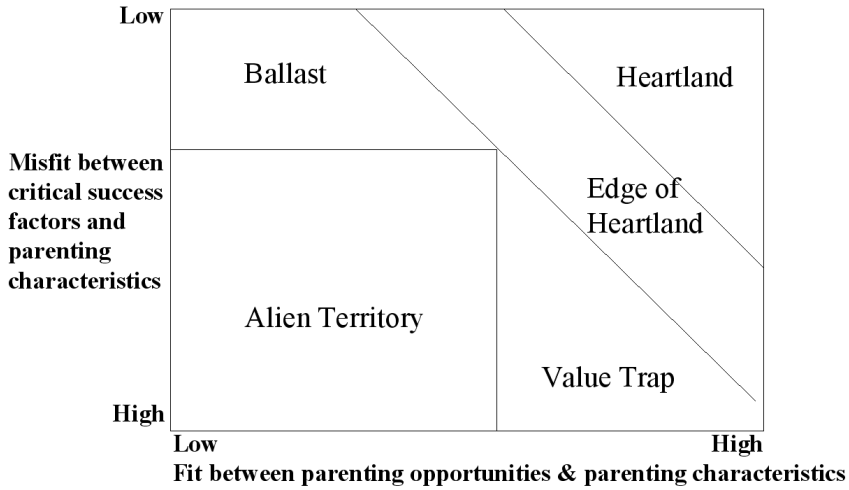
All companies, of course, employ both control methods to some degree and outcome control is more likely to be adopted in direct relation to seniority. Few would judge chief executives on the hours they have worked if company results are exceptionally good. Behaviour control is, however, almost universally exercised on the shop floor. Nonetheless, the culture and style of an organisation are strongly influenced by whether corporate controllers have a bias in system selection and maintenance towards outcome or behaviour control.

In efficiency and motivational terms:

> … outcome control is preferable when output and effort correlate closely without being distorted by exogenous factors. Behaviour control is preferable either when there is much uncertainty or many uncontrollable events so that output and effort are poorly correlated, or when senior management understands which behavioural items most affect outcomes and so can program management tasks. As a consequence, behaviour control requires an operating expertise that is found when the resource is fairly specific. (Collis & Montgomery 1995)

Parenting

Gould et al. (1994) in developing the Parenting-Fit matrix pull together the needs of the selecting role to have a portfolio analysis on one matrix, with the recognition that the SBUs in a corporation must have some relationship to each other if they are to justify remaining in that corporation. For an illustration of the matrix, see Figure 5.8.



The authors recognise that if the centre is to add value, it needs to have experience and capabilities to influence the SBUs in a value-enhancing way. The

Quick summary

Parenting

- Gould et al. in developing the Parenting-Fit matrix pull together the needs of the selecting role to have a portfolio analysis on one matrix, with the recognition that the SBUs in a corporation must have some relationship to each other if they are to justify remaining in that corporation.
- The authors recognise that if the centre is to add value, it needs to have experience and capabilities to influence the SBUs in a value-enhancing way.

centre also needs to recognise opportunities to exercise those capabilities in relation to the SBUs that will influence the achievement of the key success factors in the markets in which the SBUs operate. Using axes that encapsulate these factors, they describe a 'Heartland' and 'Edge of Heartland' for the corporation that should ideally describe the corporation's whole portfolio. It also identifies three areas of the matrix outside the Heartland that may contain SBUs that are a poor fit for the corporation. They are the value trap, the ballast area and the alien territory.

The value trap is very dangerous. SBUs have a fit with parenting opportunities but not with critical success factors. The corporation may not have the qualities needed to succeed in the identified industries, for example through excess bureaucracy or insufficient marketing skills, and the centre will waste time and resources chasing after opportunities they are not suited to exploit.

The ballast area is one with few remaining opportunities, but which the parent knows and understands well. To remain in these businesses may slow growth as value creation proves elusive. The businesses may be cash cows without much milk left.

The alien territory businesses are those that are recognised not to fit within the corporation. They may still be making profits but should be divested as they are likely to be value destroying to the corporation as a whole.

The essence of the matrix and the concept of parenting is to stress the need for the top management team running the corporation to own and direct companies with which they have some affinity from previous experience and/or inherent capability, and for that affinity to be translatable into genuine value added for the corporation.

Summary

This topic has considered the nature of the role of the centre in a multi-business corporation, i.e. corporate strategy. It has identified the separate functions as promoting, selecting, resourcing and controlling, and then added parenting as a more overall function covering many of the identified responsibilities in a more integrated way. The work of Goold and Campbell has been highlighted as of particular salience in the corporate strategy literature.

Task ...

Task 5.1

To check your understanding of the material in this topic, try to answer the following questions. If you have any difficulties, you may wish to go back and revise the relevant part of the topic.

1. What is meant by corporate as opposed to competitive strategy?
2. Why does the corporate centre so rarely add value?
3. What are the main activities of the promoting function?
4. To what extent are the traditional portfolio matrices valuable to a modern corporation?
5. What are the alternative methods of resourcing a corporation?
6. List the principal methods by which the corporate centre controls the corporation.
7. In the Parenting-Fit matrix, what is the importance of the 'Heartland'?
8. Define alien territory, value traps and ballast in the Parenting-Fit matrix.
9. What are Goold and Campbell's three principal 'styles', and when is it appropriate to use each of them?
10. Why are related SBUs considered preferable in a corporation to unrelated ones?

Resources

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Topic 6

Real Option Theory

Aims

The purpose of this topic is to:

- show the limitations of traditional models for assessing investment risk;
- illustrate how the modern theory of real options overcomes some of these;
- describe the types and nature of real options;
- shows the development of real option theory.

Objectives

By the end of this topic you should be able to:

- understand the nature and importance of investment appraisal;
- be able to employ a real options mind-set in approaching future investment opportunities;
- describe how real option theory developed;
- explain the different forms of real options and their key characteristics.

Overview

This topic addresses the problem encountered when a firm assesses that it cannot necessarily expect to achieve its financial and other objectives operating with its current products in its current markets. It must venture beyond known product/market boundaries and possibly develop or acquire new competences. This almost inevitably involves increasing risk, since it means venturing into unfamiliar territory. This topic argues that the use of real option theory can both constrain and contain the risk, whilst also sometimes leading to unforeseen opportunities.

Traditional Investment Analysis

Until the arrival of real option theory, traditional investment appraisal took the following form.

- First a model was built of the forecast costs and revenues likely to come about from the investment on a cash flow basis.
- Both costs and revenues were then discounted back to the present using the forecast discount rate.
- A view was taken of the number of years over which the investment was likely to generate revenues, and the resale value of whatever assets were involved were estimated for the end of the investment period.
- This enabled a discounted cash flow to be calculated, and a view to be taken about whether the investment should be carried out.

The problems with this were as follows:

- The whole value of the investment was allowed for, i.e. jumping in the water, rather than putting a toe in, as real options might be described.
- The number of years the investment would generate revenues could not be more than a guess, and was therefore likely to be wrong.
- Similarly the discount would have to be guessed at, and so would the projected cash flow from the investment.
- So although accurate calculation could be made, the assumptions were likely to be widely inaccurate, and the ultimate figure arrived at would be a single figure rather than a range.
- In such circumstances apparent scientific or arithmetic calculation conceals high levels of uncertainty in even the best of future projects.

In addition no allowance is made for changes in the market, for the level of competition, and increases or decreases in the level of costs. The current debate about the costs of the Scottish parliament building, off by a factor of 10 times, shows how even professionals can be widely off beam when estimating future costs.

Common sense suggests investing slowly when to do so does not damage one's ability to invest in a more major way in the future, when the pattern of the unfolding opportunity has become more apparent. This is where real option theory comes in.

Real Option Theory

The risk cube described in Topic 5 is based on the principle that the greater the unfamiliarity of products, markets, allies, new acquisitions or necessary key competences, the greater the risk. Real option theory provides a different perspective on uncertainty in that it suggests that the more uncertain a project is, the more cautiously one should proceed. A real option is defined as an investment decision that is characterised, according to Kogut (2000) by:

- Uncertainty
- Managerial discretion over timing
- Irreversibility

Your notes

Quick summary

Real Option Theory

- Real option theory provides a different perspective on uncertainty from the risk cube, in that it suggests that the more uncertain a project is, the more cautiously one should proceed.
- A real option is defined as an investment decision that is characterised, according by uncertainty, managerial discretion over timing, and irreversibility.
- Like most management decisions to venture into new areas the outcome is likely to be uncertain. However, it is generally not vital to success that a major investment is made instantaneously.
- The real options approach applies financial options theory to real investments, such as manufacturing plants, product line extensions, and research and development.

Like most management decisions to venture into new areas the outcome is likely to be uncertain. However, it is generally not vital to success that a major investment is made instantaneously. Indeed to proceed cautiously, with an eye always to not proceeding if the attractiveness of the investment diminishes, is a sensible approach that will lead to least loss if the investment turns out not to be a success. However once the investment is made the capital cannot be recovered. In such situations a real option approach is an attractive and low risk one.

Upton (2000) describes the measurement of real options as follows:

> Perhaps the most promising area for valuation of intangible assets is the developing literature in valuation techniques based on the concept of real options. Techniques using real options analysis are especially useful in estimating the value of intangible assets that are under development and may not prove to be commercially viable.
>
> A real option is easier to describe than to define. A financial option is a contract that grants to the holder the right but not the obligation to buy or sell an asset at a fixed price within a fixed period (or on a fixed date). The word option in this context is consistent with its ordinary definition as "the power, right or liberty of choosing." Real option approaches attempt to extend the intellectual rigor of option-pricing models to valuation of non-financial assets and liabilities. Instead of viewing an asset or project as a single set of expected cash flows, the asset is viewed as a series of compound options that, if exercised, generate another option and a cash flow. That's a lot to pack into one sentence. In the opening pages of their recent book, consultant Martha Amram and Boston University professor Nalin Kulatilaka offer five examples of business situations that can be modeled as real options:
>
> - Waiting to invest options, as in the case of a trade off between immediate plant expansion (and possible losses from decreased demand) and delayed expansion (and possible lost revenues).
> - Growth options, as in the decision to invest in entry into a new market.
> - Flexibility options, as in the choice between building a single centrally located facility or building two facilities in different locations.
> - Exit options, as in the decision to develop a new product in an uncertain market.
> - Learning options, as in a staged investment in advertising.

Upton (2000) continues:

> Real-options approaches have captured the attention of both managers and consultants, but they remain unfamiliar to many.
>
> Proponents argue that the application of option pricing to non-financial assets overcomes the shortfalls of traditional present value analysis, especially the subjectivity in developing risk-adjusted discount rates. They contend that a focus on the value of flexibility provides a better measure of projects in process that would otherwise appear uneconomical. A real-options approach is consistent with either fair value or an entity-specific value. The difference, as with more conventional present value, rests with the selection of assumptions. If a real option is available to any marketplace participant, then including it in the computation is consistent with fair value. If a real option is entity-specific, then a measurement that includes that option is not fair value, but may be a good estimate of entity-specific value.

Your notes

The real options approach applies financial options theory to real investments, such as manufacturing plants, product line extensions, and research and development. A financial option gives the owner the right, but not the obligation, to buy or sell a security at a given price. Similarly, companies that make strategic investments have accorded to themselves the possibility of exploiting these opportunities in the future. However, whilst a financial option involves a piece of paper in the form of a contract, a real option often does not. It merely shows an attitude to investment based on minimising exposure until more is known, and thereby keeping other options open.

As Kogut and Kulatilaka (2001) put it, real options take a number of forms.

Expand

If an initial investment works out well, then management can exercise the option to expand its commitment to the strategy. For example, a company that enters a new geographic market may build a distribution centre that it can expand easily if market demand materialises.

Extend

An initial investment can serve as a platform to extend a company's scope into related market opportunities. For example, Amazon.com's substantial investment to develop its customer base, brand name and information infrastructure for its core book business created a portfolio of real options to extend its operations into a variety of new businesses.

Abandon

Management may begin with a relatively small trial investment and create an option to abandon the project if results are unsatisfactory. Research and development spending is a good example. A company's future investment in product development often depends on specific performance targets achieved in the lab. The option to abandon research projects is valuable because the company can make investments in stages rather than all up-front.

Each of the options you have just read about – expand, extend, and abandon – owes its value to the flexibility it gives the company.

Flexibility adds value in two ways:

1. First, management can defer an investment. Because of the time value of money, managers are better off paying the investment cost later rather than sooner.
2. Second, the value of the project can change before the option expires. If the value goes up, the firm is better off. If the value goes down, it is no worse off because it doesn't have to invest in the project.

Figure 6.1 illustrates the circumstances under which real option theory is at its most valuable to a firm.

		Uncertainty Probability of receiving new information	
		Low	High
Room for managerial flexibility Ability to respond	High	Moderate flexibility value	High flexibility value
	Low	Low flexibility value	Moderate flexibility value

Flexibility value, hence the need for real option theory (ROT) is at its greatest, is where uncertainty is highest, and the opportunity for man-

agement to respond is greatest

Where real option theory is at its most valuable to a firm is in the top right-hand box of the diagram. This is where uncertainty is greatest, the probability of receiving new information relevant to the project is high, and the room for management to respond flexibly to this changing information is at its highest. Both factors need to be high for real option theory to be operable. Management flexibility in conditions of low uncertainty is not necessary, and high uncertainty where the project does not afford the opportunity for management flexibility is fruitless.

It is important to realise that, unlike financial options, real options do not require the possible existence of a tradable security. They may merely represent the softer option to defer major investment until the level of uncertainty surrounding the project is lower. Traditional valuation tools, including discounted cash flow, cannot value the contingent nature of the exploitation decision: ' things go well, then we'll add some capital'.

The History of Real Option Theory

Real option theory emerged out of the work on financial option theory of Fischer Black and Myron Scholes as modified by Robert Merton. Its central concern is investment appraisal and decision-making, and owes its emergence to the growing disillusion with net present value (NPV) and discounted cash flow (DCF) methods of appraising investment opportunities.

> The NPV rule is not sufficient for investment appraisal. To make intelligent investment choices, managers need to consider the value of keeping their options open. (Dixit and Pindyck 1994)

NPV and DCF depend for their validity on the investment appraiser being able to accurately predict the cash flow and its timing over the life of the proposed project, and also the prevailing discount rate over the same period. In most cases this is quite impossible to do, and the appraiser is reduced to making the same sort of guesses that he would have to make when using less apparently sophisticated methods.

The principle behind real option theory is quite different. It suggests that one should not make major commitments until one has to, and that by putting them off one will have more up-to-date, hence better, information with which to make the decisions.

Financial options vs real options

The McKinsey Quarterly (Leslie & Michaels 1997) sets out the means by which financial options are valued. A financial option grants the holder the right to buy or sell a stock at a fixed price within a fixed period.

That price increases:

- with the level of uncertainty of stock price movements;
- with the time to expiry of the option;
- with the level of the risk free interest rate; and
- with an increase in the spot level of the price of the stock.

The price of the option decreases:

- the lower the current level of the stock; and
- the greater the level of dividends paid on the stock.

In a similar way a real option grants the investor the right to realise future pay-off in return for further investments, but without the obligation to invest further. The option can just be allowed to run out if on further consideration the project comes to look unattractive.

The value of the option increases in line with financial options:

Quick summary

The History of Real Option Theory

- Real option theory emerged out of the work on financial option theory.
- Real option theory suggests that one should not make major commitments until one has to, and that by putting them off one will have more up-to-date, hence better, information with which to make the decisions

- if the level of uncertainty increases;
- if the up-side potential of the expected cash-flow increases;
- if the time to expiry of the option increases; and/or
- if the risk-free interest rate increases.

The option value decreases if:

- the present value of fixed costs goes down;
- the amount of value lost over the duration of the option increases; and/or
- the present value of expected cash-flows goes down.

Below is an example of how real option theory can be used effectively.

Effective Use of Real Option Theory

Leslie and Michaels (1997) give an example of how real option theory is more effective in getting the right decision that the NPV system. Thus:

- An oil company can buy a licence on a block expected to yield 50 million barrels
- The current price is $10 a barrel
- The current cost of development is $600 million
- Thus $500million – $600 million = – $100 million
- **Decision: Do not invest**

However, using a real option approach leads to the following computations:

- Uncertainty on the reserves and future price has a standard deviation of 30%
- Holding an option costs $15 million per annum
- The maximum duration of the option is 5 years
- The risk-free rate of interest is 5%
- Thus the real option valuation of the project is +$100million
- **Decision: Buy the option**

Buying the option defers commitment to the major investment, until the company can see if the future information on price, costs and level of reserves change in the option holder's favour.

The advantages of using real options

As you saw in the example above, real options are therefore important because they afford a level of flexibility that NPV and DCF tools ignore. They force the investor to consider the uncertain potential of the future, and to realise that the future has up-side potential as well as downside. During the holding of the option new reserves may be discovered, and/or the price of oil may escalate. The holding of options emphasises in the minds of the firms' executives the prime value of learning and digesting new up-to-date information, before decisions are made on the substantive investment.

- If the decision not to go ahead is taken, then all that is lost is the value of the option.
- If the project looks some time into the option period to be attractive enough to invest in, in a major way, then the taking of the option early on puts the would-be investor in a good position to make the investment with stronger grounds for belief in its attractiveness, than would have been possible without the delaying tactic of the option.

Levers for increasing the value of the option

Furthermore options can even be managed proactively to increase their value, or sometimes traded on, if the holder feels inclined to do so. What Leslie and Michaels (1997) describe as levers for increasing the value of the option, once it has been taken include:

- Taking actions to increase the present value of expected cash inflows or correspondingly to decrease the value of expected outflows;

Your notes

- Extending the opportunity's duration; and
- Reducing the value lost by taking an option, rather than investing immediately in a substantive way can also increase the value of the option. This might be done for example by locking in key customers in anticipation of being able to service them when the option is converted into a major investment.

Sensitivity analysis can be applied to all the levers that change the value of the option, in order to identify those levers that are most likely to increase option value, and be most subject to being operated upon.

Real Options and the Resource-Based View

The last thirty or so years of strategy thinking have been dominated successively by three dominant cognitive frameworks as Kogut and Kulatilaka (2003) point out, namely:

1. Portfolio theories exemplified by the famous Boston Box.
2. Industry analysis dominated by the models of Michael Porter (1980,1985).
3. The resource-based view (RBV) of which Hamel and Prahalad (1994) are perhaps the most popular popularisers, with their concept of core competences.

Figure 6.2 illustrates these.

Cognitive frame	Theory	Initial data	Analysis	Implementation
1. Experience	Scale & experience drivers	Attractive, markets	Relative market position	Dominance by scale
2. Industry analysis	Industrial economics	Industry forces	Cost or differentiation	Value chain exploitation
3. The RBV	Real options	Intended strategy	Core competence	Exploratory business strategies

Adapted from: Kogut and Kulatilaka (2003).

We are covering each of these frameworks in more detail in this course, but for now let us summarise each one:

The Boston Box

The 1970s saw the popularity of the BCG portfolio model of the Boston Box as a simple heuristic tool for identifying the appropriate corporate strategy to adopt. It shared the common belief that size meant success, mediated through the observation that the experience curve enables firms to reduce unit costs with increasing output, thus achieving a dominant market position when they have achieved leading market share. The poor performance of conglomerates in the late seventies subsequently led to scepticism regarding the effectiveness of such simplistic theories, and cast doubt upon portfolio theories that accepted totally unrelated SBUs as members of the same group.

Models of Michael Porter

The Porterian industry analysis of the early 1980s built on the industrial economics belief that industry structure had a strong influence on company profitability. The neglect of the key factor of company differential endowment with specific capabilities led to its limited success in helping in the choice of appropriate business strategies.

The resource-based view

Quick summary

Real Options and the Resource-Based View

- The last thirty years of strategy thinking was dominated by three cognitive frameworks:
  - » Portfolio theories (Boston Box)
  - » Industry analysis (Michael Porter)
  - » Resource-based view (RBV)
- **Boston Box**: simple heuristic tool for identifying the appropriate strategy, believing that size meant success - reduce unit costs with increasing output.
- **Michael Porter**: industry structure had a strong influence on company profitability.
- RBV: a firm can retain sustainable competitive advantage if it could build its position on capabilities that were valuable, rare, inimitable and un-appropriable (VRIN).

In the late 1980s the resource-based view, which remedied this industry analysis defect, came into its own. This theory suggested that a firm could retain sustainable competitive advantage if it could build its position on capabilities that were valuable, rare, inimitable and un-appropriable (VRIN) (Barney 2003). Hamel and Prahalad (1994) add that they should also be extendable to multiple markets, hard to copy and should satisfy a derived consumer demand.

The theory of real options builds on the resource-based theory that you read about above, in that a real option is defined by an investment decision characterised by:

- Uncertainty
- The existence of future managerial discretion on timing
- Investment extent and irreversibility

Thus the value of a capability is not based merely on what it is capable of doing at present, but on its potential for the future. Mechanical engineering capabilities for example are at present likely to be valued less highly than electronic ones, since the former represent yesterday's technology, and may be expected to be less central to generating future profits than their electronic equivalents. Options taken out in the form of investment in new electronic technology is likely ceteris paribus to be more valuable than investments in traditional engineering technology. Although of course there is a partially balancing factor of the greater uncertainty of cutting-edge technology, since no one can be quite sure if it will become dominant. Real options become important here therefore.

The importance of appreciating the linkage of real option theory to core competence analysis is that it emphasises the importance of introducing market valuations to core competences, a point which even Teece, Pisano and Shuen (1997) with their evolutionary concept of dynamic capabilities, fail to do.

Your notes

Compound Options

Copeland and Keenan (1998) comment that business decisions in many situations can be implemented flexibly by means of deferral, abandonment, expansion or in a series of stages that in effect constitute real options. Compound options involve sequenced investments, such that making the first investment gives the company the right to make the second, which in turn confers the right to make the third and so forth.

A case study developed by Copeland and Keenan (1998) illustrates the principle of staged options for investment.

Copeland and Keenan Case Study

A chemical company was considering whether to invest in a new plant for manufacturing polyester. It had the option of staging the investment over 12 months: $50 million up front for design, $200 million six months later for preconstruction work, and $400 million to complete the construction at the end of the year.

The factory was to convert p-xylene into polyethylene terephthalic acid (PTA), for which the price per ton of both fluctuates with the business cycle.

For the polyester industry, historical data suggested that the prices of both input and output chemical tended to revert to the mean over the cycle. Received opinion held that a company should invest when the input/output spread of price was considerably higher than its long-term average. An NPV valuation of the project suggested a negative $70million and therefore that the project should not be undertaken. A real option valuation gave a positive value of $350million, suggesting that the company should invest in the design stage at the very least. It also clarified the criteria for making decisions later on, namely the cut-off values for the spread, below which it would make

sense to abandon the project.

The reason for the difference is as follows. The NPV calculation was very sensitive to the spread, and assumed that if the spread declined, future revenues would fall below the $650million cost of the project. The real option approach gives the company the opportunity to cut its losses at several stages. The flexibility to walk away at several distinct points makes the risk of making losses on $650million much lower. Because the options approach recognises management's power to limit its losses, it factors this into its calculations, while noting also the potential for large gains. It thus comes up with a positive value.

Source: Copeland and Keenan (1998).

The case study is only one of many possibilities of staircases to growth (Baghai, Coley and White 1999) and may be seen in companies entering new markets, embarking on new technologies, or acquiring companies in new areas. The growth staircase is a compound option; if the initial acquisition is unsuccessful, the company does not need to proceed with another.

Learning Options

Compound options build value on an increase in flexibility. Learning options build it on the reduction of uncertainty. As Copeland and Keenan (1998) point out, learning options arise when a company can speed up the arrival of important information by making a limited investment, e.g. trial drilling for iron ore. Companies with learning options must balance the value of the option to act on the knowledge they gain, against the cost of obtaining that knowledge in the first place.

For example, if a company owns the right to mine land for minerals, it must decide whether to do so immediately, or defer development in the hope that the price of the ore will rise. Real option theory can be used to determine the best time to exercise the option. However, the firm may also have doubts about the quality of the ore. To resolve this uncertainty it may need to carry out limited pilot drilling. This will incur costs, but will be cheaper than going ahead with the full project in conditions of quality uncertainty (Copeland and Keenan 1998).

It may be of course that a given situation contains both a learning option and a compound option. In this case both factors need to be taken into consideration before arriving at a decision for action. R&D projects normally do combine learning and compound options. Clearly they can be embarked upon in a staged fashion, and they always involve uncertainties. The development of a new drug is fraught with uncertainties, and if evaluated in NPV fashion is almost bound to give a lower valuation than if approached through real option theory, both compound and uncertainty.

Quick summary

Learning Options

- Compound options build value on an increase in flexibility.
- Learning options build it on the reduction of uncertainty.
- Companies with learning options must balance the value of the option to act on the knowledge they gain, against the cost of obtaining that knowledge in the first place.

Real Option Valuation (ROV)

Real options present a new and more flexible way of valuing new potential investments or indeed charting the way forward for a company. The mindset recognises that the future is uncertain and therefore to chart one single path forward definitively is probably a path to disappointment.

As Standard and Poor's Applied Decision Analysis (ADA) team state (2001) real options recognise a 'multipath' view of business, where there are many possible routes to success. Given the uncertainty and irregular speed of change in the world, the completely right path cannot often be chosen at the outset. Instead, one must set off in the right direction, actively seek learning opportunities, and then be prepared to adjust appropriately as events dictate.

How does ROV improve on traditional techniques? First, ROV pro-

Quick summary

Real Option Valuation (ROV)

- Given the uncertainty and irregular speed of change in the world, the completely right path cannot often be chosen at the outset. Instead, one must set off in the right direction, actively seek learning opportunities, and then be prepared to adjust appropriately as events dictate.

vides a better assessment of the value of strategic investments and a better way of communicating the rationale behind that value. In most traditional investment valuations, a base DCF value is calculated. Then, this base value is 'adjusted' heuristically to capture a variety of critical phenomena. Ultimately, the total estimated value may be dominated by the 'adjustment' rather than the 'base value'. With ROV, the entire value of the investment is captured rigorously. Conceptually, this includes the 'base value' obtained from managing the investment in nominal fashion, and the 'option premium' obtained from managing the investment actively and exercising options appropriately. This is illustrated in the figure [6.3] taken from a high tech R&D application. (ADA 2001)

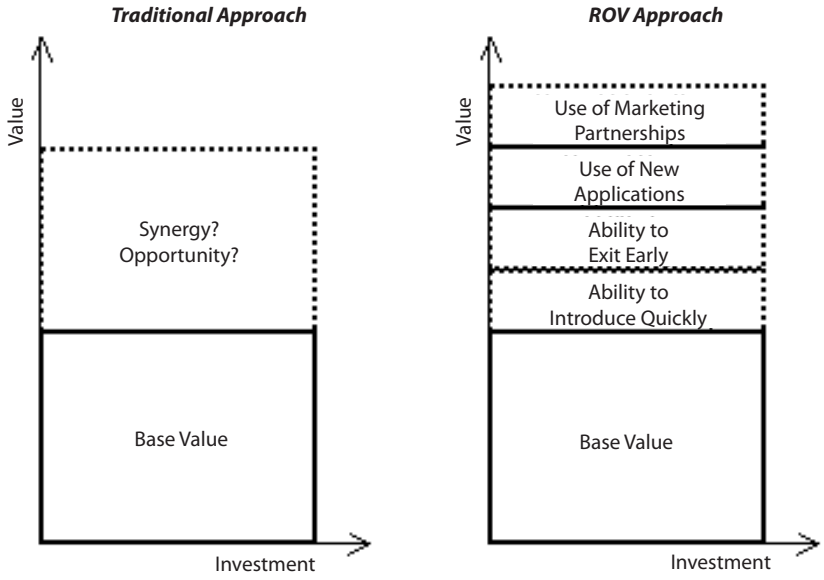


Figure 6.3 (above) illustrates a situation in which additional value is created by introducing the product quickly if initial test results are favourable. This is similar to a financial call option. It also hypothesises that additional value may be created by exiting (and licensing) if early market results are unfavourable. This is like a financial put option.

New applications and market partnerships are other options that add value under specific conditions. By identifying and evaluating these options as carefully as possible, the net effect is a more accurate estimate of the value that shareholders are likely to obtain from the investment, and a clearer understanding of where that value comes from.

Real option value (ROV) also provides an explicit roadmap for achieving the maximum value from a strategic investment. Most traditional investment valuations produce a number, and perhaps a set of assumptions underlying the number. However, the management actions required over time to realise this value are not clearly identified. With ROV, the value estimate is derived specifically by considering these management actions. As a result, ROV indicates precisely what events are important, what milestones to watch for, and what responses are necessary to achieve maximum value.

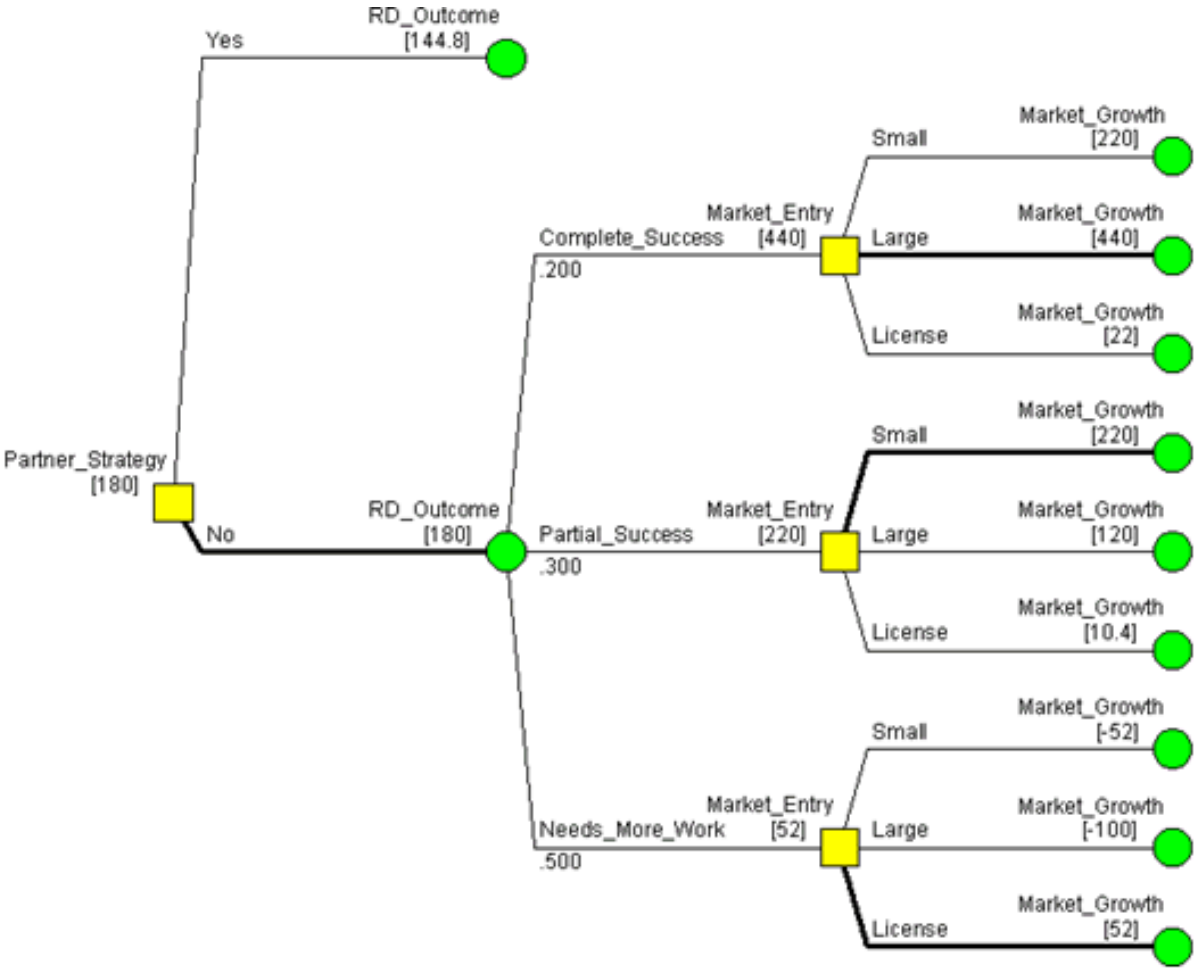
This is illustrated in Figure 6.4 in the form of a DynamicRoadmap™ from an e-business application (Standard and Poor's ADA 2001).

Figure 6.4 demonstrates that technology change and market response must be watched closely. It also shows how the market strategy shifts as these events unfold to show how the most value can be achieved from which actions.

Your notes

Application of ROV

ROV is typically applied in a three-step process (ADA 2001). As the ADA team put it:



The first step is multi-disciplinary, creative OpenFraming™. The purpose is to understand the risks and opportunities that affect the value of the investment, and the possible ways it can be managed over time to produce value. The result is a complete understanding of the potential investment, including optionality.

The second step is formal, Quantitative Analysis. The purpose is to develop the data and models needed to describe the evolution of events over time, the decisions that must be made as those events unfold, and the impact of those events and decisions on shareholder value. During this step, critical information to value the investment is obtained from expert judgment or capital markets as appropriate.

The third step is Interpretation. The purpose is to communicate the analytical results in directly useful and understandable terms. The result is consensus on the value of the investment, the strategic direction, and the action plan required to maximize value.

More and more firms are recognizing the value of ROV and are adopting it. As a result, ROV is now being applied across a wide range of industries and applications, ranging from energy M&A to life sciences R&D to high tech e-business. At the same time, thought leaders in both strategy and valuation are recognizing the value of the real options approach.

Here are other view points on the application of ROV:

> … a business strategy is much more like a series of options than a

series of static cash flows. Advances in both computing power and our understanding of option pricing … make it feasible now to begin analyzing business strategies as chains of real options. (Timothy Luehrman, 1998)

The breakneck pace of change and elevated uncertainty demand new ways of strategic thinking and new tools for financial analysis. Real options are at the core of such a strategic and financial framework…[and] will become an increasingly important tool in security analysis. (Michael Mauboussin 1999)

Your notes

Summary

Risk is in the nature of all major business decisions. In its absence the issue is merely an administrative one of efficient organisation. Risk can of course vary from very low to extremely high, and it is probable that more companies go bankrupt due to failing to assess risk properly than from any other reason. Correspondingly companies frequently fail to make investments because their toolkit of risk assessment tools gives them a lower forecast opportunity benefit than would properly-applied real option theory.

Use of the risk cube described in Topic 5 helps a company to rate the risk levels of different possible courses of action in a very ordinal sense. It will enable the executive to perceive the relative risks of entering unfamiliar areas of activity, and of doing so through risky means like acquisitions. However, if a numerical calculus is required before a decision is made, the adoption of real option theory can provide this. By calculating real options, whether of a simple, compound or learning type, or some combination of all three, the decision-maker will be able to see what the upside and downside potential is for various actions including expansion, deferral, abandonment or slower and more incremental development. The future is likely to lead to greater use of option theory than is currently the case, and a diminution of a simplistic net present value approach, based on an absence of consideration of managerial flexibility in the project or of the possibility of reducing uncertainties through learning and the acquisition of better information.

The use of real option theory in a firm is also bound to change the nature of management's thinking. Instead of being frightened in the presence of uncertainty, management using real option theory is likely to find the exercise of options stimulating, and to become more innovative in the knowledge that a number of small investments are unlikely to break the company, and maybe one will come off in a big way. The use of real options also emphasises the need to obtain the most recent and the most accurate information in the company. Furthermore it emphasises the value of strategic opportunism, enhances the value of strategic leverage, and minimises long-term commitment in favour of high flexibility of operations.

Task ...

Task 6.1

To check your understanding of the material in this topic, try to answer the following questions. If you have any difficulties, you may wish to go back and revise the relevant part of the topic.

1. What is the relationship between real options and financial options?
2. To what extent do real options help in strategy development?
3. How important is uncertainty in strategy development?
4. How can the value of a real option be increased?
5. What reduces the value of a real option?
6. What is a compound option?
7. What is a learning option?
8. How can real options be regarded as similar to financial 'put' or 'call' optionst.

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Topic 7

Strategic and Organisational Learning in Complex Environments

Aims

The purpose of this topic is to:

- to introduce the concept of organisational learning;
- to describe how to build the learning organisation;
- to show how learning can lead to new competencies;
- to introduce chaos and complexity theory.

Objectives

By the end of this topic you should be able to:

- examine the linkage between continuous innovation, organisational learning and competitive advantage;
- define what is meant by the term 'organisational learning';
- consider how the development of a learning organisation may be facilitated;
- identify how organisational learning may be translated into organisational knowledge (the basis of core competencies);
- develop an understanding of organisational complexity through the lens of chaos theory;
- establish ways of coping with complexity and factoring complexity into strategy making.

Building the Learning Organisation

A corporation that is aiming to leverage its strategic advantage through continuous innovation needs to develop its learning capabilities. The term 'learning organisation' has appeared in the literature in recent years to refer to the kind of organisation that has such capabilities (Senge 1990). Organisational learning may be defined as the ability of a firm to update, upgrade and acquire new knowledge. As Hawkins (1994) points out, organisational learning is not a systematised organisation development tool. Enhancing the ability of an organisation to learn is not a matter of applying a straightforward established technique.

Senge (1990) has some suggestions to offer as to how the development of a learning organisation can be facilitated. He also highlights some of the stumbling blocks to creating a learning organisation. Much of the literature on organisational learning stresses its importance as a strategy for coping with change in the competitive environment (see Topic 17). It suggests that organisations with superior learning capabilities can gain competitive advantages through being in a better position to innovate. Senge (1990) argues that there are five building blocks for creating a learning organisation:

1. Systems thinking
2. Personal mastery
3. Mental models
4. Building shared vision
5. Team learning

The kind of learning Senge has in mind is not the adaptive learning that would help the organisation adjust to environmental changes. It is generative learning, about creating rather than coping. It calls for new ways of looking at the world. Systems thinking is concerned with seeing the interconnectedness of organisational elements, grasping the broad picture, being able to focus on the most important areas and being able to implement enduring solutions to problems instead of merely treating the symptoms. This requires organisational members to learn new skills, take on new roles and learn new patterns of behaviour.

Senge accords a key place to mental models. He suggests that many of the best ideas in organisations are never put into practice. This, he argues, is because they are abandoned when they conflict with established perspectives. Whereas Hamel and Prahalad (1994) speak of mobilising people around a strategic intent, Senge refers to energising visions. They are nevertheless both visions which provide a future orientation.

Senge allows for the possibility of vision change. "At any one time there will be a particular vision of the future that is predominant, but that image will evolve."

However, he cautions management against the kind of short-term extrinsic vision, such as defeating a competitor, which will invite complacency leading to a defensive position. Senge suggests that intrinsic and extrinsic visions need to coexist and that this will energise a new level of creativity and innovation. Teamwork and team learning are put forward as key aspects of the development of a learning organisation and leadership is accorded a central place.

Senge writes, "I believe that this new sort of management development will focus on the roles, skills and tools for leadership in learning organisations".

Quick summary

Building the Learning Organisation

- A corporation that is aiming to leverage its strategic advantage through continuous innovation needs to develop its learning capabilities.
- Much of the literature on organisational learning stresses its importance as a strategy for coping with change in the competitive environment
- Organisations with superior learning capabilities can gain competitive advantages through being in a better position to innovate.

Organisational Knowledge and Competitive Advantage

If it is to be considered as a model for managing change, organisational learning is based on the assumption that learning is invariably beneficial, that collective learning may add more to the organisational whole than individual learning and that this kind of learning has the capacity to make the organisation more creative and profitable.

One of the ways in which organisational learning may profit an organisation is by accumulating organisational knowledge. As John Kay explains, all firms possess knowledge, but not all of it is of equal value (Kay, 1993, p. 73).

He offers the example of an insurance company that normally knows as much about insurance as its employees know. Other companies will possess the same knowledge. However, if a particular insurance company builds up a data bank and skills relevant to the assessment of a particular type of insurance risk, and that data and those skills are truly those of the company and not just of a small group of employees, then the company has created organisational knowledge. That knowledge may then give the company a distinctive capability in relation to the particular kind of insurable risk, to which this knowledge relates, and this could be a source of competitive advantage in that particular risk category.

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Creating organisational knowledge is, according to Kay, a question of turning the expertise of individuals and groups into business know-how.

In some types of firm, such as professional service firms, individual expertise can be translated into practices, procedures, systems and routines which, it may be recalled, is where the strategic capabilities of the organisation lie and is where strategic innovation is focused. This process of translation ensures that organisational knowledge pertains to the organisation itself and not just to the individuals and groups employed within it.

Once such systems have been established, the organisation will retain the knowledge it embodies even if the individuals who brought it into the organisational context subsequently leave. If the practices, procedures systems and routines reflect the combined knowledge inputs from several individuals, then if any one leaves the organisation, the organisational knowledge cannot be taken in its totality elsewhere, and therefore cannot be emulated.

If an organisation can continually learn and acquire new knowledge, and update, amend and develop its systems to reflect this knowledge, then it can turn organisational learning into an organisational knowledge advantage.

Quick summary

Organisational Knowledge and Competitive Advantage

- Organisational learning is based on the assumption that learning is invariably beneficial
- Collective learning may add more to the organisational whole than individual learning
- Organisational learning has the capacity to make the organisation more creative and profitable

Your notes

Organisational learning on its own is not therefore a sufficient condition for sustained competitive advantage.

Organisational learning and strategic advantage

In short, effective organisational learning, if it is to confer competitive advantages upon the firm, has at least two major components:

1. The learning component: the literature on organisational learning is for the most part addressed to this component. It is centrally concerned with such issues as the ability to learn collective as opposed to individual learning and how to generate collective knowledge.
2. The strategic innovation component: this is the ability to translate learning into new practices, procedures, routines and systems, and to continually update, modify and add to them as necessary to reflect knowledge acquisition in a continuous process of innovation.

Clearly, one component without the other is not sufficient to confer competitive advantage. This, no doubt, is one of the factors that lies at the roots of the scepticism about organisational learning expressed by writers such as Hawkins (1994). If consultants and companies focus centrally upon developing organisational learning, even if their efforts are successful, managers will be disappointed if the organisation does not also develop the ability to translate organisational learning effectively into the practices, procedures, routines and systems that turn it into organisational knowledge. Without this capability, competitive advantages will not accrue and the good ideas that have been put forward by Senge (1990) and others run the risk of being dubbed as just another management fad.

Dynamic Understandings of Organisations in their Environments

In Topic 2, we briefly discussed the work of Karl Weick (1979) and how he approaches an understanding of organisations from a sociological and psychological perspective. With hindsight, Weick's work supports the view that approaches to strategy that treat the organisation as if it were a linear system misrepresent the nature of cause and effect in organisations. Human perceptions and interpretations cannot be predicted with accuracy, although different scenarios based upon different ways of managerial reasoning might be considered to be determinate. Strategic decisions are not a matter of right or wrong as in mathematics; they are a matter of success or failure in practice.

Jay Forrester and the origins of organisational learning theory

Forrester (1958, 1961) is especially worthy of mention at this juncture because it was his work that first developed an approach to the analysis of organisational behaviour during the 1950s. This illustrated the importance of some of the properties of organisations that chaos and complex systems theorists have described. His work can also be seen to provide a building block for the much more recent organisational learning approach discussed earlier. Forrester treats organisations as non-linear systems and draws upon the concepts of both positive and negative feedback loops.

Forrester modelled the production and buying behaviour of the producers, distributors and retailers in a distribution chain. Minor ordering disturbances were shown to be amplified within the system. A 10 per cent increase in orders could cause production to rise to 40 per cent above its original level before it collapsed. The system he modelled therefore amplified changes in demand.

Cyclical changes in demand do occur at unpredictable intervals in an economy. They have an impact upon the industries within it and as Stacey (1996) notes,

Quick summary

Dynamic Understandings of Organisations in their Environments

- Approaches to strategy that treat the organisation as if it were a linear system misrepresent the nature of cause and effect in organisations.
- Human perceptions and interpretations cannot be predicted with accuracy, although different scenarios based upon different ways of managerial reasoning might be considered to be determinate.
- Strategic decisions are not a matter of right or wrong as in mathematics; they are a matter of success or failure in practice.

their effects are usually amplified in production. The suggestion is that if the effects of extreme instabilities in an industry environment are to be avoided by organisational decision-makers within it, they need to be aware of how and why fluctuations in the wider economic system impact upon related parts of their industry value chain.

Forrester demonstrates that the structure of the system influences behaviour, but because his system is essentially human, it is also quixotic. Negative and positive feedback loops can lead to unintended consequences. In order to cope effectively managers need to consider the entire system and the parallel decisions that are likely to be taken elsewhere in response to cyclical change. If managers think only of their own producing, distributing or retailing parts then their decisions and actions are liable to exacerbate the instability. Forrester, like Weick, identified the way in which people think about their worlds as being central to organisational dynamics and the ability of an organisation to cope effectively with change.

To follow on from the idea above, Stacey (1993a) sets out a number of principles that earlier researchers using computer simulation methods have identified as being applicable to complex human systems.

- They often produce unexpected and counter-intuitive results.
- Because relationships in such systems are non-linear, with both positive and negative feedback loops operating, links between cause and effect are distant.
- They are especially sensitive to some changes and relatively insensitive to others.

The reality is that individual organisations often do develop in unanticipated circumstances and opt for previously unforeseen courses of action, abandoning planned ones. Changes can be either opportunist or planned as environmental changes may or may not be anticipated.

Individual learning and organisational learning

It has been noted that the environment to which managers respond is one that is seen to be created by their own actions, as they are shaped by their perceptions and interpretations of their competitive position. Argyris and Schön (1978) have therefore focused upon how individuals, and through them, their organisations learn.

Human beings are argued to have limited intellectual capacity to understand the complex causes of contemporary change in their environment. They consequently construct simplified mental models of the complex world. These mental models are built up on limited past experience and lead to the development of the particular mindsets with which managers approach situations in the present. One consequence of this is that some perceptions and interpretations may drive actions that lead to unintended consequences.

When managers reason about particular situations, they do not always use algorithmic step-by-step processes. Often they make intuitive decisions. This enables them to cope more rapidly with greater levels of complexity and uncertainty. Their intuitive judgements are guided by their mental models.

One potential problem, highlighted by Argyris and Schön, is that managers may not be wholly conscious of the nature of their mindsets and the mental models they hold. If those models are deployed unquestioningly, they may become inappropriate to the changing circumstances faced. Clearly, this has implications for organisational decline. Conservative mindsets can become ideological mindtraps when the formulation of a managerial outlook is retrospective. Once again, the role of managerial mindsets as a factor underpinning organisational complexity and unpredictability is highlighted.

Argyris and Schön, in considering intuitive decisions, describe the kind of situation in which formal strategic planning techniques are not used. However,

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even when some form of rational planning process is used, particular mindsets, and the ways of thinking with which they are associated, will still influence the evaluations that managers make. Even if all managers were to use an identical process to arrive at decisions in a given situation, they would be highly unlikely to reach identical conclusions.

Stacey (1993a) summarises key observations and suggestions concerning organisational dynamics from a number of other sources in addition to those considered above. All of the writers he cites point towards the need for a better understanding of the dynamics of complex systems in general, and the dynamic processes of managerial thinking and organisational learning in particular.

Chaos Theory and Complex Dynamic Systems

Complex dynamic systems in the natural world exclude the thinking and reasoning human being as an environmental component. Clearly, in the context of human dynamic complex systems, the conquest of nature in pursuit of the satisfaction of want forms an important part.

However, this does not mean to say that managers cannot glean insights into the workings of complex non-linear dynamic systems in general from recent researches in the natural sciences. There is a tradition in management studies of looking to the natural world for analogous models that may shed light upon the organisational world, as Morgan (1986) shows in his well-known book Images of Organisation. This work may be considered as a starting point in the quest for a more comprehensive, less simplistic metaphor of the organisation.

Let us look at Morgan's metaphors in more detail.

Metaphors of organisation

In 1986, Morgan offered a number of metaphors of organisation which encouraged researchers to adopt a variety of perspectives on the nature of organisation. It was clear at this time that many of those currently in use were at best partial, and at worst, they failed to capture the nature of organisational dynamics. New ways of thinking about complex organisations, which will be discussed in this section, suggest that one of these metaphors, the machine metaphor, is inappropriate.

A number of the others, however, highlight particular characteristics and behaviours, argued by modern complex systems theorists to be pertinent to the competitive success of the corporation into the twenty-first century. These are illuminating. Morgan's metaphors individually draw our attention to particular capabilities that can be found in some organisations that are analogous to those of units of analysis studied by researchers in other fields of study, such as the organism, brain or culture of a people. Modern complex theorists offer a new metaphor which is more comprehensive in that they offer a perspective on organisations that allows for the development of a range of these capabilities.

The machine metaphor

Some of Morgan's metaphors are more appropriate than others. The machine metaphor is one that describes a set of linear cause and effect relationships in technological design. In 1979, as was noted earlier in this topic, Weick pointed to the fact that loose coupling in organisations can distance cause and effect relationships.

In the 1990s, the assumption of linearity was itself strongly called into question. The machine metaphor focuses upon doing things right rather than upon doing the right things. The model depicts a mechanistic organisation, fostered by machine-like ways of thinking, which produces structures and relationships between people that are relatively inflexible and slow to adapt

Quick summary

Chaos Theory and Complex Dynamic Systems

- In the context of human dynamic complex systems, the conquest of nature in pursuit of the satisfaction of want forms an important part.
- There is a tradition in management studies of looking to the natural world for analogous models that may shed light upon the organisational world,

to change (Burns and Stalker, 1961). During the 1980s, this view of the mechanistic organisation that had been popularised by Burns and Stalker during the 1960s, was re-affirmed by Moss-Kantor (1983) at a time when many large corporations were facing up to the need to make changes in the light of increasing international competition.

The organism metaphor

Morgan offered other metaphors which are more suited to organisational requirements for adaptability and flexibility, requirements that have received a lot of attention in the 1990s. In doing so, he highlights organisational behaviours and characteristics that have been observed by these recent researches. His metaphor of the organisation as an organism is one that draws its inspiration from biology. Organisms that adapt will survive and reproduce. Those that do not become extinct.

The brain metaphor

It is an analogy that can readily be applied to the organisation. Morgan's brain metaphor highlights the fact that living beings learn and that learning from the past helps them to cope with future situations. Organisations also learn in that lessons learned from past experiences of decisions and actions within the organisation impact upon future decisions.

Human cultures, wherever they flourish, change and evolve to support different types of requirements essential to their survival and prosperity. This is as true of so-called primitive tribal cultures as it is of modern industrialised ones. In an organisation, a particular culture can foster or inhibit particular kinds of strategy and courses of action. In the modern world of organisations, cultural change may also be taken to include the kinds of re-evaluations of managerial mindsets that ensure that strategic thinking remains attuned to external competitive realities.

The flux and transformation metaphor

Morgan offers another metaphor, drawn from the biological sciences, of the human organisation as "flux and transformation" (Morgan, 1986). He discusses how the biological theory of autopoesis may shed light upon organisational dynamics. The theory of autopoesis in biology allows for the influence of both positive and negative feedback loops in the course of an evolutionary life-cycle and describes the logic of the self-producing system.

As later discussions demonstrate, modern complex systems theorists have applied this to the organisation. This logic implies that "organisations enact their environments" (Morgan, 1986, p. 241). They assign particular patterns of significance to the events that occur in their operating environments, which is of course why the ways in which managers perceive them is so important. To extend the biological analogy further, the result is that the behaviour of an organisation is oriented towards the creation or maintenance of an identity which is considered to be desirable by its decision-makers.

The theory of autopoesis in biology suggests that the preservation of an identity is fundamental to all living organisms. Complex reproductive mechanisms and behaviours have evolved in the natural world to ensure that this happens. This process does not always operate smoothly in relation to individual members of a species. Individual corporations in an industry population may experience difficulties.

1. One scenario is that organisations, like outcasts in the animal kingdom, can become egocentric. This may lead them to try and sustain identities that have become embedded. In the animal world, males of certain species who can no longer sustain their dominant identities are liable to be ousted by younger and fitter rivals. In the organisational world, corporations that attempt to sustain what has become an unrealistic identity will

be ousted by competitive rivals and experience decline.

2. A second possibility is that organisations may adopt behaviours which ultimately destroy the contexts of which they are a part. Morgan (1986, p. 244) offers as an example the agricultural use of chemicals which can destroy the ecology upon which farming depends.

3. A third possibility, which is not discussed in detail by Morgan, is that organisations may evolve and produce changes that fundamentally change the nature of competition in the environment. In the same way that man has evolved to dominate the animal world, so can an organisation evolve to dominate an industry. Direct Line insurance, for example, may be considered to be a corporation that has evolved to change the rules of the industry game. Morgan notes that "as organisations assert their identities they can initiate major transformations in the social ecology to which they belong" (Morgan, 1986, p. 245).

As was noted earlier in this section, there is a systems theory tradition in management studies that has looked towards the natural sciences for models analogous to the human organisation.

In recent years, interest in these fields of research has grown. Some organisational theorists have focused upon recent scientific developments to explain the behaviour of complex systems in the natural world. Cause and effect relationships can be distant and non-linear in natural systems as well as in human ones and some complex natural systems can also behave in unpredictable ways.

This does not, however, mean to say that the processes that drive them cannot be theorised. Natural scientists have been making great strides forward in this respect. A number of management theorists, inspired by that progress, have begun to conceive of organisations as complex dynamic systems analogous to the organisation as organism and brain and culture and transformation and flux. In other words, they are developing a more complex metaphor that combines all the relevant characteristics of Morgan's (1986) original discrete models.

Chaos and complexity

In 1987, James Gleick published his book Chaos: Making a new science. This book popularised non-linear thinking and chaos theory. Its timing was particularly apposite from the point of view of the business community, which was still reeling from the shock of the 1987 stock market crash.

Chaos theory itself is complex, but the basic insights it can offer to managers are reasonably straightforward. It suggests that non-linear systems that operate in a negative feedback mode tend towards stability whereas when they operate in a positive feedback mode, they tend towards explosive instability. Complex systems may also operate "on the edge of chaos" (Lewin 1993), where the influence of positive feedback alternates with the influence of negative feedback. Chaos theory suggests that this third state is one of bounded instability. This is one in which behaviour is essentially unpredictable but nevertheless can be seen to have an overall qualitative pattern. Chaos theory suggests that this third bounded instability state is one that may occur as a system moves from a state of stable equilibrium to one of explosive instability. Management theorists (e.g. Stacey 1993b) have argued that it is the state in which the modern organisation operates. This is the state that is referred to as 'complexity' in this chapter.

In considering this state of complexity in relation to an organisation, there is one additional factor that must be taken into account but which does not apply to the bounded instability state in nature. In both the natural and human worlds it is a state of non-equilibrium in which there are non-linear cause and effect relationships – although in the human world, complexity has additional components. Human beings are living, thinking and reasoning. They are capa-

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ble of making intelligent, informed, strategic choices which themselves affect the dynamics of the system.

The concept of complexity theory in relation to strategy must therefore be regarded as something of an insightful metaphor, since companies do not in fact exhibit these characteristics scientifically. However, if we think of them in this way we may be less hide-bound in our strategy development.

Stacey (1993b) suggests that four important points can be made about recent researches into the behaviour of natural, complex, dynamic systems, which are applicable to the world of human organisations.

1. The first is that the chaos state which applies to competitive organisations is a form of instability in which the specific long-term future is unknowable.
2. The second is that this chaos state is one in which there are boundaries around the instability.
3. The third is that an unpredictable new order can emerge from this chaos state through a process of spontaneous self-organisation.
4. The fourth is that chaos, far from being an occasional state of affairs, is a fundamental feature of non-linear feedback systems generally, a category that includes the human organisation.

Alex Tresoglio (1995) in a draft paper delivered at an LSE strategy seminar in January 1995, compiled a table that indicates some of the most pertinent findings of complexity researchers regarding the behaviour and characteristics of complex systems. This table is illustrated in Figure 7.1.

Behaviour	Characteristics
Evolution	Creativity, innovation, diversity, punctuated equilibria, irreversibility, specialisation
Life	Homeostasis, far from equilibrium, information processing, persistence
Emergent behaviour	Simple rules create complex behaviour, especially in social and computational systems
Surprise	Discontinuity, unpredictability, uncontrollability, non-optimisation, non-describable
Edge of chaos	Self-organised, criticality, maximising flexibility and information processing

Source: Alex Trisoglio (1995, p. 11).

The point is that many of these behaviours can be evidenced to occur in the modern organisation at the same time. Complex systems theory, in its recognition of this fact, may be considered to provide new and possibly more appropriate metaphors (Morgan 1986) for understanding organisations than many others that have hitherto been deployed.

Coping with Complexity

Let us now turn to the process of coping with change. Stacey (1993b) offers eight suggested courses of action which may help the organisation to cope with change.

1. Develop new perspectives on the meaning of control

   The suggestion here is that self-organising processes can provide controlled behaviour and that sometimes the best thing that a manager can do is allow things to happen, and let new strategies emerge. The point is that control mechanisms are self-defeating if they stifle creativity and

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Coping with Complexity

- Stacey's prescriptions are contrary to the received wisdom of long-term planning. They also prompt us to consider the role of strategic vision.
- Strategic vision is a concept that has received much attention in the management literature, but Stacey's prescriptions imply that if strategic visions are too determinate, they may inhibit creative change. They relegate the role of strategic planning to the short term, and, for many organisations, imply the need to re-think issues of organisational design..

new ideas.

2. Design the use of power

   The way in which power is distributed and used is recognised to impact upon the way in which new strategic directions emerge. He argues that in a complex dynamic system, it is important to create the kind of organisational environment in which group dynamics are conducive to organisational learning. Win/lose situations need to be removed and a climate created in which open questioning and testing of ideas and assertions is encouraged.

3. Encourage self-organising groups

   Stacey argues that groups need to locate their own challenges, and determine their goals and objectives. Top managers need to create an atmosphere in which this can happen. Self-organisation is a principle, which Stacey argues allows for the emergence of proposals, which might otherwise not surface because of fear of disapproval.

4. Provoke multiple cultures

   Stacey suggests that developing multiple and even conflicting organisational countercultures is a way of generating multiple perspectives.

5. Top management should present ambiguous challenges

   This suggestion is that goals that are too clearly defined stifle innovation. Ambiguous challenges may stimulate the discovery of new ways of doing things.

6. Expose the business to challenging situations

   The suggestion here is that innovation depends on chance and that avoidance of risk also stifles innovation. If the business is exposed to challenge innovative responses may follow.

7. Devote explicit attention to improving group learning skills

   Stacey argues that new strategic directions emerge when groups of managers learn together by questioning deeply held beliefs. He suggests that this can lead to changes in existing mental models. If new information is merely accommodated to existing dominant perspectives, new directions are unlikely to emerge.

8. Create slack resource

   The suggestion is that organisational learning and emergent strategy require an investment in management resources. There needs to be enough slack resource in the system for the process to take place.

Clearly, the above prescriptions are contrary to the received wisdom of long-term planning. They also prompt us to consider the role of strategic vision.

Strategic vision is a concept that has received much attention in the management literature, but Stacey's prescriptions imply that if strategic visions are too determinate, they may inhibit creative change. They relegate the role of strategic planning to the short term, and, for many organisations, imply the need to re-think issues of organisational design.

Stacey (1993b) concludes that: "Practising managers and academics have been debating the merits of organisational learning as opposed to the planning conceptualisation of strategic management".

That debate has not, however, focused clearly on the critical unquestioned assumptions upon which the planning approach is based, namely, the nature of causality. Recent discoveries about the nature of dynamic feedback systems make it clear that cause and effect links disappear in innovative human organisations, making it impossible to envision or plan their long-term futures. The planning approach can be seen as a specific approach applicable to the

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short-term management of an organisation's existing activities, a task as vital as the development of a new strategic direction (De Witt & Meyer, 1994, p. 474). However, as the discussions to follow show, this does not necessarily mean to say that established theory must all be abandoned.

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Balancing strategies

Stacey's proposals place a great deal of stress upon organisational learning and the ability of organisations to develop differing perspectives on situations. Given this capability, appropriate perspectives will emerge. In this respect, the suggestion is that many modern organisations need to develop different types of capability than those that have proved successful in the past.

During the 1990s, two broad priorities were evidenced in the strategic prescriptions of management theorists:

1. The first is the drive to optimise efficiency. Downsizing, process re-engineering, continuous improvement and total quality management (TQM) may all, in their different ways, be considered to be directed towards this goal.
2. The second broad priority is flexibility, creativity and adaptability. This priority is consistent with approaches such as organisational learning, strategic and organisational innovation, and is the one that is seen to be a requirement for managing complexity.

Often, these two priorities are discussed as if they are alternatives. However, organisations need to remain competitive in the short term. This imposes the requirement to optimise efficiency. Sustaining competitive performance requires that learning and innovation take place. Optimising efficiency today does not ensure long-term success. In short, both priorities need to be pursued and organisations need balanced strategies, which reconcile the paradox between them.

Using differing perspectives

Stacey (1993b) suggests that it is important to develop an organisational capability to perceive and interpret situations from a variety of differing perspectives. Natural complex systems, unlike human complex systems, do not contain a thinking human component. Clearly, in the complex world of the organisation this is a key influencing factor. It may be suggested that there are as many decision-making rationalities as there are forms of reasoning and managerial mindsets. One major reason for the complexity and non-linearity of complex human systems is that there are different ways of thinking about the human world. Understanding these ways of thinking will not in itself make the organisational environment predictable, but it can improve the ability of managers to think strategically, identify additional future possibilities, opportunities and threats and cope with change and uncertainty.

The importance of developing different ways of thinking about strategic issues at corporate level was first recognised in relation to the strategic capabilities of diversified firms. Galbraith noted that companies as they diversify retain their upstream or downstream centre of gravity in the form of a managerial mindset legacy. He suggested that upstream and downstream managers tend to develop different ways of looking at business requirements and that mindsets associated with the development of the original core businesses colour perceptions of other types of business when the firm expands. The suggestion is that businesses that develop from an original downstream core might not have the most appropriate strategic thinking capabilities if they diversify into upstream activities, or vice versa. Prahalad and Bettis (1986) highlight the need for such firms to develop these capabilities. In 1986, they used the term dominant logic to:

> refer to the 'mental maps developed through experience in the core business and sometimes applied inappropriately to other business.

(Prahalad & Bettis 1986, p. 485).

Multiple dominant logics

The suggestion of Prahalad and Bettis is that diversified multinational corporations are better equipped to cope with the variety of strategic issues they face if multiple dominant logics co-exist at the corporate level. The suggestion that cognitive diversity at the level of a top management team is a factor that can facilitate the management of organisational complexity is one that has been supported by a number of other writers (e.g. Bartlett & Ghoshal 1989; Ginsberg 1990). The problem is that unless diverse perspectives at the level of the top team can be integrated, cognitive diversity can be a source of difficulty. As Bartlett and Ghoshal put it:

> diverse roles and dispersed operations must be held together by a management mindset that understands the need for multiple strategic capabilities. (Bartlett & Ghoshal 1989, p. 212)

Bettis and Prahalad (1995) subsequently revisited their concept of a dominant logic, stating that:

> Since the original article, our thinking has increasingly revolved around environmentally driven organisational change as opposed to diversification driven organisational change. (Bettis & Prahalad 1995, p. 6)

They highlight the fact that the information technology revolution has made increasing amounts of data available to managers although this has not made it any easier to sense and respond to change. Instead, they suggest that what has developed in many organisations are information-rich interpretation-poor systems (Bettis & Prahalad 1995, p. 6). They suggest that in responding to requirements for change, organisational unlearning is as important as organisational learning. They argue that in turbulent times, dominant logics must themselves be an adaptive emergent property of complex organisation, even though "the longer a dominant logic has been in place, the more difficult it is to unlearn" (Bettis & Prahalad 1995, p. 11).

In a complex world, the company that is able to remain alert to the developing threats and opportunities in its environment and develop the strategic capability to be flexible, adaptable and innovative, is likely to be one that can draw upon the insights to be gained from more than one dominant logic.

Michael Thompson and associates deploy the term 'rationalities' as opposed to 'logics', although their usage of it is similar to the way in which the term logics is used by Bettis and Prahalad. Thompson et al. (Thompson, Ellis & Wildavsky 1990; Schwartz & Thompson 1990) argue that different ways of seeing the world in an organisation are tied up in different types of social relations and that some organisations encourage particular kinds of rationality and discourage others. Despite this, responding effectively to the requirements for change calls for an increasing organisational capability for seeing the world in different ways. For example, a company facing pressures from environmental lobbyists may make headway when it is able to re-define 'the green enemy' as the dissatisfied customer.

Drawing upon the insights from previous topics, different forms of reasoning and compatible associated preferences and behaviours may now be identified and summarised – you can see an illustration in Figure 7.2.

Compatible attributes/ qualities and behaviours	**Forms of Reasoning**		
	Ontological	**Nomological**	**Teleological**
Compatible ethics	Hegelian De-ontology	Kantian Ethics	Benthamite Utilitarianism

Compatible model of competition	Competitive battle	Positioning	Innovative contest
Compatible strategic orientation	Defender	Analyser	Prospector
Attitude to change	Avert threats	Opportunist	Goal-oriented
Compatible evaluation of the qualities of a good strategy	Enables firm to maintain dominant market position	Enables firm to exploit opportunities to achieve or maintain a better industry position	Enables firm to marshal resources necessary to achieve pre-determined goal
Preferred basis for competition	Accumulated skills knowledge and resources	Contingent upon opportunities and resources	Commitment of organisational members to goal (ability to mobilise them towards it)
Perspective on strategy	Outside-in	Outside-in	Inside-out
Perceived requirements for strategic change	Protect and build on existing position. Counter any threats to it	Secure advantages of opportunities	Adopt any suitable means to achieve the goal (strategic intent)
Compatible EPRG profiles/ and orientations of HQs towards foreign subsidiaries	Polycentric	Ethnocentric	Regiocentric/ geocentric

Questioning established ways of thinking

It is often assumed in the literature that developing new ways of thinking is necessary for the development of different perceptions and innovative decisions and actions. It is assumed that this is likely to mean breaking out of established mindset patterns and effecting a shift from one form of reasoning to another.

This need not necessarily be so. The forms of reasoning highlighted in Figure 7.2 above are not themselves immutable and static. They are based upon ideological orientations to the world that can evolve and change. Ideological revolutions are not easy to achieve, but small changes in ideological belief over time can result in large changes in behaviour (Carlisle & Baden-Fuller 1995). This is a finding consistent with complex systems theory which highlights the fact that some small changes can have a large impact upon the system while other seemingly large ones have a negligible impact.

New approaches to the understanding of the complex world of dynamic systems highlight their unpredictable non-linear nature. In the complex world of human dynamic systems, managerial reasoning may itself be a factor which leads to decisions and actions that increase environmental instability. The suggestion is that there are limits to our ability to control and manage change in

such a world. Under these conditions, there is no room for complacency. Charles Handy, in the June 1992 issue of the magazine Director, suggested that:

> continuous re-invention of one's products, one's goals and one's methods, seems to be the best answer to the threat of change, the best recipe for continuity in a time of discontinuity.

This means that established ways of thinking and doing must be continually questioned. Developing a culture with structures, practices and procedures that will foster such questioning is part of the process. Some of the literature discussed in earlier topics has touched on these issues. It may also be possible to develop and deploy techniques that encourage the kind of continual discontentment and questioning of established strategies and practices which Handy (1992) suggests has contributed towards continuous success at Coca Cola. Despite Stacey's (1993b) conclusions, which were quoted above, there are some well-known examples of corporations that have deployed strategic planning techniques to provide the sort of challenge to established thinking that is required. Shell, for example, has successfully used scenario planning for this purpose in the recent past.

The complex competitive world

There is undoubtedly much work to be done before such modern ideas as organisational learning (Senge 1990) can be viewed as providing a comprehensive approach towards organisational requirements for coping with complexity. However, there would seem to be some agreement that developing an organisational capability for accepting and coping with change flexibly is likely to be a key to successful competition in the future.

The complex competitive world is one in which the long term is unknowable. It is one in which there are seldom any right answers to strategic problems that arise in a context of competing competitive pressures that present themselves to the organisation as paradoxes to be resolved. In the modern world, the phenomenon of coopetition illustrates this. In such a situation two companies may cooperative and compete at the same time, e.g. IBM and Microsoft who cooperate in building their industry and even in developing new products, but compete with each other strongly in the marketplace.

The ideas discussed so far in this topic suggest a new range of paradoxes. Short-term competitive pressures may mean that companies need to maximise efficiency today, but they must also have their eye on tomorrow and strive to become more creative and innovative and promote organisational learning. It may be recalled that Stacey (1993b) suggests these goals entails the maintenance of some degree of slack managerial resource. It is suggested that modern corporations must be bold and adventurous in outlook. To survive in the long term they have to be willing to take up the challenge to explore, develop new ideas and innovate, but they also need to be cautious enough to avoid undue risks and threats.

In a world where the future is unpredictable, it is argued that dominant logics or forms of reasoning are a potential threat. The suggestion is that successful corporations need to develop the capability to accept and adapt flexibly to change by fostering a variety of strategic perspectives at corporate level. The problem here is how can a diversity of managerial perspectives be fostered while the dysfunctional consequences of a lack of integration are avoided?

There are no definitive answers to such questions, although the recent strategic management literature offers various suggestions. In so far as prescriptions have been offered, it is the case here, as it is with many of the other strategic dilemmas considered in this topic, that prescriptive theory cannot be guaranteed to lead to success.

As Handy (1992) points out, the majority of strategic questions are divergent, rather than convergent. Convergent questions have an answer that is either right or wrong. Divergent ones invariably do not. The majority of attempted

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solutions to strategic problems can be seen with hindsight to have produced results which were anticipated or unanticipated, intended or unintended and transpire to be either desirable or undesirable. The literature discussed here and elsewhere in the topic may offer some clues as to how to resolve the kinds of strategic paradox highlighted here, while ongoing research continues to shed light upon them.

The Nature of Organisational Learning

Let us recap some of the ideas you have read earlier on, and give more illustrations of the exact nature of organisational learning: in this part of the topic we will focus more specifically on the challenges faced by multi-national corporations (MNCs).

Successful strategies are those that develop a fit between the competences of organisations and the opportunities presented by their environments. This applies as much to international as to domestic strategies and generally involves organisational learning. The term has come to be used to emphasise that organisations, just as individuals, can acquire new knowledge and skills with the intention of improving their future performance. It has indeed been argued that the only sustainable competitive advantage the company of the future will have is its managers' ability to learn faster than its rivals (De Geus 1988, p. 740). These contentions are never more relevant than in the strategies of international business.

Organisational learning consists of both cognitive and behavioural aspects. While learning is clearly a process, its outcomes must also be included within the scope of the term as well. Thus an organisation does not necessarily benefit from the acquisition of knowledge and understanding unless these are applied, so that the potential to improve actions is actually realised.

The idea of organisational learning does not resolve the paradox that "organisational learning is not merely individual learning, yet organisations learn only through the experience and actions of individuals" (Argyris & Schön 1978, p. 9).

As Nonaka and Takeuchi (1995) recognise, in a strict sense knowledge is created only by individuals and an organisation can only support creative individuals or provide suitable contexts for them to create knowledge. Their description of 'organisational knowledge creation' provides an indication of how this individual learning can become available, and retained, within the organisation as a whole. In so far as this increased knowledge can be incorporated in improved systems and routines, however, the learning can be captured by the collectivity, and extend beyond the individual.

Converting learning by the individual into organisational property

We should examine the very practical question of how learning by individuals, or groups of individuals, can become transformed into an organisational property. The challenge here is partly one of how to make explicit, codify, disseminate and store the knowledge possessed by the members of an organisation in ways that convert it into a collective resource, particularly when the corporation may encompass individuals of widely varying cultures.

It is also partly a problem of how to reduce the barriers that organisational structures, cultures and interests can place in the way of knowledge-sharing and learning. Of course the nature of learning achieved in an organisation will vary according to its organisational form and culture. Organisational learning in a transnational company, for example, is likely to exceed that in a global company ceteris paribus.

The nature of the knowledge contributed by the members of an organisation is

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The Nature of Organisational Learning

- Successful strategies are those that develop a fit between the competences of organisations and the opportunities presented by their environments. This applies as much to international as to domestic strategies and generally involves organisational learning.
- Organisational learning consists of both cognitive and behavioural aspects.
- The idea of organisational learning does not resolve the paradox that organisational learning is not merely individual learning, yet organisations learn only through the experience and actions of individuals.

of considerable significance for the process of learning. An important requirement for converting knowledge into an organisational property is to make it sufficiently explicit to be able to pass around the knowledge network.

Polanyi (1966) distinguished between tacit knowledge and explicit knowledge. The former is usually regarded as personal, intuitive and context-specific. It is therefore difficult to verbalise, formalise and communicate to others. Explicit knowledge, by contrast, is specified and codified. It can therefore be transmitted in formal systemic language. To make tacit knowledge available to an organisation at large in a form that permits its retention for future use, it has to be converted into a codified or programmable form. It may not be possible to accomplish this, either for technical reasons or because the people with tacit knowledge do not wish to lose their control over it. If this is the case, then the only way to put tacit knowledge to organisational use may be to delegate responsibility for action to the persons concerned and/or to persuade them to share their knowledge with other experts on an informal basis.

Categories of learning

Another distinction that has important implications for practice is the distinctions between the different categories of organisational learning. This distinguishes between technical, systemic and strategic types of organisational learning.

1. The technical level includes the acquisition of new, specific techniques, such as for quality measurement or for undertaking systematic market research, as well as blueprints for the application of new technologies. This corresponds to routine learning.
2. The systemic level refers to learning to introduce and work with new organisational systems and procedures. The focus here is on the restructuring of relationships and the creation of new roles and ways of doing things.
3. The strategic level involves changes in the mindsets of senior managers, especially their criteria for organisational success and their mental maps of the factors significant for achieving that success. The emphasis on vision here is somewhat different to that on 'learning how to learn', but there is a parallel in the cognitive processes involved with a view to generating new insights and being proactive.

Learning is required at all three levels – technical, systemic and strategic. Technical learning is the easiest type to achieve. With the complex nature of many modern technologies, and the importance of deploying them in conjunction with the human skills and motivations of employees, a multi-disciplinary technical competence is required. A particular technical skill, the lack of which can cause problems in international companies, is competence in languages. Hamel (1991) noted how the fact that employees in Western firms almost all lacked Japanese language skills and cultural experience in Japan, which limited their access to Japanese know-how. Their Japanese partners did not suffer from a lack of language competence to the same degree and benefited from the access this gave them to their partners' knowledge.

Technical and systemic learning

Andreu and Ciborra (1996) point to the dynamic processes which link these three categories of learning together by means of three of what they call loops.

At the technical learning level is the routinisation learning loop. This level of learning is aimed at mastering the use of standard resources and gives rise to efficient work practices. Andreu and Ciborra cite as an example "mastering the usage of a spreadsheet by an individual or a team in a specific department, to solve a concrete problem".

Systemic learning is required in order to make the most innovative use of

new knowledge or technology which is acquired. For example, the introduction of mill-wide computerisation in the paper and pulp industry opened up radical new possibilities for the constructive redesign of mill organisation and the combined empowerment and enrichment of mill workers' jobs (Child & David 1987). This new technological development came about through close cooperation between paper manufacturers and system suppliers. The ability of UK paper manufacturers to take full advantage of the potential offered by the new systems depended on their organisational vision and competence, in terms of being able to envisage and accept radically changed roles and relationships.

New work practices can be internalised by the firm in the form of routines, and in this way they become part of its capabilities. This gives rise to a capability learning loop, in which new work practices are combined with organisational routines. The learning process is systemic in character, because it involves generalising work practices and techniques and placing them into a wider context. This defines not just what the practices do and how they work, but also the circumstances under which it becomes appropriate to use them, and who has the authority or competence to apply them. A capability learning loop, for example, will become necessary whenever a systemic technological innovation is put into a production process in a factory.

Strategic learning

In the strategic category a problem can arise from a senior executive's failure to appreciate that he can derive broad strategic lessons from partners in the group rather than ones restricted to narrower issues.

General Motors, for example, approached its NUMMI joint venture with Toyota with the expectation that what it could learn from Toyota would be confined to production skills in the manufacturing of small cars. As a consequence, although the lessons to be learned were actually of general relevance, they were not applied to General Motors as a whole (Inkpen 1995a, p. 63).

This third learning loop is the strategic loop. In this learning process, capabilities evolve into core capabilities that differentiate a firm strategically, and provide it with a competitive advantage. Capabilities can be identified as 'core', i.e. becoming central to the firms activities, or 'key', i.e. having strategic potential – both by reference to the firm's mission to what will give it a distinctive edge in its competitive environment (Bowman & Faulkner 1997).

Operation within an MNC or an international alliance offers a potential for learning in all three learning categories. It may provide direct and fast access to improved techniques and specific technologies. It can facilitate the transfer and internalisation of new systems, such as lean production and TQM and it can lead to new strategic insights and the realisation of new opportunities.

Forms of organisational learning

Learning also takes different forms, some of which become far more embedded, and hence part of the firm's evolving culture, than others (Child & Faulkner 1998). Let us now look at some of the key forms of organisational learning in more detail.

- Behavioural change without cognitive change
- Blocked learning – cognitive change without behavioural change
- Cognitive and behavioural learning
- Segmented learning and non-learning

Behavioural change without cognitive change

The first form is that of forced learning. Here there is no change of cognition and hence understanding, but new behaviour is acquired under some pressure perhaps from head office. A common example of forced learning arises when head office insists on the unilateral introduction of new organisational

routines or systems without other parts of the firm either accepting the rationale for them, or indeed being offered adequate training to understand them. Although the term 'forced' refers here to how the acquisition of new behavioural practices is brought about, and not necessarily to how the process is perceived by those on the receiving end, it is likely to meet with some reluctance on their part. Forced learning can readily arise in a situation where there is strong centralisation of power in the firm and a low motivation to learn by members outside head office.

A second possibility also results in the adoption of new practices (behavioural change) but without any appreciable learning of the rationale behind them (cognitive change). This is imitative learning. There is probably at least a moderate level of motivation to learn in this situation, but the fact that the learning takes the form of imitation might indicate some limitation in the quality of training offered to support the learning process. An example of this type of learning appears in Markóczy and Child (1995) where it describes when Child had to go in and out of one hotel in China several times in succession with various packages, he was greeted on each entry by the same commissionaire with "welcome to our hotel" and on each exit with "have a nice day, sir"!

Blocked learning – cognitive change without behavioural change

The two situations mentioned above are ones in which at most behaviour and practices have changed, but without any significant increase in know-how or understanding. However, the opposite can also occur, when the members of an organisation undergo changes in cognition that are not reflected in their behaviour. This could be due to inadequacies of resourcing which prevents implementation, an over general or theoretical formulation of the new knowledge, or the overriding of the situation by other strongly-held beliefs.

These factors cause the translation of new understanding into revised behaviour to be blocked. Blocked learning can arise when staff receive training, perhaps on a course, but are not accorded the resources or opportunities to put what they have acquired at the cognitive level into practice, or find that their boss has not had their training and is sceptical of their newly acquired ideas. Their motivation to learn may well be high, but the organisation of the training may not be matched to that of the responsibilities and resources allocated.

Cognitive and behavioural learning

Another possibility is that the participants in an alliance learn both cognitively and behaviourally. This could be a unilateral process of received learning when one executive willingly receives new insights from another. If both parties endeavour to express and share their knowledge and practices, the level of integrative learning may be attained.

This latter exhibits the potential for organisational learning in its most advanced form, in which innovative synergy is attained between the different contributions and approaches which the partners in a MNC bring to their interactions. Integrative learning involves a joint search for technical, system-building and strategic solutions to the needs of the MNC or alliance. It means that partners are receptive to the concepts and practices brought in by their counterparts, and are willing to modify their own ways of thinking and behaviour in the light of these.

Segmented learning and non-learning

Two further forms of learning exist. The first is a situation in which, at best, very limited learning takes place because the firm is organised such that separate responsibilities are allocated very clearly as in multi-domestic organisational forms. This is segmented learning (Child & Faulkner 1998). In the multi-domestic MNC, learning may take place in one company subsidiary but not be transmitted to any of the others, because of the lack of communication in the company between different country subsidiaries.

The other possibility is that of non-learning, in which no learning takes place at all. This is likely to arise when the motivation to learn is low and/or because there is low transparency of knowledge between the parts of the firm. The case of a Sino-European joint venture, reported by Child and Markóczy (1993, p. 626), illustrates a negative learning priority. The Chinese partner attempted to resist the reconfiguration of production and support functions along more effective lines because it saw this as reinforcing the power of the European management over the running of the venture's facilities and over the labour force.

Learning and organisational form – international organisations

You have been reading about different forms of organisational learning, and different types of MNC or international alliance naturally lead themselves to learning of a different degree and nature. The three levels of learning, technical, systemic and strategic, and the three non-pathological forms, i.e. received, segmented and integrated, are likely to display themselves differentially in international organisations of different types as shown in Figure 7.3.

Organisational form	Categories of learning		
	Technical	Systemic	Strategic
Global	high/received	high/received	low/forced
International	low/forced	low/forced	low/ forced
Multi-domestic	high/segmented	low/segmented	high/segmented
Transnational	high/integrated	medium/integrated	high/integrated
Alliance	high/received or integrated	medium/received or integrated	low/received or integrated

- You can see from this figure that global companies are strongly directed from head office and show only limited feedback or response to local conditions. Received learning is therefore most characteristic in technical and systemic categories, and a low level of strategic learning.
- International companies are an avowedly transitional MNC form and are likely to display forced learning from the centre at best in all three categories, technical, systemic and strategic.
- Multi-domestic companies of the traditional type are characterised by largely autonomous subsidiaries and will therefore in all probability display segmented learning, with the rest of the group and the other subsidiaries learning little from the experiences of any one.
- Learning in transnationals is likely to be high, especially in the technical and strategic categories and of the highest integrated variety, since the major purpose of setting up an MNC in a transnational configuration is to maximise flexibility, sensitivity of response and integrated learning. Systemic learning in the essentially flexible and sometimes fluidly organised transnational may, however, be less strong than the other categories, as transnationals are frequently diffuse in control systems.
- In strategic alliances the level of learning will of course vary with the success of the alliance. It may be of the received variety in all three categories where one partner 'milks' the other, but in the best alliances it will be of the integrated variety where both partners learn together and embed that learning in their partner companies.

Of course there is no inevitability that a particular organisational form will necessarily display the particular categories of learning set out in this figure, or indeed one of the non-pathological learning forms. Indeed some will display

Your notes

pathological forms like blocked learning, forced learning or even non-learning. However, it is proposed that the different MNC and alliance forms each have a tendency to achieve certain types of organisational learning predominantly by virtue of their essential organisational characteristics.

Requirements for Learning

Even when a corporation undertakes to adopt a learning philosophy, there are certain requirements for learning to take place.

1. The first is that learning is included among the corporate executives' intentions when it decides to adopt such a philosophy, and that it attaches value to the learning opportunities that arise.
2. Second, the corporation must have the necessary capacity to learn.
3. Thirdly, it needs to be able to convert the knowledge into a collective property so it that can be disseminated to the appropriate persons or units within its organisation, understood by them and retained for future use.

These factors are not easy to achieve in practice.

Learning intent

Hamel (1991) found from a detailed study of nine international alliances that the partners varied considerably in how far they viewed the collaboration as a learning opportunity, and that this was an important determinant of the learning that they actually achieved. For instance, several of the Western firms had not intended to absorb knowledge and skills from their Japanese partners when they first entered alliances with them. They appeared, initially, to be satisfied with substituting their partner's competitive superiority in a particular area for their own lack of it. In every case where this skill substitution intent was maintained, the partners failed to learn much from their collaboration.

Other companies, including many of the Japanese partners, entered into the alliances regarding them as transitional devices in which their primary objective was to capture their partner's skills. In several cases, partners undertook cooperative strategies for the purpose of learning the business, especially to meet international requirements, mastering a technology and establishing a presence in new markets. These are illustrations of a company's intention to use the learning opportunities provided by collaboration to enhance its competitive position and internalise its partners' skills, as opposed to collaborating over the long term and being content merely to access a partner skills, eschewing the need to acquire the skills themselves.

The threat posed by this strategy to an unwitting partner is obvious and it does not provide the basis for an enduring long-term cooperative relationship. In fact, when learning from a partner is the sole aim, the termination of a cooperation agreement cannot necessarily be seen as a failure, nor can its stability and longevity be seen as evidence of success.

Hamel noted that a partner's ability to outstrip the learning of the other contributes to an enhancement of that partner's bargaining power within the cooperative relationship, reducing its dependence on the other partner, and hence providing a gateway to the next stage of internalising those partners' knowledge and skills. For these reasons, Hamel concludes that, in order to realise the learning opportunities offered by an alliance, a partner must both give priority to learning and consciously consider how to go about it. This applies both in alliances and within international multinational enterprises.

Learning capacity

A company's capacity to learn will be determined by a combination of factors:

Quick summary

Requirements for Learning

- Even when a corporation undertakes to adopt a learning philosophy, there are certain requirements for learning to take place - these factors are not easy to achieve in practice:
  1. learning is included among the corporate executives' intentions, and that it attaches value to the learning opportunities that arise.
  2. the corporation must have the necessary capacity to learn.
  3. it needs to be able to convert the knowledge into a collective property so it that can be disseminated to the appropriate persons

- the transferability of the knowledge;
- its members' willingness to receive new knowledge;
- whether they have the necessary competences to understand and absorb the knowledge;
- the extent to which the company incorporates the lessons of experience into the way it approaches the process of learning.

Let us look more closely at each of these.

Transferability

Transferability indicates the ease with which the type of knowledge can be transferred from one party to another. Explicit knowledge, such as technical product specifications, is relatively easy to transfer and absorb. Tacit knowledge is far more difficult.

Learning capacity – willingness to receive

The more receptive people are to new knowledge, the more likely they are to learn. When the members of an organisation in different parts of the world adopt the attitude of students towards their teachers, they are being more receptive to insights than if they assume that they already possess superior techniques, organising abilities and strategic judgement.

For example, some Chinese partners in joint ventures with foreign companies make the mistake of assuming that they cannot learn useful motivational practices from their foreign collaborators, because they already have a superior knowledge of Chinese workers (Child 1997). Equally, some foreign partners show unwise disdain for advice from their Chinese collaborators on the best ways to relate to external governmental authorities which wield an unusual degree of influence over the conditions for doing business.

What influences receptivity?

Hamel (1991) found several influences on a partner organisation's receptivity. Firms that had entered an alliance as 'laggards', in order to provide an easy way out of a deteriorating competitive situation, tended to possess little enthusiasm for learning from the other partner or belief that they could achieve it. They tended to be trapped by deeply embedded cultures and behaviours which made the task of opening up to new knowledge all the more difficult. In clinging to the past, they were not capable of 'unlearning' as a necessary prerequisite to learning (Hedberg 1981).

Receptivity also depended on the availability of some time and resources to engage in the processes of gathering knowledge, and embedding it within the organisation's own routines through staff training and investment in new facilities. The paradox of deteriorating competitiveness as a pressure to learn and yet a constraint on being able to achieve it becomes critical for poorly performing partners.

In some alliances, it may be resolved by the additional cash and other resource injected by the other partner. If a collaborator has, however, slipped far behind its partner in the skills and competences necessary for it to absorb new knowledge, it may find it extremely difficult to close the gap. Similarly a low-tech company may not be sufficiently receptive to new knowledge for it to be able to transform itself into a high-tech company due to the limited educational level of its key employees (Faulkner 1995b).

Learning capacity – competences and the lessons of experience

Cohen and Levinthal (1990) argue that a firm's 'absorptive capacity' is a crucial competence for its learning and innovative capabilities. Absorptive competence is a firm's ability to recognise the value of new, external information, assimilate it and apply it to commercial ends. This competence is largely a function of the firm's level of prior related knowledge. Hence existing competence favours the acquisition of new competence, which implies that a partner entering an alliance with learning objectives should ensure that it does so with

Your notes

not only a positive attitude towards learning but also a minimum level of skills. If those skills are not available, the training of staff to acquire them should be an immediate priority.

Experience can be both an enabler and an inhibitor. Previous experience of the learning process will normally enhance someone's capacity to learn because it gives them greater knowledge of how to manage, monitor and extract value from new information. However, prior knowledge that has been converted into an organisation's routines can become a barrier to further learning, especially knowledge that is of a discontinuous rather than merely incremental nature. Being good at single-loop learning may therefore become a handicap for double-loop learning (Argyris & Schön 1978).

The learning process experienced by Rover in its alliance with Honda (Faulkner 1995) illustrates the interplay of conditions relating to the nature and level of the knowledge, and the partner's learning intention and experience: read about this in the case study below.

The Rover/Honda Alliance: learning by Rover

In the alliance between Rover and Honda, Rover had a high intent to acquire technology and this technical learning was relatively easy to achieve. Also in the later stages of the alliance, Rover was receptive and keen to undergo technical learning. The nature of the technology transfer was clear and Honda was willing to provide the information in joint learning working teams.

Process learning, involving knowledge about Honda's organizing systems, was more difficult, since by its nature it involves a lot of tacit knowledge as well as features related to Japanese cultural paradigms. This kind of knowledge was less transparent and less easily transferred, but as Rover's learning intention and receptivity grew, it became one of the success stories of the alliance from the Rover viewpoint. Processes such as 'just-in-time' were adopted and adapted to Rover's situation, and organisational innovations such as multifunctional teams and a flattening of the management hierarchy were introduced.

Once the cooperation had deepened by the mid 1980s, to embrace the joint development of new automobile models, Rover's intent and receptivity to learning from Honda increased dramatically. The whole nature of Rover's attitude to itself, its personnel and its way of working became transformed, so that a learning philosophy came to underlie it. By this stage, Rover's senior management had fully accepted the strategic value of the alliance, though this was not so true for its parent company, British Aerospace which ultimately sold the company to BMW and led to termination of the cooperation.

Source: Faulkner (1995a).

Making knowledge collective

Nonaka and Takeuchi (1995, p. 65), drawing largely upon cases of successful Japanese innovation, stress that the creation of knowledge for organisational use is a "continuous and dynamic interaction between tacit and explicit knowledge". For this process to succeed, in their view, there must be possibilities for four different modes of knowledge conversion:

1. socialisation (tacit knowledge ? tacit knowledge): "a process of sharing experiences and thereby creating tacit knowledge such as shared mental models and technical skills";
2. externalisation (tacit knowledge ? explicit knowledge): "a process of articulating tacit knowledge into explicit concepts. This form of knowledge conversion is typically seen in the creation of concepts which offers wider access to the knowledge and also links it to applications";
3. combination (explicit knowledge ? explicit knowledge): "a process of systematising concepts into a knowledge system. This mode of knowledge conversion involves combining different bodies of explicit knowledge …

through media such as documents, meetings, telephone conversations, or computerised communication networks";

4. internalisation (explicit knowledge ? tacit knowledge): This process is closely related to 'learning by doing'. It involves the embodiment of explicit knowledge into individuals' tacit knowledge bases in the form of shared mental models of personal technical know-how.

They emphasise that organisational learning depends upon the tacit knowledge of individuals and upon the ability first to combine tacit knowledge sources constructively and then to convert these into more explicit forms which are subsequently combined. Tacit knowledge itself is enhanced by explicit knowledge, taking the form of, for example, training inputs. Theirs is an insightful framework for understanding the processes that must be in place for new knowledge to become an organisational property and hence constitute organisational learning.

Barriers to Organisational Learning

There are often obstacles to the smooth operations of these processes which derive from the nature of the organisation and its culture. When a company is international such barriers are almost inevitably increased by the variety of different national identities in the employee group. Such barriers reduce what Hamel (1991) terms 'transparency', namely the openness of one person to the other, and the willingness to transfer knowledge.

Hamel found that some degree of openness was accepted as a necessary condition for carrying out joint tasks, but that managers were often concerned about unintended and unanticipated transfers of knowledge – transparency by default rather than by design. Obstacles to the necessary transference of knowledge identified by Nonaka and Takeuchi (1995) are liable to arise because of the divergent ways of sense-making and associated with the social identities of the different parties which make up the MNC.

Social identities as a barrier to learning in the MNC

When members of a worldwide organisation come together to collaborate, they bring their own social identities with them. These social identities are sets of substantive meanings that arise from a person's interaction with different reference groups during his or her life and career. They derive therefore from belonging to particular families, communities and work groups within the context of given nationalities and organisations (Tajfel 1982; Giddens 1991).

The receptivity of the members to knowledge transfer from their partners, and their ability to learn collaboratively from their knowledge resources are bound up with their social identities. Social identities are likely to create the greatest difficulties for learning in relationships that are socially constituted by firm members who are distinct culturally, nationally and in terms of the economic development level of the society from which they come.

Learning in these circumstances is not a socially-neutral process. Just as with knowledge that is offered in the learning process by one organisational speciality to others, so knowledge and practice transferred from one firm member impinges on the other members' mental constructs and norms of conduct. Their social identity derives from a sense both of sharing such ways of thinking and behaving, and of how these contrast with those of other groups. The process of transferring practical knowledge between different managerial groups will be interdependent with the degree of social distance that is perceived between the parties involved. So, if initially this distance is high, the transfer is likely to be difficult. If the transfer is conducted in a hostile manner or in threatening circumstances, then the receiving group is likely to distance itself from those initiating the transfer. There is a clear possibility of virtuous and vicious circles emerging in this interaction.

Quick summary

Barriers to Organisational Learning

- There are often obstacles to the smooth operations of these processes which derive from the nature of the organisation and its culture. When a company is international such barriers are almost inevitably increased by the variety of different national identities in the employee group.
- Such barriers reduce what Hamel terms 'transparency', namely the openness of one person to the other, and the willingness to transfer knowledge.

Relations between social identity and knowledge transfer

Your notes

MNCs present a particular challenge for organisational learning, which is intended to draw upon knowledge transferred between the firm members and to build upon the potential synergies between their complementary competences (Child & Rodrigues 1996). While international organisational networks are extremely important means for international knowledge transfer and synergistic learning, they introduce special sensitivities into the process. They may find it difficult to accommodate the interests of their constituent groups and to manage the cultural contrasts between them. These differences contribute to a sense of separate social identity between staff.

Some types of internationally transferred knowledge have an impact on group social identity more than others. This is particularly true of knowledge relating to new systems and strategic understanding. Resistance to the transfer of such knowledge is likely to heighten the separate identities of groups, including those doing the knowledge transfer for whom persuading their recalcitrant colleagues may take on the nature of a crusade. The relation between social identity and international knowledge transfer is a dynamic one, in which contextual factors such as performance also play a part through inducing changes in factors which condition the process. By contrast, the sharing and transfer of technical knowledge is normally less socially sensitive, and indeed is likely to benefit from the common engineering or other occupational identity shared by the staff directly involved.

Beliefs and myths

Members of an organisation will be reluctant to give up the beliefs and myths that constitute important supports for their social identity. Jönsson and Lundin (1977) write of the 'prevailing myth' as one that guides the behaviour of individuals in organisations, at the same time as it justifies their behaviour to themselves and hence sustains their identity. Beliefs and myths form an important part of the 'cultural web' (Johnson 1990) that sustains an existing paradigm and set of practices against the possibilities of their replacement through organisational learning. The social identities of those involved in an MNC are likely to be tied up in this way with their distinctive and separate beliefs, rigid adherence to which may be sustained by their very proximity to their partners who comprise an 'other' or out-group. This proximity reinforces the sense of difference on which social identity thrives.

The management of organisational learning

As you have been reading, organisational learning needs to be managed to achieve its optimal level in a firm. This involves recognising and overcoming a number of common barriers, which can be summarised as:

1. Cognitive barriers
2. Emotional barriers
3. Organisational barriers

Let us now look at these in more detail.

1. Cognitive barriers

   As you read earlier, a lack of intent to learn can be an important cognitive barrier that stands in the way of realising the learning potential within or between organisations. This can arise because a partner enters into an alliance for reasons other than learning, such as to spread the risks of R&D or to achieve production economies of scale, and does not appreciate that it has something valuable to learn until it becomes more familiar with that partner's capabilities. Inkpen (1995b, p. 13) found several examples of American firms that did not have a learning intent when entering

a collaboration with a Japanese partner, and only developed this when they became aware of their inferior levels of skill. Ways of reducing lack of intent to learn due to inadequate prior knowledge include programmes of visits, and secondments, to prospective cooperation partners, and close examination of their products and services.

2. Emotional barriers

   Emotional barriers to learning often boil down to a problem of mistrust. Genuine trust cannot be instantly established. It is, nevertheless, possible to identify conditions that promote trust and therefore to derive practical guidelines to that end. Commitment to the relationship, and a degree of direct personal involvement by the partners' senior managers, are again important here. If the principals take the time and trouble to establish a close personal relationship, this gives confidence and a signal for other staff from each partner to regard one other in a positive light. The conditions for reducing emotional barriers to learning within a collaboration require a long-term view of the cooperation and sufficient managerial commitment, especially from the top (Faulkner 1995a). Similar attitudes are relevant within an MNC.

3. Organisational barriers

   Serious organisational barriers are created if the senior managers do not know how to benefit from the opportunity to learn. Inkpen found that a major problem arose because of the inability of the American parents of joint ventures with Japanese partners to go beyond recognition of potential learning opportunities to exploitation of these opportunities. They did not establish organisational mechanisms to assist this exploitation. In some cases they even resisted the idea that there was something to learn from the collaboration, so contributing to a situation of blocked learning where joint venture managers could not get their improved understanding carried over into practical actions (Inkpen 1995b; Inkpen & Crossan 1995).

Your notes

Fostering the Learning Process

There are a number of different ways in which the learning process can be fostered within an organisation. Let us look at some of the key ways now.

Joint ventures

It is vital to understand that in the case of organisational learning, managers and staff will take their cue from the senior levels. Senior management is in a position to establish organisational procedures and provisions which foster the learning process. Inkpen and Crossan (1995) identify ways in which provisions can be designed, or practices encouraged, by senior managers which facilitate links across organisational boundaries which promote the learning process. In the case of joint ventures, these include:

1. the rotation of managers from the JV back to the parent;
2. regular meetings between JV and parent management;
3. JV plant visits and tours by parent managers;
4. senior management involvement in JV activities;
5. the sharing of information between the JV and the parent (Inkpen & Crossan 1995, p. 609).

Control

Control is a further organisational feature that facilitates learning. There are two main aspects to this:

1. establishing limits to the actions of participants in the learning process;
2. assessing outcomes.

Control is not usually regarded as a facilitator of learning. Indeed, learning is normally associated with autonomy and creativity, which are considered as opposites to control. However, control seems to be a very important condition for a learning intention to be given clear direction. Secondly, the systematic assessment of outcomes should ensure that these are recorded and so entered into the organisation's memory. It also provides feedback on the effectiveness of the learning process, which should enable MNC and alliance members to improve their capacity to promote learning.

Senior and middle management facilitating learning

At different points in this topic, you have read about the focus on the facilitation of learning by senior and middle management, which derives from their critical position in the middle of the vertical system. It echoes the conclusion reached by Nonaka and Takeuchi (1995) that what they term the "middle-up-down" style of management can make a crucial contribution to fostering knowledge creation. Managers in the middle can reduce the gap that often otherwise exists between the broad vision coming down from top management and the hard reality experienced by employees. The manager in the middle has the additional tasks of articulating the objectives for learning and providing the practical means to facilitate it.

Breaking down hostile stereotypes

The aim of organisational provisions is to promote the conditions for integrated learning, which you read about earlier in the topic. Another requirement, which the techniques of organisational behaviour can facilitate, is to break down the hostile stereotypes that may exist within a firm, and which if allowed to persist will militate against the development of trust and bonding.

Many of the techniques first developed by practitioners of 'organisation development' can be used to advantage in this situation, though one must remain sensitive to the cultural mix when deciding on specific methods. The 'confrontation meeting' approach, which often works well with North American personnel could, for instance, cause grave offence if tried with staff from East Asia. Once the problems inherent within such stereotypes are recognised, various techniques for team-building are available to promote a collaborative approach to learning between members of the firm.

Open communication and information circulation

A climate of openness can also facilitate organisational learning. It involves the accessibility of information, the sharing of errors and problems, and acceptance of conflicting views. The idea of information 'redundancy' expresses an approach to information availability that is positive for organisational learning.

Redundancy is:

> the existence of information that goes beyond the immediate operational requirements of organisational members. In business organisations, redundancy refers to intentional overlapping of information about business activities, management responsibilities, and the company as a whole. (Nonaka & Takeuchi 1995, p. 80)

This adds flexibility to the organisation, as in a changing environment it ensures a pool of knowledge available to draw on to implement new strategies.

For learning to take place, information or a concept available to one person or group needs to be shared by others who may not need the concept immediately. It may, for example, be information on how a particular problem was tackled creatively in another part of the MNC. If that information is circulated, it is accessible to others should a comparable problem arise.

Redundancy also helps to build unusual communication channels, and it is indeed fostered by the combining of horizontal with the more usual vertical channels for reporting information. In this way it is associated with the interchange between hierarchy and non-hierarchy or heterarchy (Hedlund 1986) which helps to promote learning on the basis of procedures that are different from those officially specified by the organisation and hence based on the solutions to old problems (Nonaka & Takeuchi 1995).

Your notes

The role of information technology

Modern information technology makes a very significant contribution to the promotion of information redundancy, through its capacity for information storage, and more importantly through its ability to transmit that information to virtually all points within an organisation. Email in particular offers access to information and the facility to communicate in ways which are not constrained by boundaries of time, geography or formality. So long as firm members link up their email systems, these provide an excellent vehicle to circulate non-confidential information and to encourage creative commentary around it.

The case of PepsiCo, summarised in the case study below, illustrates how information redundancy and modern information technology, which you read about above, are used to promote learning within the company. Open and fast communication is coupled with an encouragement of local managers to act upon the information circulated to them, including initiatives to contact others within the company worldwide from whom they might usefully learn.

Case Study: PepsiCo's approach to creating information redundancy

PepsiCo is one of the world's largest global food and beverage corporations, ranking 19th among US companies by market capitalization in 1996. It operates through many local alliances, and stresses the value of open communication both within its corporate systems and with its partners. An illustration of open communication with its partners is the fact that, in PepsiCo's China joint ventures, all the general managers speak Mandarin Chinese, and its Asia-Pacific budget meetings are conducted entirely in Mandarin.

Despite its size and scope, PepsiCo does not operate with organization charts or many formal procedures, but instead prefers to encourage informal communication flows and to promote the empowerment of its constituent units. As one corporate officer recently said, "at the end of the day the most relevant information for me, and the job I have to do, is going to come from the people who are closest to the project … so the lines of communication are open at all levels". Senior officers of the corporation stress the benefits of this approach for encouraging learning.

PepsiCo circulates information within its corporate network to the point of redundancy. Its internal E-mail system is an important vehicle for this circulation. It overcomes international time differences, permits simultaneous communication with several people, is very fast, and encourages an open, informal expression of views. Consolidated reports for different countries and regions are also widely circulated. If, as a result, managers wish to learn more about developments elsewhere in PepsiCo's worldwide operations, they have access to all the company's telephone numbers and are encouraged to make direct contacts and to decide whether to travel to the location, subject only to their travel and entertainment budgets. Many examples are told of how this rich circulation of information, and the ability to act upon it, have promoted learning and the transfer of beneficial practices throughout the corporation. For instance, it facilitated the transfer from their Hungarian operation to their China JVs of knowledge about ways of curbing theft on distribution runs.

Source: Personal interviews by John Child cited in Child and Faulkner (1998).

Summary

This topic has made the following key points:

Organisational learning can by analysed in three basic categories: technical, systemic and strategic. These do not come about automatically but need to be facilitated by organisational and cultural factors. Different MNC forms are susceptible to learning to a varying degree.

There are several requirements for learning to take place in an MNC or an alliance. There must be intention to learn. There must be the necessary capacity to learn and there must also be the capacity to convert individual knowledge into a usable organisational resource.

There are various forms of learning within firms or cooperative relationships: forced learning, imitation, blocked learning, received learning, integrative learning, segmented learning and of course non-learning. Each of these is associated with different degrees of change in understanding and in behaviour.

The successful promotion of learning within MNCs and international cooperative ventures requires: (1) the surmounting of cognitive barriers, and emotional barriers; (2) the reduction of organisational barriers; and finally (3) openness of communication and an effective circulation of information.

Task ...

Task 7.1

To check your understanding of the material in this topic, try to answer the following questions. If you have any difficulties, you may wish to go back and revise the relevant part of the topic.

1. Define the term 'organisational learning'.
2. List Senge's (1990) five building blocks for creating a learning organisation.
3. How can organisational knowledge become a source of competitive advantage?
4. How, according to Argyris and Schön (1978), can managerial reasoning lead to organisational decline?
5. Briefly describe Morgan's (1986) machine metaphor of the organisation.
6. How can the biological theory of autopoesis shed light on organisational dynamics?
7. According to Stacey (1993b), which state of chaos do organisations operate within and why?
8. How can multiple dominant logics (Prahalad & Bettis 1986) better equip diversified multinational companies to cope with a variety of complex strategic issues?.

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Topic 8

The New Economy

Aims

The purpose of this topic is to:

- illustrate the economic differences between the traditional economy and the new hi-tech economy;
- show the problems of industries in which costs do not eventually rise and there is therefore no ultimate equilibrium;
- illustrate the importance of externalities to the new economy;
- describe the theory of 'winner takes all' and its implications.

Objectives

By the end of this topic you should be able to:

- understand the problems of companies seeking to survive in the new economy;
- perceive how information industries differ from production or traditional service industries;
- see how the rules for the new economy are developing;
- consider the degree to which all industries will eventually be pulled towards the structure of the new economy as information becomes the only source of ultimate competitive advantage.

Introduction

The dot-com bubble may have led to overoptimistic forecasts of the degree to which the Internet and microchip technology would revolutionise business methods, company valuations and asset management techniques, but even a few years after its demise some things have changed for ever, and the 'new economy' can be seen to have come into being in a number of industrial sectors.

Although the traditional economy still flourishes in many manufacturing and commodity sectors of the economy, where the information economy has taken over, clear differences in the nature of economics can be seen. The traditional world is one of planning control, scale and scope economies and diminishing returns after a point. It is also one where the economists' concept of market equilibrium, strategic optimisation, and an inexorable tendency to move towards the elimination of rents from product and company uniqueness can frequently be witnessed.

In the new economy increasing returns are the norm, and hence equilibrium is rarely found as supply and demand curves do not cross. In these high-tech and service economy markets, positive feedback and externalities are experienced in particular from email and the Internet. It is a world of high uncertainty where very high levels of finance are needed to develop new and improved technology formats, and where 'winner takes all' is the norm. Organisations eschew traditional hierarchies in favour of task forces, clear missions, flat organisation structures and power moving towards those with knowledge rather than seniority. The ability of technology format winners to lock in customers makes traditional movement towards commodities unlikely to happen. The end comes instead when the existing format is replaced by a new one. Technology development is more competence destroying than competence enhancing (Tushman & Anderson 1987)

The Traditional Economy

Let us first take a look at what we mean by a 'traditional economy'. The growth of the capitalist system, mass production in factories, the joint stock company, and Marshallian economics led to the description of the industrial system in the following terms:

> Products are made or 'supplied' in factories by wage-based labour, and costed by adding overheard costs to unit costs based on the cost of raw materials and of manufacturing processes. Economies of scale and experience curve effect lead unit costs to reduce as the level of output increases inter alia as the overheads are spread more thinly per unit of output. On the demand side, price is set by the strength of demand in relation to supply; the level of demand generally increases as price declines. Prices are determined at equilibrium by the point at which the supply curve rising cuts the demand curve declining, with a y axis of price and an x axis of output. Economists believe that output expands to the point at which the marginally supplied product equals the marginally demanded one, though it is difficult to see how this can be the case ex ante, when manufacturers rarely know the cost of their marginal product from either a supply or demand viewpoint.
>
> Nonetheless, in the traditional economy, due to diseconomies exceeding economies of scale, the cost curve eventually turns upwards and equilibrium is believed to occur when the two curves cross. In this traditional economy, firms do not become infinitely large, because their cost curves turn upwards and diseconomies of scale occur. Furthermore competitive advantage is generally transient, since in attractive and profitable markets, new entrants compete

Quick summary

The traditional economy

- Market power in a traditional economy is established through the medium of barriers to entry that inhibit would-be competitors from entering the market. Saloner notes these barriers are of three types.
  1. cost to establish new competitor in industry
  2. brand name and reputation
  3. legal barriers, for example licence restrictions to running a lottery in the UK.

away excessive rents, and firms and products move towards the status of commodities. The world is one of large factories, workers travelling to work in them, organisational hierarchies, vertical integration of functions and planning and control.

Market power in a traditional economy is established largely through the medium of barriers to entry that inhibit would-be competitors from entering the market and competing away economic rents. As Saloner (2001) notes these barriers are of three types.

1. Barriers that come from production and distribution technologies. These are essentially cost barriers, in that a new entrant would be involved in very substantial costs to establish itself in a new industry.
2. Barriers of brand name and reputation. Where these factors are important for success, a time element is added as brand names and reputations are not created overnight.
3. Legal barriers. These may be absolute barriers. For example under current UK legislation it is not permissible to run a lottery without governmental permission, which is currently granted as a monopoly to a single provider. Economies of scope provide a means whereby a new entrant to a market may hope to mitigate the costs of the first two of these types of barrier, by introducing products produced in existing factories, distributing them through existing channels and relying on existing brand names and reputation.

For example it would be very difficult, though not impossible, for new companies to enter the fizzy drinks industry which is so dominated by Coke® and Pepsi®. There may not be legal barriers but the brand name barriers make the task a daunting one.

Despite these market imperfections that lead to the development of imperfect competition, products in the traditional economy are demanded and supplied in a way largely independent of other products. It is this picture of the industrial scene that is now under threat in the global high technology industries, with their network economies, where there is little conformity with the above economic assumptions of the 'old' world.

This lack of conformity with the economic assumptions of the 'old' world can be seen in the network economy, as costs continue to decline over any foreseeable product range and equilibrium is therefore not possible. Furthermore specific proprietary technological recipes come to dominate markets and 'winner takes all' situations enable competitive advantage to be maintained over the long term.

The concepts of network can be divided into two parts – real networks and virtual networks (Shapiro & Varian 1999).

Real networks have existed for centuries and include telephony and railways, and they are generally physical and tangible. They may be one way, e.g. broadcasting or two-way, e.g. telephone systems. The value of the network to the consumer rises disproportionately higher than the increase in the number of people using the network. Each additional user can be contacted by all the existing users.

Virtual networks are exemplified by computer and software platforms. They are generally intangible but similarly liable to the network externalities that apply to real networks. Thus Apple suffers in that the Apple network is disproportionately less powerful than the IBM and clones network as it has only about 10% of its users. There are more applications written for the IBM and clones network than for Apple for this reason.

Your notes

The benefits of the network effect

The development of the Internet has provided a free infrastructure for the rapid exchange of information, and the rapid gathering of knowledge through powerful search engines like Google, which would have previously taken considerable time and money to gather. An important implication of the growing importance of networks is that companies do not have to have vast capital anymore to successfully exploit new opportunities. The virtual corporation can achieve a lot, for example, Dell, Sun Microsystems and many others.

It is not only companies that benefit from network effects but also new geographical 'centres of excellence in ICT activity'. Mature industries in developed countries can no longer be guaranteed to dominate. China, Poland and a lot of other developing countries are playing an increasingly important role (Sammut-Bonnicci & McGee 2002), and Malaysia is developing two of the world's 'smart cities'; Putrajaya and Cyberjaya.

Infrastructure within network industries

Sammut-Bonnicci and McGee (2002) identify four levels of infrastructure within network industries:

1. Technology standards
2. The supply chain driven by such standards
3. The physical platforms that are the output of the supply chains
4. The consumer networks

Technology standards

Automated teller machines (ATMs) must work to the same standard across the world or tourists cannot withdraw their cash when on holiday in foreign parts. The need for international standards is therefore vital. The process to achieve selection of such standards depends on (1) market-based selection and (2) negotiated selection. Market-based selection depends upon the ability of a company to achieve the dominant design paradigm (Teece 1987). This is a hazardous process and needs substantial finance, strong marketing, and a lot of luck. Negotiated selection is less wasteful in competitive terms. An example of this is Groupe Speciale Mobile, the current mobile technology in Europe, which is an association of 600 network operators and suppliers in the mobile phone industry (Sammut-Bonnicci & McGee 2002). It establishes industry standards.

Supply chain

With the growth of telecoms networks, of the Internet and of the use of computers in every office on every desk, the construction of supply chains has tended to become unbundled into specialist activities of expert suppliers. The supply chain then tends towards the essence of an ecosystem. Internet service providers (ISPs) supply the chain of information to the Internet user. Owners of web pages (companies of varying sizes from one person to a PLC) provide the content. The recently developed 3g telephone provides an alternative means of both communication and information provision to the computer. Information economy supply chains become complex webs with each member having to collaborate with all the other members to be effective. As technology provision become more and more similar and more open, barriers to entry become lower for most providers, and the challenge is to achieve some 'killer' application that is non appropriable. However networks are becoming more important than any one provider and the more members join a network, the more incentive there is for others to join.

Physical platforms

These are the technical networks supporting telephones, satellites, TV and local area networks. Wintel is an example of an open platform for PCs. Traditional-

ly many problems exist in connecting physical platforms in one country with those in another, e.g. railway gauges. The standards that govern how a system and its modules interact are called the network's architecture (Morris & Ferguson 1993). The main components of the Internet architecture are standard setting bodies like the world-wide web (www) and the Internet Engineering Task Force (Vercoulen & Wegberg 1998). The reach of the technical platform determines the possible size of the consumer base; see how Microsoft with its open system has a much larger potential base than Apple with its proprietary architecture. The Ethernet is an early example of an alliance formed to increase the size of a physical platform (Sammut-Bonnicci & McGee 2002.) Its strength is that it allows PCs and workstations from different manufacturers to communicate by using an agreed standard. Examples of physical platforms are Windows®, Intel chips, PCs and servers.

Consumer networks

Products have an intrinsic value in use, and this is the underlying assumption of traditional economic theory. However in a network economy there is a further value that arises from being able to take part in a network's activities known as its 'synchronisation'. For example Microsoft and Intel have cooperated to make Windows exclusively compatible with both their architectures; this is known as the Wintel Advantage. If the joint architecture becomes sufficiently popular it 'tips' the market and achieves lock-in for it users and owners. Switching costs prevent users moving to another system unless they come to regards it as very superior. The QWERTY keyboard to the traditional typewriter achieves a similar type of lock-in through the switching costs needed to retrain to use a new configuration (Sammut-Bonnicci & McGee 2002). Examples of consumer networks are PC producers, retailers, offices and homes.

The Information Economy

The new economy is often known as the information economy. The information economy has characteristics quite different from those of the manufacturing economy. It is characterised by:

- High fixed costs but negligible marginal costs (for example, the cost of an extra pack of Windows software is a few pennies). Thus there is the high cost of creating intellectual property but not of reproducing it.
- Information is an experience good, as economists term it, every time it is consumed.
- Information overload becomes the norm. For example, Google knows everything you need to know if you can access it with the right keywords. Value resides in the search engines and their manipulation.
- An extensive, expensive technology infrastructure is required to produce and distribute information, and this needs to be compatible with other purveyors and receivers of information by similar means.
- Pricing is value-based not cost-based. It's based on what the market will bear, and the competition cannot compete away.

On the basis of these characteristics there has been a systematic and ever-increasing shift from the traditional industrial economy to a knowledge-based or information economy (McGee & Bonnicci 2002).

The creation of the knowledge infrastructure lies in extracting knowledge from the original knowledge providers, such as encyclopaedia producers, software and telecoms companies, and journal article writers. It is then bundled and diffused to a market by means of the Internet. The implication of this is that much knowledge becomes a commodity, available to all, and the tacit knowledge that empowered the vertically integrated firm becomes converted into explicit knowledge. This leads to the break-up of the extensive proprietary functions of the firm. It then leads to its replacement by market relationships, out-sourcing, the hollowing out of the traditional corporation and its replace-

Quick summary

The information economy

- The new economy is often known as the information economy. .
- The creation of the knowledge infrastructure lies in extracting knowledge from the original knowledge providers, such as encyclopaedia producers, software and telecoms companies, and journal article writers.

ment by the virtual corporation.

Your notes

Developing an information economy

Quinn (2001) describes the process of the development of the information economy as coming about in six phases:

1. Economies of scale are created as large companies capture key knowledge activities, which knocks small firms out of the market.
2. Economies of scope develop as the same technologies are spread throughout the corporation embracing new products without increase in incremental costs.
3. Disintermediation then takes place as proprietary links within the firm give way to market links. The information generation department folds as Google serves every executive's desk.
4. Deconstruction of the company's vertically integrated systems in the knowledge area then takes place.
5. Deregulation of knowledge then happens as new competitors with new knowledge make cross-competition possible.
6. Redispersion of knowledge finally takes place as more localised knowledge becomes important for reassertion of competitive advantage. Local brokers and selling agents emerge.

As an illustration of this process the reader is directed to the case study of Rupert Murdoch's BskyB.

McGee and Bonnicci (2002) summarise:

> The open standards and the universal connectivity inherent in information technology enable knowledge modules to be 'snapped together' similar to the Lego system, without any expensive customisation or reworking.

The new business models

Evans and Wurster (2000) describe the development of three new business models as a result of the restructuring of the traditional models in the new information economy:

1. The new competitor
2. The deconstructed value chain
3. The reconstructed value chain

The new competitor

This approach involves a brand name company providing product in the traditional way but supplementing it by the provision of information direct to the customer that helps to establish psychological switching costs in the preferences of the customer. Thus customers can order books from Amazon.com and they will experience little difference from buying from an online mail order catalogue. However once Amazon has got the customer's email address it can use it for the provision of what is new and relevant to the known interests and tastes of the customer virtually without cost. This also creates the impression in the mind of the customer that Amazon is in some way its literary adviser, and gives it a much greater status than that of mere bookseller.

The deconstructed value chain

In this model, the service provider focuses on a few typically knowledge-based core competences that it believes it provides excellently, and on which its competitive advantage is believed to be based. It has then to ensure that the remaining activities that it is expected to provide can be bought in from quality external suppliers. It attempts to maintain control of its offering by es-

tablishing and retaining bargaining with its suppliers and partners. Thus vertical integration gives way to orchestration (McGee & Bonnicci 2002). The activities of Nike and Hewlett Packard are examples of such deconstructed value chains. Things can go wrong in this process as for IBM when the outsourced partners Microsoft and Intel became arguably more powerful than the original brand name firm. The result can be new powerful oligarchic suppliers, or fragmented specialist activity industries with largely commodity special interest products and minimal economic rents.

The reconstructed value chain

In this model, knowledge-based competences become the controlling element in the supply chains of multiple firms often in different industries. Thus Apple software is not limited to the computer industry but becomes, through the medium of the iPod® and iTunes®, critical to competitive advantage in the music industry. A second phase of this reconstruction may lead to the development of corporate level core competences able to manage a whole set of collaborative relationships made up of a web of strategic partners and suppliers. Thus the vertically integrated company is transmuted into a value web in which the centre of the web, the knowledge provision competences, is held together by a technological corporate glue and extends across a range of other strategic linkages and traditional value chains. Microsoft is the master of achieving such a position. The points of leverage for this core competence are the specific knowledge-based assets that are applied across different industries. This strategy replaces traditional product–market strategies (McGee & Bonnicci 2002).

Network externalities

A key driver of the new information economy is network externalities. Network externalities may be defined as the increase in utility that a user gets from a product as the number of other users increases (Katz & Shapiro 1985). Just as there was no point in having an email address in say 1970 if no-one else had one, it is now essential to have one as few people engaged in the modern world seem to be uncontactable by email. Indeed it is often said, "If he is not on email, he is not the sort of person we should be dealing with …!"

Externalities are to be found in all areas of life, often quite outside the information microchip economy. For example, as Economides and Flyer (1997) point out:

> The value of a sporting event is influenced by the aggregate size of its audience, as this enhances the excitement level, analysis, discussion, and remembrance of the event.

So consumer externalities are affected by the level of total demand for a product or service. Where such consumer externalities are very strong, there is a tendency towards a single network, platform or standard; hence the power of Microsoft Windows®, or the VHS format for video-recording.

Critical mass

Given what you have just read about network externalities, the battle for critical mass and therefore for a market 'tipped' dominance replaces the traditional battle for market share through the sale of individuated products. In network economies the customer will not buy if the installed base is too small. Paradoxically in the old world economics value comes from scarcity. In the new world economy however value comes from plenty! (McGee & Bonnicci 2002). The more a product is demanded, and the more it is expected to be demanded, the more valuable it becomes.

When the expectations of the market are at such a level that any new buyer only considers the dominant provider because of its dominant installed base, then the market 'tips' into 'winner takes all' mode. The skill of marketing becomes the management of expectations. An example from the political sphere

Your notes

is that many voters would vote Liberal Democrat, but they don't because they feel it would be a wasted vote. The Lib Dems are seen as the third party, not the alternative government provided by the Official Opposition. However if by powerful marketing, expectations were to be raised such that they were seen as an alternative government, then the market would 'tip' and the expectations might well be self-fulfilling.

As Mcgee and Bonnicci put it:

> traditional economic thinking is based on negative feedback systems in which the strong get weaker at the margin, and the weak get stronger, thus providing a drive towards competitive equilibrium. This is captured in economics by the concept of diminishing marginal utility as consumption grows. In the new World of networks, positive feedback rules. In this world, the valuation of a product increases the more that others consume the product.

A difficult decision

Given the circumstances you have just been reading about, firms with a new platform face a difficult trade-off:

- whether to adopt open systems and risk other competitors joining a network and managing somehow to appropriate the lion's share of the value; or
- whether to market a proprietary platform, control it and live with the lower level of externalities.

IBM chose the first route and soon faced a whole army of clones adopting its platform and competing strongly from a lower cost base. Meanwhile Microsoft and Intel, IBM's subcontractors, but ones with less immediately appropriable technologies, gained the majority of the value-added available.

Apple adopted the other strategy and remained proprietary. The result was lower externalities, fewer adopters, higher costs and a market 'tipped' towards the IBM-clones–-MSN–-Intel formula.

So both lost out. Rupert Murdoch with Sky seems at present not to have suffered a similar fate as he has built his proprietary network, weathered the storm of possible alternative platforms and seems to be emerging as a 'winner takes all' competitor. The new world competitor faces greater uncertainties than the old world one, and needs greater financial resources until he emerges as the winner, or concedes defeat as the loser.

Rules for the New Economy

The new economy however, still seems to have to some rules. Mcgee and Bonnicci (2002) suggest the following rules dominate the new unregulated information economy:

1. The new information economy depends upon connectivity for the achievement of its inherent externalities and hence value. Without connectivity we are back in the old economy of marginal utility diminishing with amount. With connectivity, the economic law of plenty comes into play.
2. The outcome of competition between rival networks is hard to predict in advance. The management of expectations is key, and until such expectations point strongly one way, anything can happen.
3. The development and marketing costs of establishing a new platform are very high, but the costs of 'rolling it out' very low. Very high financial resources are therefore necessary in the early phases of taking a market to 'tipping' point.
4. Then 'winner takes all'.

5. High uncertainty prevails until the market tips, and even then there is no certainty that a new technology may not arise and replace the current dominant one. Who would bet on the future life of the VHS video-recording system?
6. The law of inverse pricing often applies in order to get installed capacity. Thus SKY gave away set top TV boxes so that the subscriber base for its services could be expanded dramatically. Google is free to users, so that it becomes immensely attractive to advertisers because of its immensely high user base.
7. Open standards are the key to volume, but they bring vulnerability to the appropriation of value added by others. Protected standards limit one to a niche and the risk of the market tipping strongly away from you.
8. The successful strategy is difficult to choose, but before all else the difficult decision of which network to join has to be faced. If it turns out to be the wrong network, all is lost because of the failure not of oneself but of another.

An illustration of this process is to be seen in the dominance of the PC word processing market by Microsoft Windows® and Office® products. Few consumers would now consider buying anything other than Word® for word processing since everyone else has it.

Inevitably such draconian rules lead to very unstable economies. As a result the new economies are ripe either for regulation, or for the stabilising forces of collaboration.

An example of this is GSM, an association of 600 network operators and suppliers in the mobile phone industry. They have set a common standard for mobile communications in order to create a homogeneous industry where equipment, software, networks and therefore people can talk to each other wherever they are geographically. Standardisation and enforced compatibility ensures stability, and removes some of the riskiness from further research and development in the industry.

So speak the strategic conclusions of McGee and Bonnicci and others.

These conclusions are based on the original work of a maverick economist named Brian Arthur of the Santa Fe Institute in California. He was held in very sceptical regard until recently by his orthodox peers in the world of economics, but has an ever increasing following as his heterodox views proved to have considerable validity. He is most associated with the theory that returns at the margin need not decrease with volume. In other words, the doctrine of increasing returns come into play that Hicks in 1939 said would lead to the "wreckage of the greater part of economic theory".

The economics of Brian Arthur

Arthur (1996) holds that in the world of Alfred Marshall the assumption of diminishing return after a point made sense in the bulk processing, smokestack economy of the day where the finite size of factories placed limitations on the degree to which scale economies could be achieved. However developed economies have transformed from bulk material manufacturing to the design and use of technology – from processing resources to processing information.

With this transformation has come the movement from diminishing returns to increasing returns, as the limitations of factories does not apply in the realm of ideas. In the world of information those that by strategy or luck get ahead tend to move further ahead and those that fall behind get further behind. However the world of manufacturing (with diminishing returns) exists alongside that of increasing returns, so both are found co-existing in the modern world.

Your notes

The 'old world'

In the old world the limitations were in the number of consumers who preferred a given brand, the limitation of regional demand, and limited access to raw materials and other resources, plus it must be said the limitation of the size of existing production resources, and the bureaucratic inefficiency that tends to come with size and complexity. Competition also ensured that 'the best' became the most successful in most cases, as consumer choice could ensure this.

The 'increasing returns' world

In the increasing returns world this is not the case as the company that is far ahead can lock-in consumers. DOS was not the best system in the view of computer professionals but it locked in the market and built Microsoft's power. This happened, but it might not have done so. No outcome was predictable before the market tipped.

Increasing returns long regarded by orthodox economists as an anomaly are not so, and dominate the high-tech world for the following reasons:

- They have high up front costs but ever reducing unit costs as sales increase.
- Network effects guarantee the establishment of a standard and this ensures the predominance of the standard bearer.
- Customer groove-in – high-tech products are difficult to use, and when customers have learnt to use them they are reluctant to re-learn with new offerings.

The old world versus the knowledge-based world

- Organisationally the old world fitted hierarchies, planning and control, optimisation and efficiency. The new world is one not of constantly refined production methods, but of foreseeing the 'next big thing'. Thus hierarchies dissolve and companies become task forces, organisationally flat, innovative and with flexible strategies. Optimisation is replaced by being smart, guessing well or luckily, and forever changing. It is adaptation not optimisation that is the order of the day.
- Discounting heavily to get ahead is key to success. Netscape gave away its Internet browser free and won 70% of the market at one stage. Then it profited from spin-off software and applications. However this does not guarantee ultimate survival.
- Technological ecologies are now the basic units for strategy in the knowledge-based world, not individual companies. Players tend to compete not with individual products so much as by building web-alliances of companies organised around a mini-ecology that increases positive feedback from increased usage.
- Psychology is also very important in increasing returns markets. Pre-announcements, feints, threatened alliances and market posturing can frighten off competitors. Game theory is used to the full. If rivals believe that a market will become locked in by a competitor, they will get out and validate the perception.

> Above all, strategy in the knowledge world requires CEOs to recognise that a different kind of economics is at work. CEOs need to understand which positive and negative feedback mechanisms are at play in the market ecologies in which they compete. (Arthur 1996

The case of service industries

Service industries are a hybrid of the two types of economy. They exhibit some of the characteristics of increasing return industries, in that the more well known and popular they are, the more people are likely to use them. However in day to day operations they are more like traditional industries. Nonetheless,

services are using more and more high-tech technologies, and as a result their similarity to information industries is growing.

> In technology, economics and the politics of nations, wealth in the form of physical resources is steadily declining in value and significance. The powers of the mind are everywhere ascendant over the brute force of things. (Gilder 1989)

Thus increasing return industries will inexorably come to replace traditional diminishing return industries in the economies of the world.

Your notes

Summary

This session has introduced the new economy, which has emerged as a consequence of the increasing use of the micro-chip in so many areas of life. The new economy is to be found predominantly is high-tech information dominated sectors, but also in certain service sectors. As microchip-dominated automation spreads however, the traditional sectors of the economy are likely to be invaded by new economy characteristics. In short, traditional industries are characterised by movement towards equilibrium when demand and supply meet at a price, due to upturning cost curves. Diminishing returns to scale after a point are therefore the rule. These characteristics are not found in the new economy. A point is unlikely to be reached at which costs increase from the sale of a marginal unit of Windows® by Microsoft. new economy firms and industries lead to increasing return therefore over any likely scale,. They have no equilibrium point. Successful firms in the new economy only start to fail when a new technology formula takes over. However, positive feedback in markets, the importance of installed capacity and the externalities that result from an increasing volume of customers put off the point of decline, until some new technology offering reaches a 'tipping point' when new customers 'naturally' choose it rather than its predecessor, since 'everyone else is choosing it'. Companies operating in the new economy also look and feel different from traditional companies. Their organisational hierarchies are flatter. Power lies in knowledge rather than ex-officio position. Many are virtual corporations rather than fully integrated corporations, and intellectual property right plus powerful marketing are the prerequisites for success in the new economy. But even then high uncertainty surrounds the sector, and 'deep financial pockets, are needed to play at all.

Task ...

Task 8.1

To check your understanding of the material in this topic, try to answer the following questions. If you have any difficulties, you may wish to go back and revise the relevant part of the topic.

1. What are the key characteristics of a traditional industry?
2. What is meant by the new economy?
3. What are the implications of network externalities for the new economy?
4. Why are they 'winner takes all'?
5. What is a 'tipping point'?
6. What are the implications of the new economy for the value chain?
7. Are new economy industries always service sector industries?
8. Why is 'installed capacity' so important?
9. Do new economy industries have an equilibrium point?

Resources

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Topic 9

Mergers and Acquisitions

Aims

The purpose of this topic is to:

- show the importance of M&A activity in the growth of an ambitious firm;
- explain that real mergers are rare and M&A generally describes acquisitions;
- identify the key motives for M&A;
- show the evidence that M&A activity rarely improves earning per share;
- stress that post-acquisition integration is key to success.

Objectives

By the end of this topic you should be able to:

- see why M&A is so popular despite its poor record of achievement;
- understand the major forms of acquisition integration;
- see how value can be achieved in the best-judged acquisitions;
- understand the pitfalls faced by would-be acquirers.
-

Introduction

Although mergers and acquisitions are often treated together in the literature, legally they are transactions of a different kind.

- An acquisition is an outright purchase of one company by another. It occurs when one company acquires enough of another company's shares to gain control or ownership.
- A merger is in theory a collaborative agreement by two companies to combine their interests, ownership and company structures into one company. However, mergers are not normally a marriage of equals. An acquisition of two significant brand name companies is often presented to the world as a merger largely to save the face of the company being acquired. For example Chrysler and Daimler-Benz was announced as a merger of two world famous car companies. However, it soon became apparent that it was in fact an acquisition by Daimler-Benz of Chrysler. The composition of the new board and the origin of the new CEO generally show which company is actually the acquirer.

In this topic therefore the terms merger and acquisition are used interchangeably, and are frequently referred to as M&A activity.

Why Undertake M&A Activity?

Mergers and acquisitions are generally presented to shareholders as highly rational strategies with clearly defined goals and objectives. Typically these are of a financial or strategic nature.

- Financial goals include increasing shareholder wealth and financial synergy through economies of scale, the transfer of knowledge and increased control.
- Strategic reasons include increasing market share, the reduction of uncertainty and the restoration of market confidence. Mergers and acquisitions can also be sought by companies seeking to ward off hostile take-over bids.

Spurred on by the process of economic globalisation, cross-border merger and acquisition emerged as the business growth area of the mid to late 1990s. By 1996, such activities were worth more than $250 billion per annum.

Some examples

Some of the largest mergers and acquisitions during this period occurred in the finance sector. For example, in late 1998, Deutsche Bank launched a £6 billion sterling takeover of Banker's Trust of the US. This had been preceded by the £3.1 billion sterling acquisition of Mercury Asset Management Group by Merrill Lynch & Co. in 1997, and the 1996 union of Invesco plc and AIM Management Group Inc, valued at £977 million sterling.

Other influential business sectors, such as the oil industry, witnessed a major period of consolidation in the late 1990s. For instance, the 1998 acquisition of PetroFina by Total created a combined market capitalisation of almost $40 billion. The $75 billion Exxon and Mobil merger, which occurred in the same year, became the largest merger on record at the close of the twentieth century.

The trend towards mergers in the US banking sector was further consolidated when, in 1997, Morgan Stanley, the investment bank, merged with Dean Witter. In April 1998, Citicorp and Travelers Group announced a $160 billion merger, to create a world-wide financial services giant with operations ranging from credit cards and banking (retail, investment, private) to fund management and insurance. The new company was named 'Citigroup'. The market responded by adding $30 billion to the value of the two firms' shares in a single day.

Quick summary

Why undertake M&S Activity?

- Mergers and acquisitions are generally presented to shareholders as highly rational strategies with clearly defined goals and objectives. Typically these are of a financial or strategic nature.
- Mergers and acquisitions are justified by the extent to which they add value.
- The main problem associated with merger and acquisition strategy lies in the ability to integrate the new company into the activities of the old. This problem often centres around problems of cultural fit.

What drives M&A activity?

Mergers and acquisitions do not always involve companies engaged in the same business activities. A company pursuing a diversification strategy, for example, may acquire companies in other related or unrelated areas. When these forms of business expansion lead to the eventual integration of two companies in the same business, the result is a horizontal integration. This is a strategy which can be deployed to defend or strengthen an existing market position.

Mergers and acquisitions are justified by the extent to which they add value. Value is added if distinctive capabilities or strategic assets are exploited more effectively. Adding value requires some synergy, which may be obtained from matching distinctive capabilities or strategic assets, winning access to complementary assets, or deriving economies of scale and scope related to the core business.

Cross-border M&As with the highest potential for success tend to be between firms that share similar or complementary operations in such key areas as production and marketing. When two companies share similar core businesses, there can be opportunities for economies of scale at various stages in the value chain (for example, R&D, sales and marketing, or distribution).

Complementary operations + competencies = value added.

The main problem associated with merger and acquisition strategy lies in the ability to integrate the new company into the activities of the old. This problem often centres around problems of cultural fit. A merger is generally more of a mutually agreed process. Cultural fit is more likely as companies actively seek synergistic benefits.

The strategic logic behind M&A is generally impeccable, particularly in terms of cost-reduction, especially of labour costs. For example the Exxon/Mobil merger was estimated to realise cost savings of $4 billion per annum.

Yet many fail to produce the value added predicted. For example, Sony's 1989 acquisition of Columbia Pictures resulted in Sony being forced to accept a $3.2 billion write-down in 1994. As the following case study illustrates, a failure to look for, develop and foster synergies between companies prior to a take-over, can often lead to real operational problems afterwards.

Case study: One big unhappy family at Mellon Bank

In the early 1990s, Frank Cahouet, the CEO of Philadelphia-based Mellon Bank, conceived of a corporate strategy that would reduce the vulnerability of Mellon's earnings to changes in interest rates. Calhouet's solution was to diversify into financial services to gain access to a steady flow of fee-based income from money management operations. As part of this strategy, in 1993 Mellon acquired The Boston Company for $1.45 billion. Boston was a high profile money management company that manages investments for major institutional clients such as state and corporate pension funds. In 1994 Mellon also acquired Dreyfus, a mutual fund provider. As a result, by 1995 almost half of Mellon's income was generated from fee-based financial services.

Problems at Boston began to surface though soon after its acquisition by Mellon. From the start there was a clear clash of cultures. At Mellon, many managers arrive at their offices by 7am and put in twelve hour days for pay that is modest by banking industry standards. They are also accustomed to a firm management hierarchy that is carefully controlled by Frank Cahouet, whose management style emphasises cost containment and frugality. Boston managers also put in twelve hour days but they expect considerable autonomy, flexible work schedules, high pay, ample perks, and large performance bonuses. Mellon executives who visited The Boston Company unit were dumbstruck by the country club atmosphere and opulence which they saw. In its move to streamline Boston, Mellon insisted that Boston cut expenses and introduced

new regulations for restricting travel, entertainment, and perks.

Things started to go wrong in October 1993 when the Wisconsin state pension fund complained to Mellon of lower returns on a portfolio run by Boston. In November Mellon liquidated the portfolio, taking a $130 million charge against earnings. Mellon also fired the portfolio manager, who it claimed was making 'unauthorised trades'. At Boston, however, many managers saw Mellon's actions as violating guarantees of operating autonomy that Mellon had given Boston at the time of the acquisition. They blamed Mellon for prematurely liquidating a portfolio whose strategy, they claimed, Mellon executives had approved and that moreover, could still prove a winner if interest rates fell (which they subsequently did).

Infuriated by Mellon's interference in the running of Boston, in March seven managers at Boston's Asset Management unit, including the unit's CEO, Desmond Heathwood, proposed a management buyout to Mellon. Mellon rejected the proposal and Heathwood promptly left to start up his own investment management company. A few days later Mellon asked its employees at Boston to sign employment contracts that limited their ability to leave and work for Heathwood's competing business. Another thirteen senior managers refused to sign. These thirteen all quit and went to work for Heathwood's rival money management operation.

These defections were followed by a series of high profile client defections. The Arizona state retirement system, for example, pulled $1 billion out of Mellon and transferred it to Heathwood's firm.

Reflecting on the episode, Frank Cahouet noted that 'we've been clearly hurt … but this episode is very manageable. We are not going to lose our momentum'. Others were not so sure. In this incident they saw yet another example of how difficult it can be to merge two divergent corporate cultures and how the management turnovers that result can deal a serious blow to any attempt to create value from an acquisition.

Source: Adapted from Hill and Jones (1998) Strategic management: an integrated approach, p. 329.

Your notes

Acquisition

A 1998 PriceWaterhouseCoopers (PWC) investment management survey found that the primary rationale for most acquisitions is that it provides the fastest route to growing revenues. This can be achieved in a number of ways:

- Helping to reach critical mass or otherwise increase penetration in existing markets
- Bringing together complementary assets, e.g. product and distribution
- Providing an immediate track record in a new market.

This is especially true when setting out to develop new business in other countries, where local knowledge and expertise are required or regulations demand a local presence (PWC 1998). Acquisition also allows quick access to new product and/or market areas. A company may lack the internal resources or competencies to develop a particular strategy and may therefore, for example, acquire a company for its R&D expertise. Furthermore, acquisition may be used as a means of avoiding the danger of excess capacity in static markets.

Other financial motives include the fact that a firm with a low share value may be a tempting target. This may result in short-term gain through 'asset stripping'. Finally, as already mentioned, acquisition strategy can benefit a company through increased economies of scale. This emerges not only through lower unit costs but also increased capital for investment in service.

Acquisition strategy often proves problematic, particularly when there is insufficient cultural fit between the acquirer and the acquired. Indeed Porter (1987) finds that they are more often than not failures in terms of meeting the expectations of the buyer.

M&A as an alternative growth strategy

M&A can be regarded as an alternative growth strategy to internal development and strategic alliances. Depending upon the specific circumstances, each of these three means of development may be preferred, but each has distinctive characteristics and drawbacks.

- Internal development preserves control and proprietary information in the company, but limits the strategic assets to those already possessed and tends to be slow.
- Alliances are relatively low risk and inexpensive but involve dilution of control and the high possibility of culture clash.
- M&A can be very expensive (35% average share premiums on purchase), may lead to hostility in the acquired company workforce and/or the loss of the best staff, and frequently involves integration problems. However it remains the most popular means of growth and extension of global reach. It has been estimated that there are ten examples of M&A annually for ever one strategic alliance. 1999 recorded 32,000 acquisitions worldwide and a total value involved of $3,317 billion. (Thomson Financial securities data)

Classification of M&A

Cartwright and Cooper (1992) describe three different types of acquisition:

1. Friendly: when the first take-over bid is accepted, it is classified as friendly.
2. Contested: when there are specific issues which need to be debated and resolved, the take-over is classified as contested.
3. Hostile: this is the type that attracts the most attention in the media. When a company realises that a take-over is inevitable, it can deploy tactics to ward it off. One such tactic is to make a bid for another company in order to force up the price of its shares. Another is to seek a more attractive bid from another interested company.

Mergers may be classified in a very similar fashion. Pritchard (1985) describes four types of merger:

1. Rescue: this occurs when one company is rescued from liquidation or insolvency by merger with another;
2. Collaborative: mergers can be friendly, mutually satisfactory or beneficial arrangements;
3. Contested: as in the case of an acquisition, a contested merger is one in which specific issues need to be discussed;
4. Raid: this type of merger may be considered to be analogous to the case of a hostile take–over.

However note that the frequently dubious distinction between what the press and the actors describe as m or alternatively a limits the value of the above classification.

A friendly takeover would that of ICL by Fujitsu who already had a strategic alliance in place with ICL at the time.

A contested takeover would be Morrisons acquisition of Safeway fighting off rival bids from Sainsburys Tesco and others.

Contested and hostile takeovers are difficult to distinguish except by the level of hostility. However the takeover of Manchester United by Malcolm Glazer certainly come somewhere in this category.

Motives for making an acquisition are many and varied, and not always those that are declared to the Press when the bid is announced. They can be classified into three categories:

1. Strategic motives;
2. Financial motives; and
3. Managerial motives. (Schoenberg 2003).

Let us now examine each of these in more detail.

Your notes

Strategic motives

An acquisition may be carried out to increase a firms overall strength and presence in world markets. More specifically it can establish it overnight in new segments of a market or in new geographical markets, and give it the vehicle to extend its brands into areas in which it was previously not represented. By giving it access to new strategic assets, core competencies and capabilities it can strengthen its portfolio of product value chains, and facilitate the successful development of new products. It can give it a stronger presence in its existing markets and dramatically change the pecking order for market share and hence buying power and customer power. If two companies each have 20% of a market and a third company has 30%, the acquisition of one of the 20% companies by the other will immediately catapult the acquiring company into the position of market leader with all the cost and reputational advantages that go with it.

The merger, or perhaps it was an acquisition, by Cap Gemini of Ernst and Young the management consultancy company is an example of an event with these motives behind it.

Similarly a company may acquire another in order to retire its capacity from the market, and thereby remove surplus capacity and enable improved margins to be achieved from an improvement in the supply – demand balance. An acquisition policy may also be adopted in order to achieve a better balance of sales over the year through increased diversification. In such a way a company focusing on Christmas sales may attempt to iron out sales peaks and troughs by acquiring a company focusing on summer sales. In terms of acquiring strategic assets a company, particularly in the service sectors, may make an acquisition in order to attract a particularly talented marketing or research and development team, from for example an investment bank or a bio-tech company. In such circumstances, however, they would need to ensure the watertight nature of the talent team's contracts.

Other strategic motives for acquisitions may involve asset stripping, which is buying undervalued assets in order to dress them up more attractively and sell them off at a profit.

The retired Lord Hanson was famous for making large-scale acquisitions and them selling off the unwanted parts in order to pay for a large part of the whole. This is sometimes called 'unbundling' these day, as a company buys a job lot of assets held by an unfashionable and hence lowly rated investment trust or latter day conglomerate, and frees the constituent business units up either to float independently as PLCs, or to find new parents in related and hence more rationally relevant sectors.

When Philip Green acquired Sears in 1999 it included six retail businesses in distinctly different sectors of the market. The acquisition cost him £540 million. The businesses were sold off over the next six months for approximately the same value, but leaving him with a property portfolio estimated at £200 million (Financial Times, 9 July 1999).

Financial motives

The unbundling or asset stripping motive can be classed as strategic from the viewpoint of the entrepreneur carrying it out. It also falls very clearly within the category of financial motives.

Other financial motives include cost reduction. Acquiring a company in the

same market sector improves a company's strategic position in that market but it also generally provides the opportunity for considerable organisational rationalisation involving substantial work-force reductions and hence cost savings. Two sales forces are not necessarily required. Nor are two R&D departments necessary particularly if their activities overlap to a large extent. The same level of overhead staff will often be able to monitor and support the activities of two companies as easily as one. Economies of scale and hence unit cost reduction will therefore result from the spreading of the overheads over a larger sales turnover.

A collaborative merger in the US banking industry intended to achieve greater economies of scale is detailed in the case study below.

Case study: The Chemical and Chase Banks merger

In August 1995, two of the world's largest banks, Chemical Bank and Chase Manhattan Bank, both of New York, announced their intention to merge. The merger was officially completed on 31 March 1996. The combined bank, which goes under the Chase name, has more than $300 billion in assets, making it the largest bank in the United States and the fourth largest in the world. The new Chase is capitalised at $20 billion and is number one or two in the United States in numerous segments of the banking business, including loan syndication, trading of derivatives, currency and securities trading, global custody services, New York City retail banking, and mortgaging services.

The prime reason given for the merger was anticipated cost savings of more than $1.7 billion per year, primarily through the realisation of economies of scale. The newly merged bank had good reason for thinking that these kinds of cost savings are possible. In a 1991 merger between Chemical and Manufacturers Hanover, another New York-based bank, cost savings of $750 million per year were realised from the elimination of duplicated assets, including physical facilities, information systems and personnel.

The cost savings in the Chase-Chemical combination have several sources. First, significant economies of scale are possible from combining the 600 retail branches of the original banks. Closing down excess branches and consolidating its retail business into a smaller number of branches should allow the new bank to increase the capacity utilisation of its retail branching network significantly. The combined bank will be able to generate the same volume of retail business from fewer branches. The fixed costs associated with retail branches – including rents, personnel, equipment, and utility costs – will drop, which translates into a substantial reduction in the unit cost required to serve the average customer.

A second source of scale-based cost savings arises from the combination of a whole array of 'back office' functions. For example, the entire bank now only has to operate one computer network, instead of two. By getting greater utilisation out of a fixed computer infrastructure – including mainframe computers, servers and the associated software – the combined bank should be able to drive down its fixed cost structure even further. Substantial savings will also arise from the combination of management functions. For example, the new Chase bank has doubled the number of auto loans and mortgage originations it issues but, because of office automation, it can manage the increased volume with less than twice the management staff. This saving implies a big reduction in fixed costs and a corresponding fall in the unit costs of servicing the average auto loan or mortgage customer.

Source: This case is reproduced from Hill and Jones (1998, p. 146).

Further financial motives

It may well be also that the predator has observed that the victim company displays considerable cost inefficiencies in its business, and many of these can be eradicated immediately by the elimination of unwanted and under-performing departments. Again Lord Hanson was famous for buying companies with large staff departments and immediately closing them down, holding

Your notes

that business was about making things and selling them, and therefore any posts doing neither of these activities directly needs to be strongly justified if they were to survive under the new ownership. Corporate planners, personnel and management services departments were seen to quake in their boots at the rumour of a Hanson bid for their company.

There are also more direct financial motives for acquisitions, targeted at financial manipulation rather than direct business activities. Companies can be acquired to take advantage of their tax losses or their high balance sheet liquidity, thereby saving on corporation tax in the subsequent year and improving the acquirer's cash ratios. Similarly acquirers with a strong set of financials can substantially enhance the prospects of an acquiree previously undercapitalised and consequently over-geared, and unable to carry out the necessary marketing expenditure to develop its otherwise strong product portfolio.

Managerial motives

Companies wishing to make a bid to acquire always justify this to their shareholders and the financial public by pointing to the strength of the financial and strategic arguments for the acquisitions. The word 'synergy' does overtime in such bid documents. It will be remembered that when BAE bought Rover in the early 1980s much was made of the supposed technological synergy between the fibre optics avionics in its aircraft, and the modern dash-board of up-market cars. When that acquisition was completed however Rover was run as a completely separate business to the Aircraft business and no more was heard of these supposed synergies. This is more the norm than the exception. Where managerial motives actually dominate financial or strategic ones, the shareholders should beware the probable impact on their earnings per share.

The problems of managerial motives

Where M&A is motivated by the self-interest of the top management team or the CEO ('managerial hubris' as it is often called), the results are unlikely to lead to a value maximisation for the shareholders. It has been suggested that in too many acquisitions the winners are the management team of the acquirer with enhanced salaries and share options, and the previous shareholders of the acquiree, who walk away with a 35% premium on the earlier value of their shares before the bid.

The losers are the acquirer's shareholders with a substantially reduced earning per share, as they have to face an extra 35% of 'goodwill' on their balance sheet resulting from the high costs of acquisitions rarely balanced by achieved synergies. Other losers of course are the management team of the acquiree, as many lose their jobs, and even the survivors lose their independence. Research shows that a strong board of directors with independent analytical skills and the willingness to use them, can limit the ability of CEOs to indulge their managerial hubris and allow ambition for size to cloud their judgement (Hayward & Hambrick 1997).

Acquisition Performance

Acquisition performance at its most charitable interpretation tends to disappoint its advocates as a vehicle for corporate strategic development and as a means of replacing poor corporate governance with an improved variety. Bleeke and Ernst (1993) reveal that 435 of international acquisitions fail to produce a financial return that meets the acquirer's cost of capital: in other words they destroy shareholder value.

This statistic is not widely at variance in its message with Porter's (1987) article, demonstrating the limited success from all types of new activity as shown in Figure 9.1.

Quick summary

Acquisition Performance

- Acquisition performance at its most charitable interpretation tends to disappoint its advocates as a vehicle for corporate strategic development and as a means of replacing poor corporate governance with an improved variety.
- Financial economists have attempted to estimate the wealth generation, if any, of M&A activity by calculating the change in share price of bidder and target at the time of the acquisition announcement.

This figure shows that according to his methods of assuming an acquisition sold within five years is a failure, over 70% of acquisitions in unrelated sectors in his sample are failures, and over 60% fail even in a closely related sector.

To follow on from Porter's findings, Schoenberg (2003) finds that:

> recent research along these lines indicates that 45–55% of acquirers are neutral to highly dissatisfied with the overall performance of their acquisitions. Interestingly the failure rates are similar for domestic and cross-border acquisitions and show no improvement over figures reported in 1974 from the first such study.

The high divestiture rate is not however all bad. As Kaplan and Weisbach (1992) show, 40% of divestitures are sold on at a price in excess of their acquisition cost. Clearly the Hanson strategy mentioned earlier is not unique to Hanson.

Financial economists have attempted to estimate the wealth generation, if any, of M&A activity by calculating the change in share price of bidder and target at the time of the acquisition announcement. A study of UK acquisition between 1980 and 1990 found that target companies gained about 30% in share value and bidders lost about 5%. The results suggest that overall wealth creation is negligible, and that the gains, as suggested earlier, generally go to the shareholders of the target company. This of course does not answer the question of whether the M&A activity was a 'good thing', since any synergies realised would take some time to come about.

Furthermore on the bright side, most studies do show that up to 50% of acquirers do make good returns. It may be concluded then that at most one in two acquisitions can be classed as successful for the acquiring company. The question is therefore raised as to how an acquirer can ensure that he is in the positive 50%.

Getting the right results

Larsson and Finkelstein (1999) suggest that good results depend on three factors:

1. The acquisition's potential for value creation is high.
2. The post-acquisition integration of the acquired company is purposeful and rapid.
3. The level of employee resistance to the acquisition in the acquiree is low.

A study by the management consultants Braxton Associates in 1988 provides some general insight into why acquirers believed their acquisitions had failed to lead to the gains they expected. They identified three factors:

1. Poor industry selection
2. Poor company selection and negotiation
3. Poor implementation

Poor industry selection

They stated that poor industry selection had come about through insufficient attention being paid to the closeness of the relationship of the target's industry to their own, and hence to their existing competences, to an overestimation of the target industry's growth potential and to an unexpected and dramatic change in the industry's environment since the acquisition.

Poor company selection and negotiation

Expanding on the issues of poor company selection and negotiation, they claimed that inadequate due diligence had been carried out into the existing condition of the target company; that the wrong company had been chosen based on a range of factors; and that there had been a distinct cultural clash or at least a mismatch between their culture and that of the new acquisition.

Poor implementation

As regards the third factor, that of poor implementation, they stated that there had been inadequate implementation planning and execution, that too many of the target's key personnel had left shortly after the acquisition had been completed, and that the new company had failed to generate a sufficiently strong stream of new products.

All of these factors might seem to be intuitively fairly obvious, but this does not detract from their importance and impact. It does however pose the question of how a larger percentage of acquisitions can be made to be successful, and how value can be created and realised.

Porter (1987) identified three tests that in his view a potential acquisition must pass before the acquisition proposal should be validated by the shareholders:

1. The attractiveness test:

   The target must be in an industry that is deemed attractive after a Porter Five Forces analysis. It should be noted here that Hanson built a very powerful industrial combine by buying in unattractive industries, since prices were lower and competition less severe.

2. The cost–benefit test:

   The cost of acquisition including the premium paid must be less than the clearly realisable benefits in financial terms that can be achieved from the deal.

3. The better-off test:

   Synergies must be achievable such that the target company must bring something of value to the parent or vice versa.

The takeover of Rowntree by Nestlé is generally thought to have met the Porter tests.

Again these criteria are intuitively apparent, but in the heat of a takeover battle they are often not heeded by the would-be acquirer as the price premium is bid up beyond levels that would pass the Porter tests.

PriceWaterhouseCoopers have identified several actions that need to be carried out if M&A success is to be achieved.

1. Clarify the deal objectives and business case

   The proposed deal price, expected implementation costs, value of inev-

itable losses as a result of the combination (e.g. staff), and the value of synergies, should all be made clear at the outset.

2. Monitor implementation against contribution to shareholder value

   Effective progress in mergers requires an understanding of not just what tasks have been completed but also what benefits have been realised. Flexibility is also required, to accommodate change along the way.

3. Integrate quickly

   A major contributor to risk in merger situations is uncertainty and the impact it can have on motivation and staff performance. This means that merging entities should quickly identify those activities and functions that are essential to the immediate bringing together of the companies and other improvement projects that can be undertaken subsequently.

4. Focus on retaining existing business

   Mergers can cause a shift in focus from external to internal at the very time when the merging enterprises are under greatest scrutiny from both clients and investment consultants. As a result, opportunities to win new business are limited and the importance of retaining existing business is underlined. It is therefore important that sufficient resources are devoted to maintaining 'business as usual', protected from the distractions of the merger process.

5. Focus on retaining key people

   During a merger, senior management must also focus on retaining key staff, especially in sectors such as investment banking where the value of the business is so heavily linked to key people. A significant proportion of the value of the deal could be lost if key individuals are lost early in the merger process

Achieving and Realising Value

The following factors are derived from cross-sectoral surveys as well as hands on experience, given the merger of Price Waterhouse and Coopers & Lybrand to create PWC in 1997.

Improved shareholder value through M&A

- Improve breadth and depth of product range
- Leverage innovation and technology investment
- Exploit economies of scale
- Spread development risk
- Overcome regulatory barriers
- Alter competitive landscape
- Enable entry into new markets
- Improve supply and distribution
- Increase market share

Source: PriceWaterhouseCoopers (1998) Pursuing profitability: variations on a theme, p. 9.

Value creation mechanisms

Many of these recommendations of the consultancies are of course self-evident truths, yet the results do not bear out the hope that the lessons are learnt by optimistic acquirers.

Schoenberg (1999) believes that value creation in acquisitions depends a lot on successful knowledge transfer. Acquirers therefore need to identify in advance which knowledge needs to be transferred, determine mechanisms for its transfer and engender an atmosphere conducive to its successful transfer

Quick summary

Achieving and realising value

- Many of these recommendations of the consultancies are of course self-evident truths, yet the results do not bear out the hope that the lessons are learnt by optimistic acquirers.
- The frequent failure of acquirers to achieve the anticipated synergies from M&A arises from their inability to activate the four generic value creation mechanisms.

post-acquisition. This is rarely explicitly done.

Haspeslagh and Jemison (1991) have identified four generic value creation mechanisms that apply in all acquisition situations. They are:

1. Resource sharing. This applies principally in acquisition of similar companies. In such cases R&D departments may be combined. Factories can be rationalised, as can sales forces. Substantial costs can be saved and economies of scale achieved through such rationalisation. Schoenberg (2003) cites the Glaxo Wellcome Smith Kline Beecham merger as identifying potential annual savings of £1 billion.
2. Knowledge and skills transfer. Superior knowledge and skills in all areas of activity may be transferred from the parent company or from the acquired one to enhance the competences of the other. This may be in technology, marketing, R&D, administration, production or financial control. Much of Hanson's success depended on its ability to transfer strict financial control systems to its new acquisitions. Knowledge transfer is particularly important in cross-border M&A where geographical distance makes the sharing of resources difficult.
3. Combination benefits. Major M&A activity can transform industry structure and catapult a new combine into market leadership overnight. The new market leader will then enjoy the benefits that such a position brings in enhanced market power, better supply term, improved profit margins and reduction of competitive intensity in the industry through the taking out of an erstwhile rival. The above mentioned Rowntree Nestles deal meet as these criteria.
4. Restructuring opportunities. In this way, surplus assets can be sold off, organisations can be streamlined and rationalised, and substantial cost savings can be achieved. The skill come from the acquirer's ability to identify the real value of the target's assets which may have been concealed due to a low price-earnings ratio resulting from poor overall economic performance. Hanson always sought such opportunities in his deals, and frequently ended up with very cheap acquisitions when he had stripped out and sold off the unwanted businesses from them. Royal Bank of Scotland's acquisition of Nat West Bank led to restructuring of the UK clearing bank industry

The frequent failure of acquirers to achieve the anticipated synergies from M&A arises from their inability to activate the four generic value creation mechanisms. This is particularly the case with knowledge transfer in hostile take-overs. Much knowledge is tacit and its transfer requires the active willingness of both parties to teach and to learn. This is difficult to achieve if the take-over has been hostile, and may even be lost all together if the knowledge holders leave the company as a result of the take-over.

Post-Acquisition Integration

When the deal is done and the investment banking advisors have been stood down, the excitement rapidly fades and the hard work of integrating the acquisition and creating value from it begins. It is at this point that the all too frequent lack of post-acquisition planning becomes apparent. Appointments are made and they are left to get on with it. There are however many different ways of integrating an acquisition in addition to the non-way of just taking it as it comes and reacting to events – a sure recipe for failure.

Haspeslagh and Jemison (1991) have developed a popular four box framework for post-acquisition integration positioning. It depends on the trade off between the degree of strategic interdependence between parent and new acquisition and the extent of organisational autonomy needed to maintain its distinctive capabilities. See figure 9.2 for an illustration.

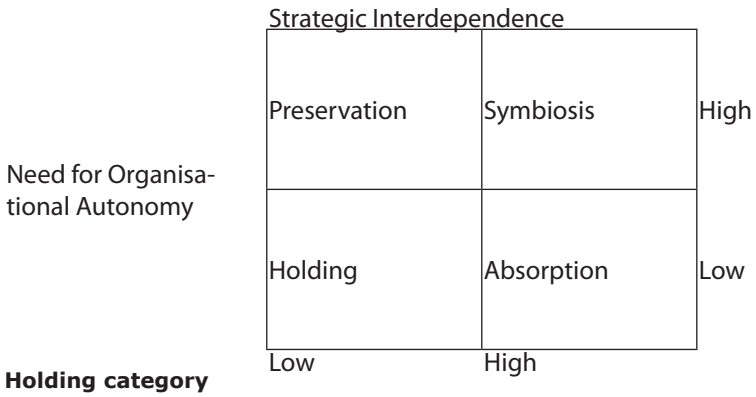
Your notes

Quick summary

Post-acquisition integration

- These four forms of integration are of course archetypes, and rarely found in their pure form as described. Actual situations may well require a combination of forms.
- Furthermore different nationalities have been found to favour different approaches.

Haspeslagh & Jemison's (1991) approach:



Holding category

The acquirer tries to affect a turn around but without any degree of integration

Preservation approach

The acquired company is also left unintegrated but in order to continue making good profits

Symbiosis

Both partners have something to contribute to achieve synergy

Absorption

The acquirer completely 'digests' the acquired company

Let's examine each part of the four box framework in more detail.

Absorption integration.

This involves the acquirer consolidating the new acquisition into its organisation root and branch. This may even involve the discarding of existing brand names, and generally does involve the change of name of the company to that of the parent and its physical integration into the parent group. As a result little continues to exist of its former identity, and staff members are encouraged to identify closely with the history, culture and operational methods of the acquiring company. As Child, Faulkner and Pitkethly (2001) found, this is most commonly the preferred integration method of US acquirers. Angwin (2000) found that 15% of UK acquirers in the 1990s employed this method of integration. It often leads to substantial executive departures from staff unhappy with the new imposed culture, but can lead to considerable cost savings from resource sharing, knowledge transfer, combination benefits and sometimes restructuring.

Symbiotic integration.

This method of integration attempts to achieve a balance between preserving the operational independence of the acquired firm whilst transferring capabilities between the two firms to enhance the strength of both value chains. The CEO of the acquired firm is often retained and great care must be taken to preserve much of the subsidiary's existing culture. This form of integration is often used where the acquirer buys a firm that is making good profits and has clear skills and competences valuable to the acquirer. Such integration requires exceptional judgement from the acquirer in striking a balance between absorption and autonomy in its integration activities. Child, Faulkner and Pitkethly (2001) found it to be a favour integration form of Japanese acquirers in particular.

Preservation.

This form of deliberate non-integration is adopted particularly when the ac-

Your notes

quired company is a successful one but may be undercapitalised, thus making it a take-over target. Despite the fact that preserving the autonomy of the new subsidiary makes it very difficult to activate many of the generic value-creating mechanisms, particularly combination benefits, it is the most common way of treating a new acquisition in the UK. Angwin (2000) found that 49% of all UK acquisitions were treated in this way over the period of his study.

Holding.

The fourth Haspeslagh and Jemison (1991) form is adopted where a turnaround is required. Low levels of strategic interdependence are required, but the new subsidiary is granted low levels of autonomy. Frequently the acquirer puts in a project team of turnaround executives who proceed to tighten financial controls, probably bring about a wholesale change in company culture and attempt to bring a failing firm back into profit. Angwin (2000) found that this form of post acquisition plan was adopted by 27% of acquirers in his sample.

These four forms of integration are of course archetypes, and rarely found in their pure form as described. Actual situations may well require a combination of forms.

Furthermore different nationalities have been found to favour different approaches. Child, Faulkner and Pitkethly (1991) found for example that UK acquirers typically attempted to achieve performance improvements in their acquisitions through product differentiation, strengthened marketing, and granting a relatively high level of operational autonomy. Japanese acquirers favoured the adoption of priced-based competitive strategies. The French introduced tight cost control, allowed considerable operational autonomy but retained strategic control firmly in the parent company. They found little if any difference in overall effectiveness on a national basis of the differing integration styles.

Other Post-Acquisition Problems

Although a firm achieving acquisition success in a hostile take-over may be initially energised by its victory against opposition, such a take-over situation does not bode well for the future. It is likely to lead to substantial employee resistance to the new owners, and where employees are unable to get another job, they are likely to show passive resistance in carrying out their current one, making knowledge and skill transfer difficult if not outright impossible. Other more marketable executive are likely to leave the firm thus reducing the attractiveness of the acquisition, where they have rare and valuable skills. Cannella and Hambrick (1993) found that high rates of management turnover are associated with poor acquisition performance.

Culture clash

Issues of culture clash may also cause problems for the new parent, particularly in cross-border acquisitions where national culture differences are imposed on corporate culture problems. The individualistic, performance-orientated US corporate culture is always likely to meet problems when it acquires a company used to a more collectivist culture say from Germany or Japan, and if it is to be successful may need to take account of this in its integration planning. A decision to wade in with a thoroughgoing absorption approach and just accept the inevitable staff resistance and management exit may lead to the loss of substantial skill and experience from the acquired firm not easily recovered.

Many Japanese acquisitions in the West have avoided this problem by careful analysis of the contrasting cultures, and the adoption of a hybrid culture based partly on the Japanese philosophy, but also retaining important aspect of the human resource practices that the acquired company are more famil-

Quick summary

Other post-acquisition problems

- Although a firm achieving acquisition success in a hostile take-over may be initially energised by its victory against opposition, such a take-over situation does not bode well for the future.
- It is likely to lead to substantial employee resistance to the new owners, and where employees are unable to get another job, they are likely to show passive resistance in carrying out their current one, making knowledge and skill transfer difficult if not outright impossible.

iar with and attached to. This can help overcome some of the culture shock that inevitable follows from a cross-border acquisition (Child, Faulkner and Pitkethly 1999).

Also not all introduction of a new culture has detrimental effects. The adoption of enlightened human resource policies from an acquirer of an old-fashioned and poorly performing company, can lead to effective re-energising of the management team of the new subsidiary.

A final thought

M&A activity is still by far the greatest and most popular approach to corporate growth particularly when a company is involved in extending its global reach. Cross-border M&A seems to be the easy answer to rapidly establishing yourself in a new part of the world. For every strategic alliance concluded, there are an estimated ten examples of M&A activity. Yet all the academic evidence suggests that at best one in every two acquisitions fails.

One must conclude either that this message is not reaching corporate executives, or alternatively that widespread managerial overconfidence makes many CEOs mistakenly believe that their acquisition will be one of the ones that succeeds.

A third possibility of course harks back to agency theory which suggests that the interests of the shareholders and the top management team are not always aligned. Although many acquisitions do not prove to add value to the shareholders' portfolio, almost all enhance the positions, power and personal financial situation of the top management team of the acquiring company. Thus, acting in their own personal interests, if not in the interests of their shareholders, they are motivated to continue to pursue M&A policies.

Current corporate governance systems give a fragmented ownership structure in most PLCs little power to prevent an ambitious CEO from pursuing an active M&A strategy even if the shareholders fear it will reduce their earning per share as a result of having to pay a hefty bid-premium. Their only resort is to sell their share, which if they do this in sufficient numbers will bring about the result they fear by deflating the share price. Given these circumstances a reduction in the popularity of M&A is very unlikely to come about in the foreseeable future.

Your notes

Summary

This topic has discussed merger and acquisition activity as a possible growth strategy for a company. It has analysed the key motivations for a company pursuing such a strategy and categorised them under the headings of strategic, financial and managerial motivations, noting that the managerial motivations are the one least likely to lead to value-added for the shareholders of the acquiring company.

It has noted the prevalence of 'managerial hubris' in acquisitions that fail to realise their value-creating potential. It has discussed the various types of post-acquisition integration, and given illustrations of circumstances in which each is most appropriate. It has noted that at best only one in every two acquisitions succeeds, and it has attempted to identify reasons why this is so, blaming managerial over-confidence, poor target selection and employee resistance as key factors behind this disappointing record.

Finally it has noted that despite this, M&A is unlikely to decline as a growth strategy, since even if it is so frequently unsuccessful in increasing value per share for the shareholders of the acquirers, its ability to improve the fortunes of the acquirer's top management team is far greater.

Task ...

Task 9.1

To check your understanding of the material in this topic, try to answer the following questions. If you have any difficulties, you may wish to go back and revise the relevant part of the topic.

1. What are the principal motives for M&A?
2. Why are results often so poor from an acquisition?
3. What is the importance of CEO hubris?
4. What are the four archetypical methods of integrating acquisitions?
5. In what circumstances are each typically employed?
6. What are three major areas of mistakes made in failed acquisitions?
7. Do acquisitions typically capture value or add value?
8. Is there such a thing as a genuine merger?
9. Do different cultures and nationalities treat acquisitions differently?

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Topic 10

Strategy in an International Context

Aims

The purpose of this topic is to:

- show how international strategy differs from domestic strategy;
- illustrate the roles played by comparative cost theory in the modern economy;
- show that competitive advantage is still the aim of all strategy;
- explain the theory behind the major international organisational forms;
- show how economic theory is still relevant to strategy in international trade.

Objectives

By the end of this topic you should be able to:

- identify how configuration and coordination are necessary for success in international trading;
- establish the differences between multi-domestic (multinational) and globalisation strategy;
- describe the difference between domestic and international strategy;
- describe the basis for the theory of comparative costs;
- perceive the importance of having a strong 'diamond';
- identify the different demands for organisational forms internationally.

Introduction

International trade goes back at least to the beginning of recorded history. Many of the great expeditions and celebrated explorers in the history books, and indeed many wars and colonial conquests, were about discovering or making one's own new trading routes. The world has generally been dominated by the strongest trading nations, and their political power has stemmed largely from their economic power.

In the nineteenth-century expansion of the British Empire into Africa, trade was said to follow the flag and equally colonial aggrandisement often followed from earlier mainly, trading exploits. Both India and Rhodesia are clear examples of this movement, as were the African and Asian ex-colonies of France, Holland, Germany and Belgium.

International versus Domestic Strategy

A critical question for a firm is whether to operate locally or internationally. One of the key issues in operating internationally is how to organise one's enterprise so that it is possible to compete with local companies, who are likely to be equipped with better knowledge of the local market, in both demand and supply terms, than the new foreign entrant can hope to have. International strategy must, then, be a very important corporate subject area for all but the determinedly local niche player.

- The first question that must be addressed is 'why should the development of an international strategy be any different from the development of a domestic one?' At first sight, the answer seems to be that it should not be fundamentally different. Competitive strategy is about being able to achieve the highest level of PUV at the lowest cost in relation to one's competitors in each product/market, whether the market is national or international. Similarly, corporate strategy is about having excellent core competences in relation to one's competitors', and developing them so that they become key competences in all the markets in which one chooses to compete. This must be so whether the firm is competing nationally or internationally.
- The next question is whether one has the option of defining a market as national or international, and here the answer is clearly 'no'. The preferences of the customers and the cost structures of the operating firms make this decision. If Sony is able to bring its electronic products to the UK at competitive prices, and UK customers find them acceptable as alternative sources of PUV to those of local suppliers, then the consumer electronic market has become international. This will not of course apply to all products. The market for corrugated cardboard is said to have a radius of about 50 miles. It is a low-value commodity in which little differentiation is possible and, once 50 miles have been travelled, the local producer is able to realise lower costs than the travelling producer. The same applies to building aggregates.

Factors in formulating international strategy

There is, then, a strategic market that is defined by the relative homogeneity of consumer tastes and the company's possible cost structures that enable it to be a credible competitor over varying distances. As Levitt remarked in the 1960s and Ohmae and others have confirmed more recently, with the passing of each year, more and more products and even services fall into the category of global competition, as tastes become increasingly similar around the world. Technologies also become global and transportation costs become a smaller and smaller percentage of delivered costs.

The question of why we should regard international strategy as in any way

Quick summary

International versus domestic strategy

- One of the key issues in operating internationally is how to organise one's enterprise so that it is possible to compete with local companies, who are likely to be equipped with better knowledge of the local market, in both demand and supply terms, than the new foreign entrant can hope to have.
- International strategy must be a very important corporate subject area for all but the determinedly local niche player.

different from national strategy reasserts itself. The answer of course is that the nature of strategic analysis is in no way different, although there are factors that need to be considered in formulating international strategy that are typically less important in trading within national boundaries. These fall into three categories of factor:

1. Those that determine which segment to select, and whether or not they involve global competition.
2. Those that affect the company's ability to resource and deliver the product at a competitive price anywhere in the world, i.e. political factors and cost structures (configuration).
3. Those that are concerned with how a company should organise itself to control its international activities (coordination).

In Porter's terms (1986), one has to seek comparative advantage internationally in order to achieve competitive advantage, and then configure one's value chain appropriately internationally and coordinate the activities optimally in order to succeed.

Selecting international segments

A useful framework to help the manager decide how to approach the selection task in an international strategy is that provided by a schema relating strategic objectives to three key bases of potential competitive advantage developed by Ghoshal (1987) as shown in Figure 10.1.

Strategic objectives	Sources of competitive advantage		
	Country differences	**Scale economies**	**Scope economies**
Efficiency in current operations	Factor cost differences, e.g. wages and costs of capita	Potential scale economies of each value chain activity	Sharing of resources and capabilities across products markets and businesses
Risk management	Assessment of risk by country	Balancing scale with strategic and operational flexibility	Portfolio diversification
Innovation and learning	Learning from cultural variety in process and practice	Opportunities for technology-based cost reduction	Shared organisational learning

Source: Ghoshal (1987).

The framework above holds that there are three basic strategic objectives that need to be considered in a global strategy:

1. Efficiency: This means carrying out current activities to a required quality at lowest cost. This is the most frequently emphasised objective in the literature. Indeed, it is often the only objective mentioned.
2. Risk management: This means managing and balancing the risks inherent in operating in a number of diverse countries, e.g. exchange rate risks, political risks or raw material sourcing risks.
3. Innovation learning and adaptation: This means the opportunity to learn from the different societies and cultures in which one operates.

This organising framework takes the three types of strategic objective identified above and relates them to what are identified as the three key sources of competitive advantage.

Your notes

National differences

Competitive advantage can come from exploiting differences in input and output markets in different countries. For example low wage countries are perhaps the most commonly cited examples of such factors, and can reasonably be said to have led to the decline and fall of the textile industry in the UK, and the sports shoe industry in most of Europe.

Scale economies

These provide a source of competitive advantage if one firm is able to so configure its activities that each is able to operate at the optimal economic scale for minimum unit costs, while competitors fail to do this. Of course, achieving optimal scale economies globally may lead to dangerous inflexibility creating high risk where changing exchange rates alter or destroy these potential economies after plant has been brought on line to take advantage of them.

Scope economies

These are the third source of global competitive advantage. They are most easily exemplified in the use of global brand names like Coca-Cola or McDonald's but can be found in any area of the firm's activities where resources used to produce or market one product in one country can be reused virtually without cost to do the same for other products and in other countries. Technology, IT, any learning or skills are further examples of areas of potential scope economies.

The organising framework described enables the global decision-taker to identify the potential sources of global competitive advantage available to the firm, and to cross-reference them to the three basic types of strategic objective – efficiency, risk and learning – with the ultimate objective of deciding where, why and how to compete internationally.

Resourcing global production

Porter's configuration issue, mentioned earlier, is concerned with what part of the value chain for a product should be produced within the company and what outsourced, and where that production should take place: in the home country, the Far East or elsewhere. The configuration profile is influenced by a number of cost-incurring barriers.

There are a number of factors that have traditionally ensured that most markets remain local. However, some of these are becoming progressively less important. Global products had traditionally been considered to have limited potential in many industries, since people in different parts of the world living in very diverse cultures were assumed to have different tastes and values and therefore to require different products and services to satisfy them. To some extent that is still true: more tea is sold per head in the UK than elsewhere in the world, the Far East consumes more rice than the West, and the West more potatoes than the Far East. Yet such variations are far less common in the manufactured products area. Levitt's (1960) comments that:

> the same single standardized products – autos, steel, chemicals, petroleum, cement, agricultural commodities and equipment, industrial and commercial construction, banking, insurance, computers, semiconductors, transport, electronic instruments, pharmaceuticals, and telecommunications [are sold] largely in the same single ways everywhere.

are undoubtedly true, and the list gets longer every year.

Barriers to international trade

Your notes

What about the supply side? There are a number of traditional barriers that make would-be international traders' jobs more difficult, for example:

- Tariffs, quotas and other market distorting devices.
- Foreign ownership rules – in many developed nations, Western companies are prohibited from setting up local companies without major shareholdings being held by locals.
- Languages and cultures – these can provide important inhibitors to, say, a Western company marketing abroad and require, at the very least, packaging messages in different languages.
- Transport costs – if other costs are equal, transport costs can make the product from afar uncompetitive on price, especially for low-value, high-volume products.
- Currencies – the problem of exchange rates, and of shipping into a market or manufacturing a product in a country with a different legal and tax system, can make international trade very hazardous.

The perceived globalisation of markets during the 1980s and 1990s has come about through the marginalisation of the importance of, or complete elimination of, many of the traditional barriers to trade. The spread of Western culture through films, videos, travel and satellite television has done much to homogenise tastes. There has even been some movement the other way, with Eastern food, so called 'ethnic' clothes, and objets d'art becoming acceptable and more common in the West.

A globalised market is where substantially the same product is sold in all markets of the world. An international market is less concerned with product homogeneity and, although accepting the power of well-known brand names around the world, accepts that different markets require different local responses in terms of product recipes.

Many of the supply side costs also have become less important. Larger trading blocs and international trade agreements have emerged, e.g. the EEC, ASEAN, GATT and the North American FTA, to reduce the levels of tariffs and, where possible, eliminate quotas and domestic subsidies (outside agriculture). Fewer countries now require local majority shareholdings in joint ventures set up with foreign companies, and where they do, the foreign companies have learnt to live with this and operate in a multicultural way.

Language barriers remain to some degree but, increasingly, English is becoming the language of international trade and any company wishing to operate globally is virtually required to become proficient in it.

The remaining traditional barriers are transport costs and exchange rates. Transport costs are reducing, but they remain an inhibitor to competitive global trade, the importance of which varies with the value and volume of the article traded. Transport costs are virtually irrelevant to international trade in diamonds, but of considerable importance in limiting such trade in corrugated cardboard. Exchange rates, however, will remain of considerable importance whilst every nation maintains a unique currency and retains the right to devalue or revalue it against other currencies, when the government or the market deems this advisable. To be caught with cash or debtors in a newly devalued or depreciated currency can wipe out any profit at a stroke.

Taking the decision to become an international enterprise

How, then, is the corporate decision to become an international enterprise to be taken? Since the international trade inhibitors listed above are now so reduced in strength, the decision must be taken as it would be for domestic products.

- * A customer matrix and a producer matrix should be constructed for

the strategic market of each product/market. It will then become apparent which markets the company has products for and which of the market's required key competences are close to the firm's core competences.

- * The market size should also be assessed to ensure it is sufficiently interesting for the firm.
- * A separate set of matrices will need to be developed for each country, since not only are the dimensions of PUV likely to be different by country, or at least to have different weightings, but also the perceived price is likely to be different for each country for reasons of exchange rate, local taxation and cost of living, and the impact of transport and perhaps other costs will need to be factored into the producer matrix.

The firm also needs to configure and coordinate its activities in such a way that it comes out in a strong position on the customer and producer matrices relevant to the particular countries in which it seeks to operate. The ever-present tension in international commercial activity between the demand-led needs of local tastes and the supply-led requirements for global integration needs to be resolved individually market by market (Stopford & Wells 1972).

International Trade Theory

Quick summary

International trade theory

- It is important to understand why the greatest economic welfare is not necessarily served by local firms serving their local populations.
- a welfare gain is possible so long as the internal cost ratios between the production of two or more goods in one country are different from the internal cost ratios from producing those goods in another country.

In international trade, it is important to understand why the greatest economic welfare is not necessarily served by local firms serving their local populations. Adam Smith's (1776) theory of international trade was based upon the simple idea that an overall welfare gain was made if countries produced the goods in which they had an absolute cost advantage and traded them with other countries for goods in which those countries had absolute cost advantages.

Ricardo (1992) increased the sophistication of this theory by developing it into the theory of comparative advantage, which is less intuitively obvious. Under this theory, a welfare gain is possible so long as the internal cost ratios between the production of two or more goods in one country are different from the internal cost ratios from producing those goods in another country. Thus Country A may produce all its goods at a lower cost than Country B, but it will still benefit from trade with Country B so long as its costs are comparatively different in producing one good rather than another from those in Country B. The terms of trade will ensure that the goods are traded at prices advantageous to each country.

Comparative advantage

Comparative advantage can be expressed as international differences in the opportunity costs of goods, i.e. the quantity of other goods sacrificed to make one more unit of that good in one country as compared to another country. Thus if, in a closed economy with finite resources, it is assumed that either cheese or cars can be made, the opportunity cost of cheese is the quantity of car output that has to be sacrificed by using resources to make cheese rather than make cars. Even when Country A produces both goods at a lower cost than does Country B, trade will still be beneficial to both, since it is clearly most efficient in terms of resource usage for a country to use as many as possible of its resources on producing the goods it is best endowed to produce in cost terms, rather than those it is less well endowed to produce. Where economies of scale exist, the advantage of specialising in producing goods in which one has comparative advantage is even greater.

This law of comparative costs initially underpinned the development of all international trade, which was mainly in non-branded goods. In the Ricardo model, countries develop different costs in producing various goods because they are differentially endowed with the three traditional factors of production: land, labour and capital. Exchange between countries will generally be possible to the advantage of all and will lead to potential welfare gains. From this, it follows that impediments to trade like quotas, tariffs and other forms of

protectionist policy reduce overall welfare, although of course there may be temporary justification for them in specific circumstances. They may be needed, for example, to protect infant industries, so that they can reach maturity and achieve international competitiveness (Grindley 1995).

However, it can be seen that this model no longer represents the modern world.

Traditionally Western nations have possessed the skills, competences and resources to produce manufactured goods. Correspondingly developing nations have by means of cheap labour and through the lack of a manufacturing economy been comparatively advantaged in primary produce. There has therefore been a historical trade movement of manufactures from the West to be traded for commodities from the developing nations. Such a pattern is of course by no means a permanent one, and in the 21st century with the rise of the Asian economies notably China and India it is no longer a useful description of the current shape of international trade.

Porter's 'advanced factors' of modern international trade

This traditional economic theory of international trade based on immobile factors of production and companies without proprietary distinguishing features, culture, management styles or strategies is now too simplistic to realistically describe most of modern international trade.

Indeed, Porter (1990) contends that classical factors no longer generally lead to comparative advantage. He stresses that a modern theory of international strategic management must take account of what he calls 'advanced factors'. Some typical examples of 'advanced factors' might include the following:

- Human resources, in particular managerial and technological skills.
- Physical resources (like the quality and accessibility of a country's climate, natural resources or locations).
- Knowledge resources (like the educational and research infrastructure).
- Capital resources (such as the financial infrastructure seen in the availability of start-up and other risk capital).
- Infrastructure (like the transportation system and the communication system).
- The quality of life in the country and the health care facilities may also constitute advanced factors liable to give companies comparative advantage in some countries rather than others.
- Technological developments may provide the opportunity for rapid shifts in infrastructure advantage. Consider, for example, the spread of mobile telecommunications (telephones) in developing economies such as China or Eastern Europe, which replace the requirement for expensive investment in cable.

Different sources of comparative advantage

Almost all economies contain some potential sources of comparative advantage, which may be utilised by industries or organisations within it to generate potential competitive advantage, at least for short periods of time. Any specific comparative advantage is rarely permanent.

Consider one of the most commonly cited sources of comparative advantage: labour costs. Low labour costs attract investment from MNCs (multinational corporations) wishing to sustain low production costs. Gradually, such investment changes the structure of wage levels in the local labour market and creates increased consumer demand from increased levels of pay in a more competitive labour market. Economic growth drives up labour costs and diminishes comparative advantage based on low labour costs.

The sources of potential comparative advantage in any given economy are extremely varied. One of the advantages is climate in a given country and the specific opportunities to which that gives rise. This is exemplified by the wine

Your notes

industries of the world, historically clustered in the warmer southern countries of Europe and their growth more recently in the equally kind 'new world' climates of Australia, New Zealand and west-coast USA. Climate also affects world leisure industries – whether sun-seeking or snow-seeking for skiing and so on. Strategic assets (Amit & Schoemaker 1993), such as the pyramids and temples of Egypt or the canals, churches and artworks of Venice, may be considered sources of comparative advantage in a similar way.

Where tariff barriers have been largely removed between countries, the gains from trade arise less from the exploitation of different classical factor endowments than from comparative cost advantages arising through specialisation or from reduction in comparative unit costs through the economies of scale and scope that a larger international market allows. Indeed, the search for scale and scope economies forms an important element of international strategy making.

Porter (1990) stresses that particular factors need to be emphasised in the international context.

Internationally mobile factors of production.

Land may still be immobile but its ownership may shift from that of the nation in which it exists to a multinational corporation owned and run off-shore. Labour is becoming increasingly mobile in a globalising world. The 'brain drain' from the UK in the 1970s was an illustration of the increasing willingness of scarce skilled individuals to escape high taxation areas for lower taxed ones.

Recent developments have emphasised that improving communications, homogenising life-styles, the growth of the English speaking world and the rise of multinational companies employing international executives equally at home in any of the Triad regions (i.e. USA, Europe or Japan (Ohmae 1985)) have made the immobility of labour, at least at executive level, a thing of the past. Declining capital barriers between nations has also led major companies to be able to trawl the world to raise capital at the best rates.

The keys to international competitiveness have also become more than the traditional factors of production. Porter's (1990) 'advanced factors' have a claim to greater importance in the modern world than the traditional factors of land, labour and capital.

Specific and fast-changing technology

Technologies are fast changing and very specific in the modern world. In many industries like electronics, no sooner does a technology become widely adopted than another one appears on the horizon to challenge it. It is also impossible to protect technologies despite the use of patents and copyright. These give only temporary protection while imitators catch up and attempt to improve the technology still further. Largely for this reason, an equilibrium condition is rarely reached in any widely traded industries.

Monopoly power

The traditional international trade model does not allow for monopoly power in the hands of multinational companies. This leads to prices being set above marginal costs and equilibrium output therefore being reached on account of a downward sloping demand curve below the point at which it would be reached with a horizontal demand curve to the firm, i.e. under conditions of perfect competition.

In non-economic terminology, this means that each product has a market of its own to some extent and is only imperfectly substitutable for a competitive product. As a result, the producer has some discretion in setting its price and is not in the position of having to accept the externally determined price as it might be with, say, oil or wheat.

The consequence of this is a distortion of international trade to the advantage of the monopolist. Of course, in global markets, monopoly power is likely to

survive for less time than in more restricted markets due to the larger number of potential suppliers.

Mobility barriers

These take the form of entry barriers, exit barriers or barriers that inhibit the movement of companies from one strategic group to another and are amongst Porter's identified five forces determining the intensity of competition in an industry.

The most powerful mobility barriers are those that are difficult or impossible to imitate, for example know-how, strategic assets (such as a gold mine (Kay 1993)) or market-leader brand names. Other barriers that inhibit new entrants and that exist in most industries are those listed in Porter's (1980) five forces schema, for example access to distribution, learning curve scale and scope advantages, government regulation and so forth.

Branded products

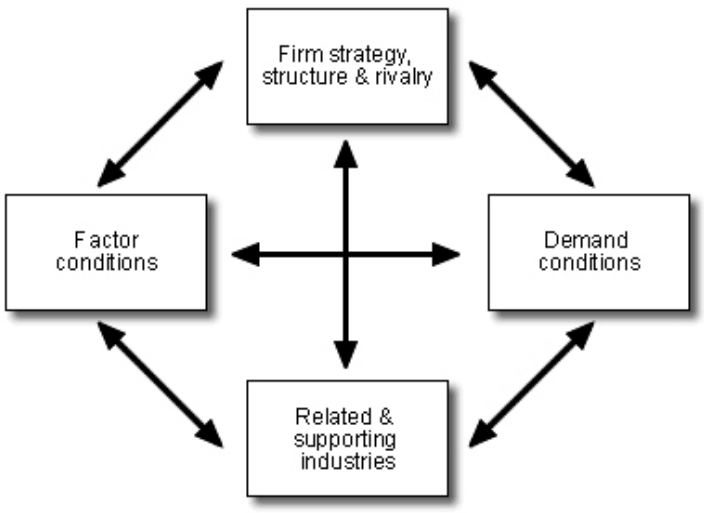
Classical trade theory does not allow for the utility distorting effects of brand names. Brands become powerful because customers lack the skills to adjudicate between competing products on the basis of their perceived qualities. They therefore choose a brand that they know and respect, since they believe that the company owning that brand will stand behind the product in the event of its failure, and furthermore that the company in question is unlikely to field an unreliable product. This leads to a market distortion as customers develop a degree of inelasticity of substitution between the branded product and its rivals. The effect of this is similar to the creation of monopoly power.

Not only are there these perfect market distorting factors to take account of in international trade, over and above those provided by governments such as through tariffs and other forms of protection, there are also additional factors of production to complicate the picture still further. These are described by Porter (1990) as the 'advanced factors', which in his view are more relevant than the classical basic factors in determining international competitive advantage. Such an analysis goes some way to explain how countries like Japan or Korea are able to compete successfully in world markets with better endowed countries in classical terms like the USA.

The Porter Diamond

Let us now look at how Porter has adapted his Five Forces model to the international scene.

Porter (1990) takes his Five Forces model and adapts it in the form of a diamond. For an illustration, see Figure 10.2.



Quick summary

The Porter Diamond

- This model blends the five forces with the already identified advanced factors of production that Porter identifies as largely responsible for the comparative advantage of a nation.
- The diamond embodies four key factors that determine the strength of a country base for international trading

This model blends the five forces with the already identified advanced factors of production that Porter identifies as largely responsible for the comparative advantage of a nation (or more accurately of an industry cluster).

The diamond embodies four key factors that determine the strength of a country base for international trading. These four factors are covered in more detail on the following pages.

1. Advanced factors

   Although classical factors of production have diminished in importance as determinants of the direction and scale of international trade, there are within a country specialised advanced factors that do accord comparative and competitive advantage, some of which are less mobile than the traditional factors have become.

   » * The level of managerial and technological human resources in the country influences its capacity for involvement in hi-tech and complex industries and products.
   » * The knowledge resources in the country exemplified in its number and quality of universities and of graduates, other knowledge-based institutions and the sophistication of its governmental system and statistical and data collection services. The degree to which information technology is widely used in the country is also an important advanced factor for a would-be global company.
   » * The strength of the country's currency on world markets and the degree of development of its banking system are also of some significance to the global operator.
   » * The country's infrastructure is also important to the ability of a company to develop, i.e. its road and rail system, its health care and generally the quality of life in the economy. Where this is high it provides a sound basis for the developing company.

   Post-war Japan was an unlikely candidate for international success, if the traditional factors of production had still held the keys to success. It had very few natural resources such as minerals and oil and its comparative advantages were difficult to identify. However, through human resources, infrastructure, financial systems and its growing knowledge base, it was able to drive itself to the forefront of global performers in the post-war world.

2. Demand conditions

   The Italians as a nation are amongst the most sophisticated customers in the world of fashion. As such, they provide a demanding and critical market-place for Benetton's designs. If you can survive as a fashion retailer in Italy, you are likely to have a product that will survive in other international markets.

   Demand conditions at home are also, perhaps paradoxically, an important factor in supporting the global development of a company. Thus:

   » A large and growing home demand provides a strong base for the firm, and if it proves necessary to accept lower profit margins in developing foreign sales, a strong national base makes this easier to do. If demand has plateaued at home, and the industry shows signs of maturing, then this provides a strong incentive for the company to put a lot of effort behind opening up new foreign markets.
   » A strong domestic demand leads to the growth of a well-developed network of supplier industries, important to a company intent on producing complex multi-part products.
   » The effectiveness and efficiency of a company's operations are also stimulated by the existence of demanding customers in the home economy. If domestic buyers require high standards, the company will develop the systems and quality controls to provide them and this will enhance its potential for success abroad.

Your notes

» Furthermore, if there is early demand for a product at home, it stimulates a company to provide a steady stream of new products, helping the company to move to the forefront of its industry internationally – an important factor in aiding its foreign performance.

3. Firm strategy, structure and rivalry

Items for consideration in this part of the diamond are the Five Forces industry analysis issues. Here, the point Porter wishes to make is that firms located in very competitive industries with high levels of national rivalry are the ones most likely to do well in international markets. Those with few or no national rivals are unlikely to be as efficient or as responsive to customer requirements. They may, nevertheless, survive and prosper within a relatively protected domestic market-place but are unlikely to perform strongly internationally. Benetton is located in an overcrowded domestic fashion market from whose competitive rigours it will benefit as an international firm.

Firms compete best where their industry structure fits their source of competitive advantage. Italian companies tend to succeed in entrepreneurial, fragmented, often family-owned industries. Their strategies are focused, niche orientated and differentiated in industries that tend to lack obvious scale advantages.

» Strong domestic rivalry creates strong competitors able to compete in international markets through the pressure to improve and to innovate; note the strength of innovation in the electronics industry emerging from Japan.
» Many successful companies locate geographically near to close competitors, and the evident rivalry accentuates the stimulus towards excellence. The electronics-dominated Route 128 in Boston exemplifies this, as does Silicon Valley in California, Silicon Glen in Scotland and the Swindon M4 corridor in England. Evidence shows also that international success is stimulated by the rate of new business formation in the home country. It is possible that this is not a causal link but both factors result from the existence of a dynamic home economy in which embryonic and growth industries predominate over mature and declining ones.
» Strong supplier industries benefit the downstream industries. Illustrations of such situations are the keiretsu supplier groups in Japan and the chaebols in Korea where the suppliers provide the brand name producers with guaranteed high quality supplies and components to an agreed price and 'just in time' to ensure super-efficient logistics, and hence reduced inventory costs.

4. Related and supporting industries

Italy has a national cluster of very strong industries both in the fashion industry itself, with its numerous designer labels, fashion houses and high priests of the Milan fashion shows, but also in many related industries such as leather goods, shoes, handbags, belts, luggage and furniture. All these industries share common factors such as high design skills and knowledge of materials. There is also a strong network of largely family-owned intermediate supporting industries to provide an efficient infrastructure for the fashion industry.

» * The existence of related industries also provides opportunities for beneficial value chain reconfiguration. The UK traditional strength in engines has led to the beneficial development of the lubricants sector. German strength in chemicals has supported the development of its printing ink industry, and Swiss strength in pharmaceuticals had led to it also becoming strong in food flavourings.
» * This synergy between industries within countries and their inherent competitiveness, has also led to the development of clusters of world-class industries in particular countries, for example electronics

Your notes

in Japan, printing in Germany, ceramic tiles, shoes and fashion clothing in Italy, automobiles in the USA, and engineering in Sweden.

Whereas it is possible for a company operating within a weak national diamond to achieve international competitive advantage, the task is far more difficult than that for a company operating within a strong diamond.

The potential of the diamond

We can relate Porter's diamond to the producer matrix (covered in Topic 4). If, as Porter argues, the four elements of the diamond help firms achieve success in competing globally, then these elements should assist the development of key competences. We can see that favourable factor conditions can make a direct contribution to competence development by providing the right cost and quality of skills and resources. Similarly, high-performing related and supplying industries provide a richer pool of resources for the corporation to draw upon; relevant knowledge can be more readily transferred into the corporation. So factor conditions and related and supporting industries can provide some of the means for competence development.

On the other hand, demanding customers and strong domestic competition provide the stimulus or motivation for competence development. A vigorous and sophisticated home demand, competitively served, will stimulate suppliers to outperform each other in terms of PUV and price. These competitive stimuli will help to ensure that motivator dimensions of value will become hygiene dimensions in this market first. Similarly, learning and scale advantages will accrue to firms in this market ahead of less stimulated markets. The combination of a strong stimulus to develop key competences coupled with the means to effect these developments results in these favourably situated firms taking a lead in a globalising market.

The Porter diamond is therefore seen as a tool to analyse the potentiality of a company in an industry for achieving international success. Porter (1990) suggests that internationally successful firms are most likely to be those that operate in strong domestic diamonds.

Rugman and D'Cruz (1993) extend the Porter diamond to demonstrate, in their concept of the double diamond, that successful MNCs do not need to operate from strong national diamonds. They can access other countries' diamonds, particularly those in Triad countries and thereby configure their productive assets to give themselves comparative advantage, even if their home country lacks it. The authors point out that this is how successful companies operating from Canada succeed. They leverage their productive capacity off the USA diamond.

Economic Paradigms

The Heckscher–Ohlin–Samuelson economic model of international trade, developed between the world wars, provides a variant of the traditional comparative cost Ricardo model described in the last section. It tells us that trade reflects an interaction between the characteristics of countries and of the production technologies of different goods. Countries will therefore export goods whose production is intensive in the factors with which they are abundantly endowed, for example countries with a high capital:labour ratio will export capital intensive goods. Such a theory would suggest that countries with abundant factors relevant to industrial goods would normally export to less developed agriculturally-based economies and import food products from them. This seems theoretically plausible.

However, this is not how the general pattern of international trade has evolved. In general, the main trading partners of industrially developed economies are other rather similar industrially developed countries, as shown in Figure 10.3 below, for the countries of the EU. Part of the reason for this must be that only

Quick summary

The Porter Diamond

- The Heckscher-Ohlin-Samuelson model tells us that trade reflects an interaction between the characteristics of countries and of the production technologies of different goods.
- Countries will therefore export goods whose production is intensive in the factors with which they are abundantly endowed
- The main trading partners of industrially developed economies are other rather similar industrially developed countries.

developed countries have the wealth to import expensive capital and consumer goods, but that is not the only reason as we shall see later in this section.

Index of Intra-Industry Trade	
Primary commodities	0.58
All manufactures	0.80
Road vehicles	0.70
Household appliances	0.80
Textiles	0.91
Other consumer goods	0.80
Weighted average	0.83

Source: GATT International trade cited in Begg, Fischer & Dornbusch (1994).

The table in Figure 10.3 above records an index ranging from 0.00 where one country exports a product and only imports other products, to 1.00 where there is complete two-way trade in the product range. Generally, the more products are undifferentiated, the more comparative cost theory operates effectively, and the country with the resource abundance does the exporting and hence has a low index in the table. For branded products, comparative advantage may lose some of its importance, as customers buy brands for a variety of reasons, not all of which are to do with externally testable value. Thus intra-industry trade becomes more significant.

In circumstances where tariffs have been largely removed between geographically closely related countries, the gains from trade arise less from the exploitation of different factor endowments than from advantages arising through specialisation in diversity and resultant brand marketing with the consequent reduction in comparative unit costs through the economies of scale and scope that a larger international market allows.

In international trade in the modern world, brand marketing is one of the key factors for success. With the close communication through radio, television and travel that exists, a brand developed successfully in one country may instantly have the key to entering a new market and achieving immediate market share in relation to domestic rivals. Coca-Cola® or Pepsi® cola, for example, are brands known world-wide and are instantly recognised and powerful brands in any new country they may wish to enter.

Economic theory has within its models the ability to explain modern international trade but three models are required rather than one. This is important since so much of international trade is based not on the comparative costs of a perfect market, but on the monopolistic competition power of MNCs and the strength of brand marketing to differentiate products that might otherwise be sold on the basis of their costs. Look at Figure 10.4 for an illustration. Then go to each of the links below to examine these models in more detail.

	Assumptions	Key Characteristics	Examples
Perfect Competition	Complete information Homogeneous products Commodities Constant and rising costs	Price taking Comparative costs key Brands unimportant	Wheat Steel Minerals

Monopolistic Competition	Incomplete information Proprietary products Differentiation Scale/scope economy	Price discretion Advanced factors key Branded goods Limited substitutability	Travel services Electronic goods Consumer goods
Oligopoly	Interdependence Differentiation Collusion opportunities Branded goods Scale/scope economy	Price strategy Interdependent Advanced factors key High advertising Few large rivals Game theory factors	Aircraft manufacture Machine tools Defence National news

Source: Segal-Horn and Faulkner (1999).

1. Perfect competition

   The classical theory of international trade has underlying it sometimes implicit assumptions of perfect competition. This abstract and idealised form of economic model assumes perfect rationality, complete information, homogeneous products, profit maximisation and that firms are price takers with horizontal demand curves, although the industry as a whole will of course have a downward sloping curve, i.e. demand will increase as price reduces.

   Such a model is useful in the analysis of food commodities such as rice, potatoes, wheat and other agricultural products that defy branding. These products will sell on a world market based on their comparative costs of products, distorted only by transport costs and the intervention of governments aiming to prop up prices to support their farming industry. The Common Agricultural Policy (CAP) of the EU is a current example of the way in which governments can distort agricultural prices that would otherwise be governed by the laws of supply and demand in nearly perfect competitive conditions.

2. Monopolistic competition

   A monopoly is a market in which only one company is able to do business. This may be because the government gives it and only it a licence to trade in particular goods, such as a television franchise, or it may be that only one company has access to a particular good, for example the UK water companies, which are mostly monopolists within their geographical areas. In world trade, monopolies are difficult to sustain due to the existence of a large number of governments and a wide variety of at least imperfectly substitutable resources.

   However, much international trade takes place in industrial branded goods for which the perfect competition paradigm is not only useless, but positively dangerous, if it is used as a basis for strategy formulation. Internationally traded industrial goods and consumer goods generally take place in conditions of at least monopolistic competition.

   Monopolistic competition (Chamberlain 1939) is the name given by economists to that form of imperfect competition that takes place between branded goods produced by competitive companies. They are supplying similar needs, but are regarded by consumers as substitutes only to a degree. A keen devotee to Coca-Cola® would only reluctantly accept Pepsi® as an adequate substitute if very thirsty.

   Scale economies, scope economies and the experience curve

   Under monopolistic competition, perfect knowledge is not assumed, so

Your notes

advertising can affect the strength of demand. The perfect rationality assumption is not relaxed but, with the seducing effects of advertising, it is possible to act rationally and buy a product in response to perceived qualities rather than the real superior qualities of that good. This gives firms the power to determine the price of their goods within a range limited by the acceptability in the market of their nearest competitive good. They have, then, a market niche in which they have power by virtue of their committed customers. They can choose prices to some extent and so are not price takers. Therefore they are able to develop the size of their production units beyond that possible in a commodity market by developing brands that give them a specialised market.

It may be said that they control 100% of the market share for their brand and are only vulnerable to the extent that the market is willing to accept other products as substitutes for theirs. Thus they are able to reduce their unit costs through economies of scale and, if they are multi-product companies, often economies of scope as well.

Scale economies arise through a number of technological factors that make it cheaper in unit cost terms to produce a large amount rather than a small amount of a product. Scope economies come about because once one product has been produced and marketed some factors needed for its production and marketing, such as its brand name, can be used costlessly for a second product. A third factor, namely the experience curve, aids this cost reduction process even further. Under the influence of this process, costs reduce with cumulative production of a product as producers develop better and better ways of producing a product of a given quality.

Economies of scale and scope and the experience curve thus enter into the picture and unit costs fall as output increases, which may act as a countervailing force to comparative cost theory since it enables countries poorly endowed with appropriate factors of production to match or even improve upon unit cost levels of better endowed countries, if the less well endowed countries are able to achieve sufficiently high levels of sales.

The theory that you have just read about explains how scale, scope and experience effects can and do enable large companies to succeed internationally even when they operate within an economy not well endowed on a comparative cost basis. Economists can accept this within their theoretical models, since the theory of monopolistic competition does not infringe the cardinal theory of economics, namely that all markets tend towards equilibrium.

However, in the real world even this condition may not always be obtained. Ever faster technological change seems in some markets to lead to a situation in which marginal costs continue to decline with increasing output, for example in software products. With ever-declining unit costs, there can be no equilibrium, since such a state is only reached when the revenue from selling an extra good is no more than the extra cost of making it, and it is no longer profitable to attempt to sell one more unit. In a dynamic theory of monopolistic competition, changing technology needs to be accepted as a realistic assumption; the existence of equilibrium in such markets becomes questionable and the onset of turbulence becomes a more realistic basic prediction.

Products internationally traded under monopolistic competition conditions currently include automobile or electronic goods. Indeed, monopolistic competition applies in all areas where there are many sellers of branded products with only partially acceptable substitutes, such that each player has some but only limited price setting power, and where advertising is able to distort demand and is therefore a powerful weapon in such competition.

3. Oligopoly

Your notes

An oligopoly is a market where a small number of competitors feel themselves constrained more by the actions of their rivals than by those of the customers. It is monopolistic competition with a significantly reduced field of competitors. This third form of competition applies in international trade where there are so few global players that each is predominantly concerned with the possible behaviour of its rivals, the threat of new entrants and the risk of substitutes emerging through new technology or change in consumer taste.

Under conditions of oligopoly, neither the comparative cost requirements of generous factor endowments nor the unit cost reducing power of scale, scope or experience curve economies and the demand increasing power of advertising become the primary concern of international strategists, although these last two factors clearly still have a place in these strategic calculations.

The primary concern becomes the ability to second-guess rivals. Aircraft manufacture is a good example of oligopoly where Airbus Industrie, Boeing and McDonnell Douglas need to keep a keen eye on each other's actions if they are to prosper. An effective understanding of the principles of game theory therefore becomes the most critical skill of the strategist under oligopoly. They need to guess correctly what a rival's response to a price change will be, to understand when a new entrant should be accommodated rather than driven out and when a rival should be colluded with, either implicitly or explicitly, rather than fought in cut-throat fashion.

Oligopoly is seen to have emerged out of monopolistic competition when competitors in a global market have become so few that their primary concerns become each other's actual and potential actions, rather than the capricious changes of the market.

Summary

International trade and its changing nature plays a critically important role in the economic development of the world and in the power relationships between nations. It is important to understand, therefore, how it came about in the first place and why the greatest economic welfare is not advanced by local firms serving their local populations in a self-reliant manner, without the MNCs being able to find a source of competitive and comparative advantage in relation to them. We live then in a world not of small firms producing according to their comparative advantage in factor cost, exporting their surplus production and importing product that they are less well endowed to produce, but rather in one of MNCs, single corporate entities selling on a global scale and with activities in many parts of the world, and operating generally in monopolistic competition conditions.

MNCs carry out global strategies that involve producing standard products with minor variations and marketing them in a similar fashion around the world or sometimes proving adept at adjusting to local needs, tastes and cultures, sourcing assets and activities on an optimal cost basis, only selling in countries where at least break-even can be achieved and employing contestability principles to this end where possible. Modern MNCs that carry out such global strategies differ from those of earlier times in that they work with a shared knowledge base, a common set of values and an agreed set of priorities, and a determined set of measures to judge performance. Given these conditions, they may be organised into a relatively decentralised network of companies. These issues are discussed further in later topics.

Task ...

Task 10.1

To check your understanding of the material in this topic, try to answer the following questions. If you have any difficulties, you may wish to go back and revise the relevant part of the topic.

1. What is the distinguishing feature of the world-wide competitor?
2. How would you define 'global competition'?
3. What is a global company?
4. How does a multi-domestic strategy differ from a globalisation strategy?
5. Describe the US definition of globalisation strategy, as espoused by Levitt.
6. Discuss Ohmae's five steps to the globalisation of a firm.
7. In what ways does the 'European interpretation' of globalisation strategy differ from others?
8. How did an ethnocentric predisposition amongst Japanese firms contribute to their successful efforts at globalisation during the 1970s and 1980s?
9. What explains the fact that most companies that come closest to being classified as truly global are European in origin?
10. Why might it be argued that the global company is more myth than reality?

Resources

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Topic 11

Cooperative Strategies

Aims

The purpose of this topic is to:

- explain the nature of strategic alliances;
- show the advantages and limitations of cooperative strategy;
- show when particular forms of alliances fit certain situations;
- explain how strategic alliances can be run successfully.

Objectives

By the end of this topic you should be able to:

- determine why some forms of inter-firm alliances are considered 'strategic';
- provide a typology of strategic alliances.

Introduction

Previous topics in this course have focused on internal development as the prime means by which a firm may leverage its strategy to achieve competitive advantage. Corporate success is built upon sound company competences, skills and capabilities. Advantage can accrue from the optimal utilisation of internal resources and the resultant market position adopted.

Most companies reach a stage, however, when internal development and external fit need to be complemented by other strategy choices. External options involve greater risk than internally generated choices. Such a situation usually arises when a company embarks upon a rapid growth trajectory – often beyond its national market. It may also arise when a company is attempting to block gaps or deficiencies in its resource base or competences.

The Rationale for Cooperation

In recent times, cooperative forms of doing business have grown rapidly, and continue to do so as firms of all sizes and nationalities in an increasing number of industries and countries perceive value in such arrangements.

At this moment in history, the companies of the East are showing themselves to be able to compete successfully against those of the West in an increasing number of industries. Despite the West's claims to be the birthplace of the industrial capitalist system, its economic dominance for the nineteenth century and the first half of the twentieth, and its emergence from the Second World War in a position of supreme power, world leadership in automobiles, electronics, steel, textiles, shipbuilding and pharmaceuticals either has or arguably is in the process of passing to the East. If there is one key difference between the West and the East in business philosophies it is that the West is individualistic and competitive right down to a person-to-person level, whilst the East is collective and cooperative within dense networks of relationships. Perhaps, many commentators argue, this is the basis of its strength. If so, it is important that we understand the philosophy, and perhaps adopt those aspects of it that are culturally congruent with our own way of doing things. If we adopted more cooperative strategies, we might regain our pre-eminence.

Cooperative activity between firms has become increasingly necessary due to the limitations and inadequacies of individual firms in coping successfully with a world where markets are becoming increasingly global in scope, technologies are changing rapidly, vast investment funds are regularly demanded to supply new products with ever-shortening life-cycles and the economic scene is becoming characterised by high uncertainty and turbulence. Strategic alliances, joint ventures, dynamic networks, constellations, cooperative agreements, collective strategies and strategic networks all make an appearance and develop significance. In tune with the growth of cooperative managerial forms, the reputation of cooperation seems to be enjoying a notable revival to set against the hitherto dominant strength of the competitive model as a model of resource allocation efficiency.

Why is this revival of the popularity of cooperation coming about, since the obvious problem with cooperating with your competitor is that your secrets might be stolen? If this is the case, how can cooperation be justified? A look at the situation found in the Prisoners' Dilemma situation shows how cooperation can be the best policy for both partners.

> In 1951, Merrill Flood of the Rand Corporation developed a model later termed the Prisoners' Dilemma by Albert Tucker. It addresses the issue of how we individually balance our innate inclination to act selfishly against the collective rationality of individual sacrifice for the sake of the common good including ourselves. John Casti in his book Paradigms Lost (1989) illustrates the difficulty effectively.

Quick summary

The rationale of cooperation

- West is individualistic and competitive right down to a person-to-person level, whilst the East is collective and cooperative within dense networks of relationships. Perhaps, many commentators argue, this is the basis of its strength.
- Cooperative activity between firms has become increasingly necessary due to the limitations and inadequacies of individual firms in coping successfully with a world where markets are becoming increasingly global in scope, technologies are changing rapidly, vast investment funds are regularly demanded to supply new products with ever-shortening life-cycles and the economic scene is becoming characterised by high uncertainty and turbulence.

The Rationale for Cooperation

In Puccini's opera Tosca, Tosca's lover has been condemned to death, and the police chief Scarpia offers Tosca a deal. If Tosca will bestow her sexual favours on him, Scarpia will spare her lover's life by instructing the firing squad to load their rifles with blanks. Here both Tosca and Scarpia face the choice of either keeping their part of the bargain or double-crossing the other. Acting on the basis of what is best for them as individuals both Tosca and Scarpia try a double-cross. Tosca stabs Scarpia as he is about to embrace her, while it turns out that Scarpia has not given the order to the firing squad to use blanks. The dilemma is that this outcome, undesirable for both parties, could have been avoided if they had trusted each other and acted not as selfish individuals, but rather in their mutual interest.

To analyse the dilemma, you will see in Figure 11.1 that there are two parties and both have the options of cooperating (C) or defecting (D).

		Column Player	
		Co-operate	**Defect**
Row Player	Co-operate	R=3, R=3 Reward for mutual co-operation	S=0, T=5 Sucker's payoff and temptation to defect
	Defect	T=5, S=0 Temptation to defect and sucker's payoff	P=1, P=1 Punishment for mutual defection

NOTE: The payoffs to the row chooser are listed first

Source: Faulkner and Campbell (2003, p. 120).

If the maximum value to each of them is 3 (a positive benefit with no compromise involved) and the minimum value 0, then the possible outcomes and values for A are as shown below:

- A defects and B cooperates: A scores 3 (and B scores 0: Total 3) Tosca gets all she wants without making any sacrifices. This would have happened if Tosca had killed Scarpia and Scarpia had loaded the rifles with blanks thus enabling Tosca's lover to escape.
- A cooperates and B cooperates: A scores 2 (and B scores 2: Total 4) Tosca, although saving her lover's life, has to submit sexually to Scarpia in order to do so, which it is presumed represents a sacrifice for her. Similarly Scarpia's compromise involves not killing Tosca's lover.
- A defects and B defects: A scores 1 (and B scores 1: Total 2). This is what happened. At least Tosca has killed the evil Scarpia, but he in turn has killed her lover. Not a successful outcome for Tosca or Scarpia, however, but marginally better for her than the fourth possibility.
- A cooperates and B defects: A scores 0 (and B scores 3: Total 3). This is the worst outcome from Tosca's viewpoint. She has surrendered herself to Scarpia, but he has still executed her lover. This is the 'sucker's payoff' and is to be avoided if possible at all costs.

The dilemma is that, since Tosca (A) does not know what Scarpia (B) will do, she is likely rationally to defect in order to avoid the sucker's payoff. Thus she may score 3 if Scarpia is as good as his word and she can make him the sucker. She will at least score 1. However, if both cooperate they will each score 2, which is the best joint score available. Yet in the absence of trust, it is unlike-

ly to be achieved.

You will see from this dilemma that, in the situation of a cooperative agreement, the optimal joint score can only be achieved through genuine trusting cooperation. Yet this may be difficult to achieve if both parties in the alliance are overly concerned not to be the sucker, and are thus reluctant to release their commercial secrets for fear that their partner will defect with them. Prisoner X defects fearing that the prisoner Y will defect and that prisoner X will end up as the 'sucker'.

To conclude the dilemma situation above, you will note that the payoffs listed only apply to a single shot game. In a situation where the partners intend to work with each other over an indeterminate period, the situation changes. In this case, trust can be built and the potential synergies from cooperation can be realised.

Furthermore, reputation comes into the equation. If one partner is seen to defect, that partner may find it difficult to attract further partners in the future. And if both partners are still reluctant to cooperate in a genuine fashion, the risk–reward ratio can be changed deliberately. If, in the Tosca defection situation that you read about above, the defector immediately forfeits his or her life, the incentive to defect is radically reduced. In the more prosaic world of business, this might mean that a potential defector automatically forfeits a large sum of money or shares in the event of defection. Thus the situation can be constructed in such a way that the dominant strategy is one of cooperation. A cooperative strategy can then become a stable way of combining the competences of multiple partners to achieve a competitive strategy with competitive advantage.

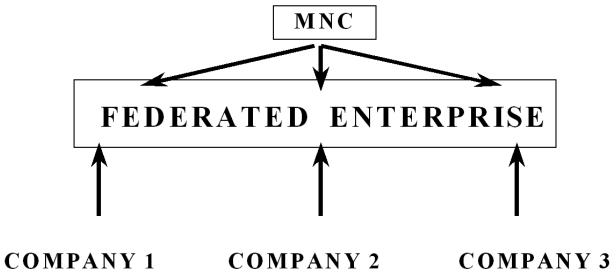
In sum:

1. The rational strategy of defection (competition) applies on the assumption of a zero-sum game, and a non-repeatable experience, i.e. if you are only in business for a single trade (such as buying a souvenir in a bazaar in Morocco), defection is a rational strategy for you.
2. As soon as the game becomes non zero-sum, for example through scale economies, and/or it is known that the game will be played over an extended time period or defection is costly, the strategy of defection is likely to become sub-optimal, i.e. to cooperate and keep your bargain is a better strategy for both players. At the very least, if you defect it will harm your reputation. You will become known as a player not to be trusted.
3. In these circumstances, then, forgiving cooperative strategies are likely to prove the most effective.

Corporate organisational form has also been dramatically influenced by the globalisation of markets and technologies, through a decline in the automatic choice of the integrated multinational corporation as the only instrument appropriate for international business development. The movement away from the traditional concept of the firm is accentuated by the growth of what Handy (1992) describes as 'The Federated Enterprise' seen both in the form of newly created joint ventures between existing companies and in the development of so-called virtual corporations where a number of companies cooperate in producing a single product offering generally under a distinct brand-name. For an illustration of the Federated Enterprise, see Figure 11.2.

The recent growth of alliances and networks approaches the flexible transnational structure from the other end, i.e. the amalgamation of previously independent resources and competences in contrast to the unbundling into a federal structure of previously hierarchically controlled resources and competences. Where the traditional concepts of firm, industry and national economy start to become concepts of declining clarity, and thus to lose their exclusive usefulness as tools for strategic analysis, the need for an adequate theory of strategic alliances and other cooperative network strategies assumes increased importance.

Your notes



Source: Faulkner and Campbell (2003, p. 122).

The search for sustainable competitive advantage is of course what the whole game is about, yet this is a factor that can often not be measured directly. Its extent can only be inferred from the measurement of other factors like profit, market share and sales turnover. It is nonetheless the Holy Grail that all firms seek to find and to maintain. Coyne (1986) identifies it as stemming from:

1. Customers' perception of a consistent superiority of the attributes of one firm's products to its competitors.
2. This being due to a capability gap.
3. The capability gap being durable over time.
4. The superiority being difficult to imitate.

It is this configuration of knowledge, skills, core competences and superior products that strategic alliances and networks seek to achieve, where the partners believe that they cannot achieve it alone.

Cooperative activity is frequently implicitly founded on the resource-based theory of competitive advantage. This theory (Grant 1991) holds that competitive advantage is most productively sought by an examination of a firm's existing resources and core competences, an assessment of their profit potential, and the selection of strategies based upon the possibilities this reveals.

The task is, then, to assess the current core competences the firm has and fill whatever resource or competence gap is revealed by the inventory taking of existing resources and competences, in relation to the perceived potential profit opportunities.

This is where strategic alliances and networks come in. The matrix in Figure 11.3 suggests how the make/buy/or ally decision should be influenced both by the strategic importance of the activity in question and by the firm's competence at carrying it out. Under this schema, alliances should be formed if the activity is at least moderately strategically important, and the firm is only fairly good at carrying it out

STRATEGIC IMPORTANCE ACTIVITY				
	High	ALLIANCE	INVEST & MAKE	MAKE
	Med	ALLIANCE	ALLIANCE	MAKE
	Low	BUY	BUY	BUY
		Low	Med	High
		COMPETENCE COMPARED WITH THE BEST IN THE INDUSTRY		

Source: Faulkner and Campbell (2003, p. 123).

Your notes

The resource-based theory of competitive advantage suggests that a firm should not invest in an enterprise not strongly related to its own core competences. Only strategies based upon existing core competences could, it would hold, lead to the acquisition and maintenance of sustainable competitive advantage.

The resource-based approach emphasises that firms do not always tend towards similarity, and markets towards commodity status, in a situation of stable equilibrium. If the opportunity requires certain competences in addition to those already present within the firm, a strategic alliance with a partner with complementary skills and resources or a network of complementary companies may represent a low-risk way of overcoming that deficiency.

Resource dependency perspective theory

The resource dependency perspective (RDP) theory (similar but different to what you have just read about) (Pfeffer & Salancik 1978) proposes that the key to organisational survival is the ability to acquire and maintain resources. Thus in the last resort, it is organisational power, and the capacity of the organisation to preserve itself, that determines competitive survival, not merely organisational efficiency.

The unit of analysis for the RDP is the organisation:environment relationship not the individual transaction. To deal with this uncertainty, firms attempt to manage their environment by cooperating with key parts of it, for example by cooperating with other companies owning key resources for them. An RDP approach treats the environment as a source of scarce resources and therefore views the firm as dependent on other firms also in the environment.

Resource dependency theory stems from the much earlier theory of social exchange, which holds that where organisations have similar objectives but different kinds or different combinations of resources at their disposal, it will often be mutually beneficial to the organisations in the pursuit of their goals to exchange resources.

Classical international trade theory is based on similar foundations. Organisations have as their rationale to seek to reduce uncertainty and enter into exchange relationships to achieve a negotiated and more predictable environment. Sources of uncertainty are scarcity of resources, lack of knowledge of how the environment will fluctuate, of the available exchange partners, and of the costs of transacting with them. These are all factors very common in the modern business world.

Resource dependency and strategic vulnerability

The degree of a firm's dependence on a particular resource is a function of the critical nature of the resources in the exchange to the parties involved, and of the number of and ease of access to alternative sources of supply. Where few alternatives exist and the resources are essential, a state of dependency exists. This creates a power differential between trading partners, and the dependant firm faces the problem of how to manage its resources with the concomitant loss of independence, since unchecked resource dependence leads to a state of strategic vulnerability.

Such strategic vulnerability can be tackled in a number of ways:

- Western firms may do it, for example, by multiple sourcing of materials and components, internal restructuring, merger or acquisition;
- Japanese ones by the establishment of semi-captive suppliers within keiretsu groups.

The establishment of a strategic alliance can thus be regarded as an attempt by a firm or firms to reduce strategic vulnerability, and hence to overcome perceived constraints on their autonomy in choosing their strategic direction. Strategic alliances and networks can be seen as attempts by firms to establish

a negotiated environment, and thus to reduce uncertainty. On the basis of this argument, alliances and networks will occur most when the level of competitive uncertainty is greatest.

In RDP motivated alliances and networks, all parties typically strive to form relationships with partners with whom balance can be achieved at minimum cost and with a desirable level of satisfaction and determinacy. Thus, wherever possible they will link up with firms of a similar size and power.

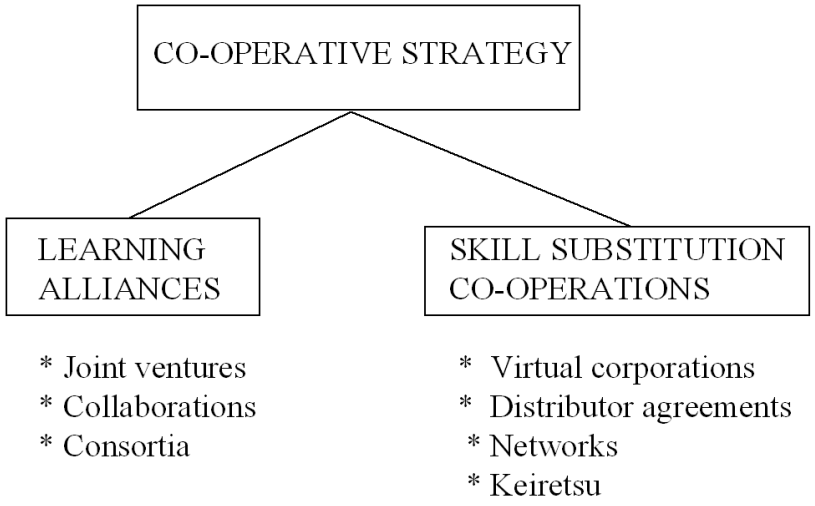
Strategic alliances and the role of corporate learning

Strategic alliances are frequently formed from resource dependency motives, and the ability of the partners to achieve and sustain competitive advantage in their chosen market is strongly influenced by the degree to which they place corporate learning as a high priority on their alliance agenda and seek to cause the alliance to evolve in a direction based on that learning.

In a sense, corporate learning can be seen as the dynamic counterpart to the resource dependency theory of the firm. Thus, a firm will diagnose its resource and skill deficiencies in relation to a particular external challenge, and through the process of deliberate and planned corporate learning set about remedying its weaknesses. Truly strategic alliances are generally competence driven, i.e. explicitly adding to either the task or the knowledge system or to the organisational memory of each partner. The idea of the organisation as a residuary for learning is a popular one. Decision theory emphasises the importance of the search for information to enable organisations to make informed choices. Prahalad and Hamel (1994) stress the role of learning as a source of competitive advantage, through the development of unique competences.

Strategic networks versus alliances

Strategic networks on the other hand are more likely to be formed for skill substitution reasons: for example company A forms a network with companies B and C who carry out specific functions, such as R&D or sales and marketing, whilst A does the production. Figure 11.4 illustrates the differing situations of networks and alliances.



Source: Faulkner and Campbell (2003, p. 125).

Even faced with success stories of the evolution of an alliance through mutual learning leading to competitive advantage, nagging doubts may well remain about the role of value appropriation in the form of learning by the partners and of the consequent stability of the alliance. It is often suggested, in fact, that the alliance is an inherently unstable and transitory arrangement and undoubtedly, given opportunistic attitudes by the partners, it can be, particularly in alliances between erstwhile competitors.

The alliance as a 'marriage'

Following on, the often cited comparison of an alliance with a marriage is pertinent here. Marriages could be regarded as unstable as they currently have a high failure rate. In fact, they have many of the qualities of strategic alliances. The partners retain separate identities but collaborate over a whole range of activities. Stability is threatened if one partner becomes excessively dependent on the other, or if the benefits are perceived to be all one way. But, nonetheless, successful marriages are stable and for the same reason as successful alliances. They depend upon trust, commitment, mutual learning, flexibility and a feeling by both partners that they are stronger together than apart. Many businesses point to the need to negotiate decisions in alliances as a weakness, in contrast to companies, where hierarchies make decisions. This is to confuse stability with clarity of decision-making, and would lead to the suggestion that dictatorships are more stable then democracies.

In this analogy, it is commitment to the belief that the alliance represents the best available arrangement that is the foundation of its stability. The need for resolution of the inevitable tensions in such an arrangement can as easily be presented as a strength, rather than as an inherent problem. It leads to the need to debate, see and evaluate contrasting viewpoints. Similar points arise in relation to strategic networks although to a lesser degree since the closeness and interdependence of a network is typically lower than that of an alliance.

The movement of enterprises away from a simple wholly owned corporate structure to more federated forms is accentuated by the growth of alliances and strategic networks, which aid the development of global loyalties and cooperative endeavours, quite distinct from those encouraged by the traditional national and firm boundaries.

The impact of transaction costs

Transaction costs is another body of theory applied to provide a rationale for the development of cooperative relationships, or hybrid organisations as they are called by TCA theorists. In transaction cost analysis, organisational forms are conventionally described on a scale of increasing integration with markets at one end as the absolute of non-integration, to hierarchies or completely integrated companies at the other.

It is suggested that the organisations that survive are those that involve the lowest costs to run in the particular circumstances in which they exist. Thus, integrated companies will be the lowest cost in situations when assets are very specific, markets are thin, and where conditions are highly complex and uncertain, opportunism is rife and assets are very specific, as it would be very difficult and therefore costly to handle transactions in a fragmented, marketplace way.

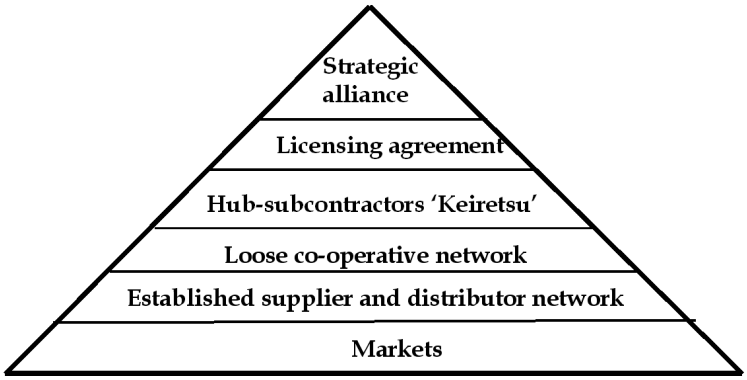
At the other extreme, transactions are best carried out in markets where no one deal implies commitment to another, and relationships are completely at arm's length. This is most commonly the case when the product is a frequently traded commodity, assets are not specific, market pricing is needed for efficiency, there are many alternative sources of supply and the costs of running a company would be very high.

Different levels of integration

Between the extremes of markets and integrated companies, there is a range of inter-organisational forms of increasing levels of integration, which have evolved to deal with varying circumstances and, where they survive, may be assumed to do so as a result of their varying appropriateness to the situation. All forms between the extremes of markets and hierarchies exhibit some degree of cooperation in their activities. It is even likely that most hierarchies include internal markets within them in order to create situations where market pricing will improve efficiency: for example a strategic business unit (SBU)

Your notes

may be empowered to use third-party marketing advice if it is not satisfied with that available internally. Figure 11.5 illustrates forms of ascending interdependency, all of which are cooperative.



Source: Faulkner and Campbell (2003, p. 127).

As you can see from Figure 11.5, arm's-length market relationships may develop into those with established suppliers and distributors, and then may integrate further into cooperative networks. Further up the ladder of integration come the hub subcontractor networks like Marks and Spencer's close interrelationships with its suppliers. Licensing agreements come next, in which the relationship between the licensor and the licensee is integrated from the viewpoint of activities in a defined area but both retain their separate ownership and identities.

Between licensing agreements and completely integrated companies, where rule by price (markets) is replaced by rule by fiat (companies), comes the most integrated form of rule by cooperation, namely that found in strategic alliances. Alliances may be preferred organisational forms where sensitive market awareness is required, the price mechanism remains important, risks of information leakage are not considered unacceptably high, scale economies and finance risks are high, there is resource limitation and flexibility is important.

The Motivation for Cooperation

The most common motivations behind the development of cooperation between companies as suggested by Porter and Fuller (1986) are:

- To achieve with one's partner, economies of scale and of learning.
- To get access to the benefits of the other firm's assets, be they technology, market access, capital, production capacity, products or manpower.
- To reduce risk by sharing it, notably in terms of capital requirements but also often R&D.
- To help shape the market, e.g. to withdraw capacity in a mature market.

Another motive behind the conclusion of cooperative strategies is the need for speed in reaching the market. In the current economic world, first mover advantages are becoming increasingly important, and often the conclusion of an alliance between a technologically strong company with new products and a company with strong market access is the only way to take advantage of an opportunity. There may also be opportunities through the medium of cooperation for the achievement of value chain synergies (Porter & Fuller 1986), which extend beyond the mere pooling of assets and include such matters as process rationalisation and even systems improvement.

It is suggested that for cooperation to come about there needs to be at least one external force in play that challenges would-be players in the market-place, and at least one internal perception of vulnerability or need in responding to that force. Such a response may well be to form a strategic alliance or network.

Quick summary

The motivation for cooperation

- Another motive behind the conclusion of cooperative strategies is the need for speed in reaching the market.
- It is suggested that for cooperation to come about there needs to be at least one external force in play that challenges would-be players in the market-place, and at least one internal perception of vulnerability or need in responding to that force.

External forces

There are a number of external forces that have stimulated the growth of strategic alliances and networks in recent years. Amongst the most important are:

- the globalisation of tastes and markets;
- the rapid spread and shortening of the life-cycle of new technology and its products;
- the development of opportunities for achieving major economies of scale, scope and learning;
- increasing turbulence in international economies;
- a heightened level of uncertainty in all aspects of life;
- declining international trade barriers.

Theodore Levitt (1960) was credited over 40 years ago with first having drawn attention to the increasing homogenisation of tastes, leading to the development of the 'global village'. Since that time, the globalisation movement has spread to an increasing number of industries and, as Kenichi Ohmae (1989) points out, it is now possible to travel from New York to Paris and on to Tokyo, and to see the very similar articles on display in department stores in all three cities at least in some industries like electronics, computers or automobiles.

Changes in trade barriers

After the Second World War, trade barriers between nations placed a limit to the development of a world economy. With the dramatic economic recovery of the major combatant nations, the move towards increasing international trade was stimulated by international agreements to reduce trade barriers, and thus increase overall economic welfare by allowing greater specialisation on the basis of comparative costs and the development of global brand names as easily recognisable in Tokyo as in New York or London.

GATT (now the WTO), the EU, EFTA and other trading agreements and common markets enabled national firms to develop opportunities internationally, and to grow into multinational corporations. More recently, the 1992 EU legislation, the reunification of Germany, the establishment of NAFTA and the break-up of the communist bloc have accelerated this movement and, in so doing, stimulated the growth of strategic alliances between firms in different nations.

Changes in technology

However, not only are markets rapidly becoming global, but also the most modern technologies (micro-electronics, genetic engineering and advanced material sciences) are, by now, all subject to truly global competition. The global technologies involved in the communications revolution have also succeeded in effect in shrinking the world and led to the design and manufacture of products with global appeal due to their pricing, reliability and technical qualities. But not only is technology becoming global in nature, it is also changing faster than previously, which means a single firm needs correspondingly greater resources to be capable of replacing the old technology with the new on a regular basis.

Changes in scale and scope economies, and in forecasting uncertainty

The globalisation of markets and technologies leads to the need to be able to produce at a sufficiently large volume to realise the maximum economies of scale and scope, and thus compete globally on a unit cost basis. Although one effect of the new technologies is, through flexible manufacturing systems, to be able to produce small lots economically, the importance of scale and scope economies is still critical to global economic competitiveness in a wide range of industries. Alliances are often the only way to achieve such a large scale of operation to generate these economies. The advantages of alliances and networks over integrated firms are in the areas of specialisation,

Your notes

entrepreneurship and flexibility of arrangements, and these characteristics are particularly appropriate to meet the needs of today's turbulent and changing environment.

The oil crises of 1973 and 1978, the Middle East wars and the subsequent aggravated economic cycles of boom and recession, coupled with ever shortening product life-cycles, have made economic forecasting as hazardous as long-term weather forecasting. Strategic vulnerability due to environmental uncertainty has become a fact of life in most industries. Cooperative strategy helps to reduce that vulnerability by enabling 'cooperative enterprises' to grow or decline flexibly, to match the increasing variability of the market situation.

Internal conditions

A range of external conditions and challenging situations may stimulate the creation of strategic alliances and networks. However, firms will only enter into such arrangements when their internal circumstances make this seem to be the right move. These internal circumstances have most commonly included a feeling of resource and competence inadequacy, in that cooperative activity would give a firm access to valuable markets, technologies, special skills or raw materials in which it feels itself to be deficient, and which it could not easily get in any other way.

In conditions of economic turbulence and high uncertainty, access to the necessary resources for many firms becomes a risk, which raises the spectre of potential strategic vulnerability for even the most efficient firm. This leads to the need to reduce that uncertainty and secure a more reliable access to the necessary resources, whether they be supplies, skills or markets. Strategic alliances or a developed network with firms able to supply the resources may then develop where previously market relationships may have dominated.

For cooperation to be appropriate, both partners must be able to provide some resource or competence the other needs or reach a critical mass together that they each do not reach alone. If the needs are not reciprocal, then the best course of action is for the partner in need to buy the competence or resource or, if appropriate, buy the company possessing it. Cooperative arrangements require the satisfaction of complementary needs on the part of both partners and thereby lead to competitive advantage.

There are many forms of resource dependency that provide the internal motivation for cooperation.

Access to markets

Access to markets is a common form. One firm has a successful product in its home market, but lacks the sales force and perhaps the local knowledge to gain access to other markets. The alliance between Cincinnati Bell Information Systems (USA) and Kingston Communications (Hull, England) was set up from CBIS's viewpoint in order to gain market access into the European Community, with the purpose of selling its automated telecommunications equipment. The market motivator is also a strong one in the current spate of Eastern Europe and former USSR alliances with Western firms.

New technology

New technology is another form of resource need. Thus, in forming Cereal Partners to fight Kellogg's domination of the breakfast cereals market, Nestlé has joined forces with General Mills principally to gain access to its breakfast cereals technology.

Access to special skills

Access to special skills is a resource need that is similar to access to technology. The special skills or competences may be of many types and include the know-how associated with experience in a particular product area.

Access to raw materials

Your notes

Access to raw materials is a further form. Thus, for example, Monarch Resources has allied with Cyprus Minerals to gain access to Venezuelan gold mines. Although this motivation was a very common one in past decades when the developed nations sought allies in less developed areas, it is currently less common.

Further internal conditions

Other internal circumstances that have stimulated the search for alliances have included the belief that running an alliance would be less costly than running and financing an integrated company, or the belief that an alliance, or a series of alliances, would provide strong protection against take-over predators. Others may be that firms believe it is the best way to limit risk or to achieve a desired market position faster than by any other way.

Transaction cost theory encompasses these motivations within its orbit. However, accurate calculation of the costs involved in various organisational forms is very difficult to compute since it involves assigning costs to some unquantifiable factors, such as opportunism or information asymmetry. The lowest cost concept is still valuable in determining whether a particular activity is best carried out by internal means, by purchasing it in the market-place or by collaboration with a partner. Where the transactions cost perspective is taken as the justification for the development of the alliance, this suggests the priority is to improve the firm's cost and efficiency rather than quality position.

Limiting risk and achieving speed

Alliances are also frequently formed as a result of the need to limit risk. The nature of the risk may be its sheer size in terms of financial resources. Thus, a £100 million project shared between three alliance partners is a much lower risk for each partner than the same project shouldered alone. The risk may also be portfolio risk. Thus, £100 million invested in alliances in four countries probably represents a lower risk than the same figure invested alone in one project.

The trade-off is between higher control and lower risk. An acquisition represents a high level of control but is expensive and however well the acquirer may have researched the target company before purchase, it may still receive some unexpected surprises after the conclusion of the deal. A strategic alliance involves shared risk, is probably easier to unravel if it proves disappointing and enables the partners to get to know each other slowly as their relationship develops.

The need to achieve speed is a further internal reason for alliance formation. Many objectives in the business world of the 1990s can only be achieved if the firm acts quickly. In many industries, there is a need for almost instantaneous product launches in the retail markets of London, Tokyo and New York if opportunities that may not last for ever are not to be missed. This suggests the need for alliances, which can be activated rapidly to take advantage of such opportunities.

Alliances and networks are not all formed with expansionary aims in mind, however. Many are the result of a fear of being taken over. Thus, in the European insurance world, AXA and Groupe Midi of France formed an alliance and eventually merged to avoid being taken over by Generali of Italy. General Electric of the UK has formed an alliance with its namesake in the USA for similar defensive reasons.

Strategic Alliance Forms

A strategic alliance has been defined as:

> a particular mode of inter-organisational relationship in which the

> partners make substantial investments in developing a long-term collaborative effort, and common orientation … (Mattsson 1988)

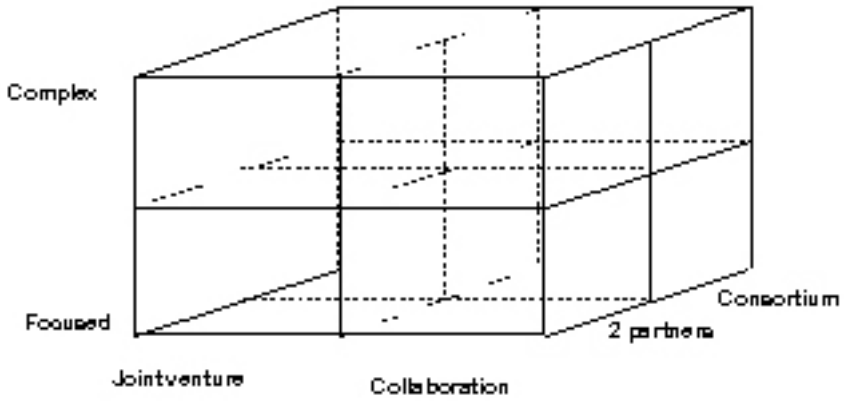
This definition excludes projects between companies that have a beginning and pre-ordained end, and loose cooperative arrangements without long-term commitment. In establishing the "collaborative effort and common orientation" the alliance partners forsake a competitive strategy in relation to each other in agreed areas of activity and embark on a cooperative one.

Types of alliance

Alliances can be classified along three dimensions that define their nature, form and membership:

1	Nature	Focused	Complex
2	Form	Joint venture	Collaboration
3	Membership	Two partners only	Consortium

Figure 11.6 illustrates the options available from which a choice may be made.



Source: Child and Faulkner (1998, p. 106).

Focused alliances

The focused alliance is an arrangement between two or more companies, set up to meet a clearly defined set of circumstances in a particular way. It normally involves only one major activity or function for each partner, or at least is clearly defined and limited in its objectives. Thus, for example, a US company seeking to enter the EU market with a given set of products, may form an alliance with a European distribution company as its means of market entry. The US company provides the product and probably some market and sales literature, and the European company provides the sales force and local know-how. The precise form of arrangement may vary widely, but the nature of the alliance is a focused one with clear remits and understandings of respective contributions and rewards.

Complex alliances

Complex alliances may involve the complete activity cost chains of the partners. The companies recognise that together they are capable of forming a far more powerful competitive enterprise than they do apart. Yet they wish to retain their separate identities and overall aspirations, whilst being willing to cooperate with each other over a wide range of activities.

The alliance between the Royal Bank of Scotland and Banco Santander of Spain is a good example of a complex alliance. It includes exchange of banking facilities in the respective host countries, partnership in an electronic European foreign funds transfer conglomerate and joint participation in a number of

Quick summary

Strategic alliance forms

- A strategic alliance has been defined as a particular mode of inter-organisational relationship in which the partners make substantial investments in developing a long-term collaborative effort, and common orientation
- This definition excludes projects between companies that have a beginning and pre-ordained end, and loose cooperative arrangements without long-term commitment.
- In establishing the "collaborative effort and common orientation" the alliance partners forsake a competitive strategy in relation to each other in agreed areas of activity and embark on a cooperative one.

third country joint ventures. It remains separate, however, in the critical marketing and sales areas in the partners' respective home countries and both companies retain clearly distinct images.

Your notes

Joint ventures

A joint venture involves the creation of a legally separate company from that of the partners. The new company normally starts life with the partners as its shareholders and with an agreed set of objectives in a specific area of activity. Thus, a US company may set up a joint venture with a UK company to market in the EU. The partners provide finance, and other support competences and resources for the joint venture in agreed amounts. The aim of the joint venture is normally that the new company should ultimately become a self-standing entity with its own employees and strategic aims quite distinct from those of its parent shareholders.

Unilever is a good example of a joint venture set up by a Dutch and an English company in the 1920s and which has grown into a major multinational enterprise. Joint ventures usually involve non-core activities of the partners, and are characterised by having clear boundaries, specific assets, personnel and managerial responsibilities. They are not generally set up in such a way that their products compete directly with those of the founding partners. Ultimately, they are divestible by the partners in a way that the non-joint venture form is not. They are the most popular form of alliance, being responsible for about half of all alliances created in the samples of several alliance researchers.

Collaborations

The collaborative alliance form is employed when partners do not wish to set up a separate joint venture company to provide boundaries to their relationship. This might be because they do not know at the outset where such boundaries should lie. Hence the more flexible collaborative form meets their needs better. Collaborative alliances are also preferred when the partners' core business is the area of the alliances and, therefore, assets cannot be separated from the core business and allocated to a dedicated joint venture. The collaborative form can be expanded or contracted to meet the partners' needs far more easily than can a joint venture. Royal Bank–Banco Santander is a classic example of the collaboration form of alliance.

The consortium

The consortium is a distinct form of strategic alliance in that it has a number of partners and is normally a very large-scale activity set up for a very specific purpose and usually managed in a hands-off fashion from the contributing shareholders. Consortia are particularly common for large-scale projects in the defence or aerospace industries where massive funds and a wide range of specialist competences are required for success.

Airbus Industrie is a consortium where a number of European shareholders have set up an aircraft manufacturing company to compete on world markets with Boeing and McDonnell Douglas. The European shareholders, although large themselves, felt the need to create a large enough pool of funds to ensure they reached critical mass in terms of resources for aircraft development, and chose to form an international consortium to do this. A consortium may or may not have a legally distinct corporate form. Airbus Industrie originally did not have one but is now restructuring itself to have one.

Paths of evolution

There are, then, eight possible basic configurations of alliance covering the alliance's nature, its form and the number of partners it has: for example focused/two partner/joint venture, complex/consortium/collaboration and so forth. The alliance type that involves setting up a joint venture company is currently by far the most popular method.

There are also well-trodden paths by which alliances evolve. For example, focused alliances that are successful frequently develop into complex alliances as the partners find other areas for mutual cooperation. Two-partner alliances often recruit further partners and develop into consortia as the scale and complexity of opportunities become apparent. Alliances initially without joint venture companies frequently form them subsequently, as they experience difficulty in operating in a partially merged fashion but without clear boundaries between the cooperative and the independent parts. It is also quite common for one partner in a joint venture to buy out the other. This need not mean the alliance was a failure. It may have been a considerable success but the strategic objectives of the two companies may have moved onto different paths.

Other paths of evolution, however, are probably less likely to be followed. Consortia are unlikely to reduce to two-partner alliances. Alliances with joint venture companies are unlikely to revert to a non-joint venture situation but to keep the alliance in being. Thirdly, complex alliances are unlikely to revert to a simple focused relationship between the partners.

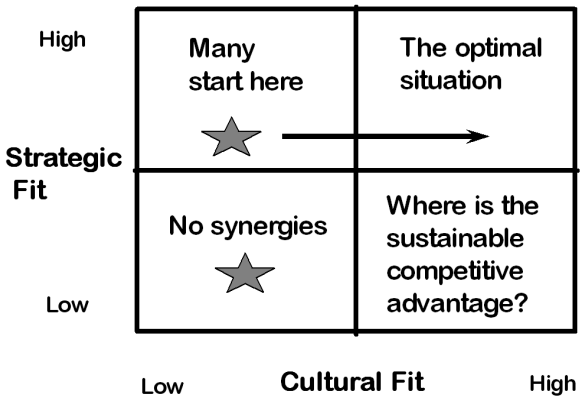
It is not possible to predict definitively which form of alliance will be adopted in which specific set of circumstances, since certain companies show policy preferences for certain forms rather than others, irrespective of their appropriateness. However, most alliances fall into three types:

1. Two-partner joint ventures
2. Two-partner collaborations
3. Consortium joint ventures

Firms seeking strategic alliances generally choose between these three forms before moving on to define their relationships in a more specific way.

Selecting a Partner

The creation of a strategic alliance does not, of course, guarantee its long-term survival. Research by the consultancy firms McKinsey and Coopers & Lybrand (now Price Waterhouse Coopers) has shown that there is no better than a 50% survival probability for alliances over a five-year term. This conclusion is, however, put in perspective when considered against Porter's (1987) research into the success of acquisitions, which concluded that the success rate of acquisitions is even lower. Undoubtedly, the 50% failure rate of alliances could be considerably reduced if firms learned the managerial skills necessary to develop and maintain successful cooperative relationships, an aspect of management theory given only limited emphasis at business schools.



Source: Faulkner and Campbell (2003, p. 136).

One of the keys to a successful alliance must be to choose the right partner. This requires the consideration of three basic factors:

1. The synergy or strategic fit between the partners.

Quick summary

Selecting a partner

- The creation of a strategic alliance does not, of course, guarantee its long-term survival.
- The 50% failure rate of alliances could be considerably reduced if firms learned the managerial skills necessary to develop and maintain successful cooperative relationships,

2. The cultural fit between them.
3. The existence of only limited competition between the partners.

The importance of strategic fit and cultural fit is illustrated in Figure 11.7.

Your notes

Strategic fit

A high degree of strategic fit is essential to justify the alliance in the first place. Strategic fit implies that the core competences of the two companies are highly complementary. Whatever partner is sought, it must be one with complementary assets, i.e. to supply some of the resources or competences needed to achieve the alliance objectives. These complementary needs may come about in a number of circumstances:

- Reciprocity – where the assets of the two partners have a reciprocal strength, i.e. there are synergies such that a newly configured joint value chain leads to greater power than the two companies could hope to exercise separately.
- Efficiency – where an alliance leads to lower joint costs over an important range of areas, namely scale, scope, transaction, procurement and so forth, then this provides a powerful stimulus to alliance formation.
- Reputation – alliances are set up to create a more prestigious enterprise with a higher profile in the market-place, enhanced image, prestige and reputation.
- Legal requirements – in many developing countries it is legally required that international companies take a local partner before being granted permission to trade.

Strategic fit of some form or another is normally the fundamental reason that the alliance has been set up in the first place. It is important both that it is clearly there at the outset and that it continues to exist for the life-time of the alliance. Strategic fit implies that the alliance has or is capable of developing a clearly identifiable source of sustainable competitive advantage.

Two forms of alliance

Garrette and Dussauge (1995) classify strategic fit into two forms of alliance:

- Scale (where two competitors come together to achieve scale economies).
- Link (where two companies at different points in the value chain link up to reduce transaction costs).

Clearly the tensions and risks of cooperation alliances will generally be greater in scale than in link alliances. Whatever partner is sought, it must be one with complementary assets, i.e. to supply some of the resources or competences needed to achieve the alliance objectives. Cooperative arrangements require the satisfaction of complementary needs on the part of both partners, and leading to competitive advantage.

Cultural fit

For an alliance to endure, cultural adaptation must take place leading the most successful alliances to graduate to the top right-hand box of Figure 11.7, which you saw earlier in this section. Cultural fit is an expression more difficult to define than strategic fit. In the sense used here, it covers the following factors: the partners have cultural sensitivities sufficiently acute and flexible to be able to work effectively together, and to learn from each other's cultural differences; and the partners are balanced in the sense of being of roughly equivalent size, strength and consciousness of need. One is not, therefore, likely to attempt to dominate the other. Also, their attitudes to risk and to ethical considerations are compatible.

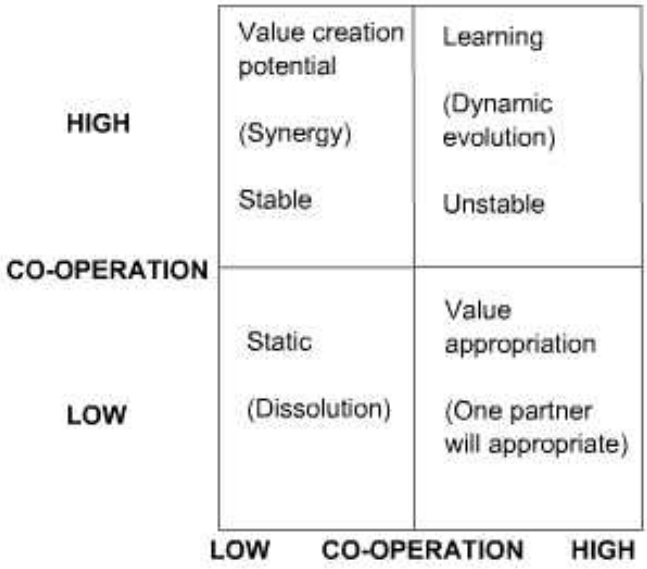
Cultural difficulties are very frequently cited as the reason for the failure of an alliance but the question of compatible cultures is rarely explicitly addressed

when an alliance is being set up. Additionally, clearly different cultures (e.g. UK and Japan) often make for better alliances than superficially similar ones (e.g. UK and the USA). Indeed, in support of this point, research has shown that an ethnically Chinese American national has a far more difficult task running a US–Chinese joint venture in China than an explicitly Caucasian American. Less tolerance is accorded to the ethnically Chinese American for cultural lapses in China.

Your notes

Limited competition

It is also important that the partners are not too competitive. See Figure 11.8 for an illustration.



Source: Faulkner and Campbell (2003, p. 138).

In Figure 11.8, we can see that alliances in the top left-hand box should be relatively stable since their areas of cooperation are far stronger than those of competition. Alliances in the bottom left do not have strategic fit and are likely to dissolve over time. The top right-hand box alliances may be very dynamic and significant mutual learning may take place. However, the high level of potential competition between the partners renders them ultimately unstable and they are likely to have a future of either complete merger or break-up to reduce this competitive tension.

Partners in the bottom right-hand box have strong competitive characteristics and only weak cooperative ones. Such a situation is likely to lead to the appropriation of key skills by one partner or the other. It is generally fairly simple to analyse the situation at the outset of an alliance, and avoid the dangerous bottom right-hand box. However, situations change with time and alliances can slip unnoticed into this box after starting out in the more healthy top-level boxes. Such changes need to be guarded against by constant monitoring of the situation.

The Royal Bank of Scotland and Banco Santander of Spain were very little in competition since they were strong in different geographical areas.

The Management of Alliances

The management of an alliance consists of two primary factors:

1. The systems, mechanisms and organisation structure chosen to operate the alliance.
2. The attitudes of the partners towards each other.

Much the same concerns apply to a network but in a rather looser way. Although the mechanisms chosen will obviously vary widely according to the cooperative form chosen, the attitudes necessary for success are similar in all forms. The relationship of the partners, as in a marriage, is a key to the success of the arrangement. It may not be a sufficient factor by itself, since the successful alliance needs positive quantifiable results, but it is certainly a necessary condition. An appropriate attitude has two major components: commitment and trust.

Lack of commitment can kill an alliance in a very short time. Alliances have failed because the partners have not allocated their best people to the project, have placed it low on the priority agenda or have set up too many relationships, in the hope that at least some would succeed. These attitudes have the seeds of failure within them.

Trust is the second key factor for survival. Unless this develops early on in the partnership, the alliance soon ceases to be the best organisational arrangement for the partners, as they spend increasing amounts of time and resources monitoring each other's activities as a result of their mutual lack of trust. Trust may be classified in three forms:

1. Calculative trust, which exists at the outset of a relationship because the partners perceive that it is in their self interest to set up the relationship, and to do so they must accord their partner some measure of trust.
2. Predictive trust develops as the partners discover by working together that each is as good as their word, and their actions may therefore be accurately predicted to be as they commit to them.
3. Bonding trust or a warm human relationship may then develop over time but does not necessarily do so in all business relationships. If it does, however, it is the best guarantor of a successful relationship.

Trust does not imply naive revelation of company secrets not covered by the alliance agreement. It implies the belief that the partner will act with integrity and will carry out its commitments. The appropriate attitude must be set from the start. During the negotiation stage, friendliness should be exhibited and a deal struck that is clearly 'win–win': qualities quite different from those that often characterise take-over negotiations.

Further qualities essential to alliance success

Cultural sensitivity can also be the key to alliance success as mentioned earlier in the section on selecting a partner. Many alliances have failed purely as a result of cultural incompatibility. Cultural compatibility does not necessarily imply the existence of similar cultures. Indeed, partners have more to learn from differences than from similarities. It does, however, require a willingness to display cultural sensitivity and to accept that there is often more than one acceptable way of doing things. A comparison of the partners' cultural profiles will often highlight possible areas of future cultural discord.

Goal compatibility is vital to the long-term success of a partnership. Of course, the specific goals of the alliance will evolve over time. However, if the goals of the partners at a basic level fundamentally clash, the alliance cannot but be a short-term opportunistic affair. Compatibility does not necessarily mean the partners' goals must be identical. There is no fundamental incompatibility in having different sets of goals so long as they do not conflict, as did those of Courtaulds coatings and Nippon Paint when both conceived of the ambition to be the world number one in marine paints.

Managing a joint venture

The mechanisms for running a joint venture are quite distinct from those of a collaboration. A joint venture, whether two-partner or consortium, involves the creation of a separate company to those of the partners. There are there-

Quick summary

The management of alliances

- The relationship of the partners is a key to the success of the arrangement. It may not be a sufficient factor by itself, since the successful alliance needs positive quantifiable results, but it is certainly a necessary condition.
- An appropriate attitude has two major components: commitment and trust.
- Lack of commitment can kill an alliance in a very short time.
- Unless trust develops early on in the partnership, the alliance soon ceases to be the best organisational arrangement for the partners, as they spend increasing amounts of time and resources monitoring each other's activities as a result of their mutual lack of trust.

fore two types of relationship to cope with:

1. The relationship between the partners.
2. The relationship between each partner and the joint venture company.

The most appropriate systems for running a joint venture are also the simplest. The venture should be set up with sufficient resources, guaranteed assistance by the partners whilst it is young and allowed to get on with the job of realising its objectives and targets. Involvement by the partners should be limited to board level except at the request of the venture company. A chief executive should be appointed and given sufficient autonomy to build the joint venture company.

Although this seems common sense, it is surprising how many joint ventures falter or fail through the unwillingness of the partners to give them sufficient autonomy and assets, and to realise that the venture will inevitably not have fully congruent objectives with those of the partners. Joint venture companies inevitably develop cultures, lives and objectives of their own, and owner partners frequently find this fact difficult to adjust to. The now retired managing Director of the EVC joint venture between ICI and Enichem is on record as claiming that both partners expected him to pursue their interests rather than those of the joint venture company he was employed to run, and both accused him of being biased in favour of the interests of their partner.

Further considerations

The relationship between the partners is different in nature between partners in collaborations. Here the 'boundary spanning' mechanism is the area crucial for success. The interface between the companies is the area where culture clashes or conflict of objectives will probably show themselves first. The establishment of a 'gateway' executive or office as a channel for all contacts between the partners, at least during the settling down period of the alliance, is a good way to avoid unnecessary misunderstandings.

In all circumstances, a good dispute resolution mechanism should be established before the alliance begins to operate. If this is left to be worked out as necessary, there is a high risk that its absence will lead to a souring of the relationship between the partners at the ultra-sensitive early stage of the partnership.

An effective system for disseminating alliance information widely within the partner companies is a further important factor for ensuring that both, or all, partners gain in learning to the greatest degree possible from the cooperative arrangement.

A procedure for divorce should be considered at the outset of an alliance in the event of a wish by either party to end the alliance, since this will increase the feeling of security by both parties that an end to the alliance does not represent a potential catastrophe.

Alliance Evolution

Bleeke and Ernst, in a 1995 article in the Harvard Business Review, claim that there are six possible outcomes to alliances including the dissolution of the alliances and the swallowing of one partner by the other. Only one solution was that the alliance continue successfully largely unchanged over an indefinite time period, and it is certainly true to say that two firms running an enterprise may well lead to an ultimate outcome of the simpler 'one firm running it' type. However this is not necessarily the case.

One key factor in the life of an alliance seems to be that if it ceases to evolve, it starts to decay. The reality of a successful alliance is that it not only trades competences but also demonstrates synergies. Whereas the resource dependency

Your notes

Quick summary

Alliance evolution

- Bleeke and Ernst claim that there are six possible outcomes to alliances including the dissolution of the alliances and the swallowing of one partner by the other.
- One key factor in the life of an alliance seems to be that if it ceases to evolve, it starts to decay.

perspective identifies a key part of a company's motivation for forming an alliance, the successful evolution of that alliance depends upon the realisation of synergies between the companies and the establishment of a level competitive advantage for the partners, that each could not as easily realise alone.

Important conditions for evolution include:

- Perception of balanced benefits from the alliance by both partners.
- The development of strong bonding factors.
- The regular development of new projects between the partners.
- The adoption of a philosophy of constant learning by the partners.

The Fujitsu and ICL alliance evolved so far that it became a full merger, or rather a take-over by Fujitsu.

Strategic Networks

Strategic networks differ from alliances in that they generally involve a lower level of interdependence between the members, and the learning factor is rarely so important. Members provide their own skills and leave other members to provide theirs. The table below illustrates the differences between different organisational forms on a number of dimensions.

Key features	Hierarchy	Alliance	Network	Market
Normative Basis	Employment	Secondment	Complementary strengths	Contract
Communication	Routines	Relational	Relational	Prices
Conflict Resolution	Fiat Supervision	Reciprocity & reputation	Reciprocity & Reputation	Haggling & the law
Flexibility	Low	Medium	High	High
Commitment	High	High	Medium	Nil
Tone	Formal Bureaucratic	Committed Mutual benefit	Open-ended Mutual benefit	Precision Suspicion
Actor Preference	Dependent	Interdependent	Interdependent	Independent
Mixing of Forms	Informal Organisation	Equality	Status Hierarchy	Repeat Transactions
	Profit centres Transfer pricing	Flexible rules Recent systems	Multiple partners Formal rules	Contracts

*Source: **adapted from Powell (1990).***

The nature of strategic networks

There is a clear distinction between the idea of a network with its implication of close but non-exclusive relationships and that of an alliance, which, however loosely, implies the creation of a joint enterprise at least over a limited domain. The term network is in fact often very loosely used to describe any relationship from an executive's 'black book' of useful contacts, to an integrated company organised on internal market lines (compare Snow, Miles & Coleman 1992). Johanson and Mattsson (1991) make a useful additional distinction be-

tween network theory and the form of strategic alliance theory that is based upon transaction cost analysis. Alliances may be concluded for transaction cost reasons, but networks never are.

Networks, like alliances, generally exist for reasons stemming from resource dependency theory. In other words, one network member provides one function that is complementary to and synergistic with the differing contribution of other members of the network and provides other members with privileged access. Although costs enter into the calculus of who to admit and persevere with as network members, the existence of the network and the loose bonding implied by it emphasises autonomy and choice, in contrast to the more deterministic governance structure and stable static equilibrium applied to alliance theory by transaction cost theorists.

> We think the relationships among firms in networks are stable and can basically play the same coordinating and development function as intra-organizational relations. Through relations with customers, distributors, and suppliers a firm can reach out to quite an extensive network. Such indirect relationships may be very important. They are not handled within the transaction cost approach. (Johanson & Mattsson 1991)

Networks of whatever type arise for a number of distinct reasons.

To reduce uncertainty

Indeed, this motive has been suggested as the prime reason for the development of all institutions. Impersonal relationships in markets are fraught with uncertainty, in that a transaction once made can never be assumed to be repeatable since it implies no more in relationship terms than is contained in the exchange. Networks imply developing relationships and thus promise more in terms of mutual solidarity against the cruel wind of economic dynamics.

To provide flexibility

This quality is offered not in contrast to markets but to hierarchies. Vertically integrated companies establish overheads and production capacity and in doing so forsake the flexibility of immediate resource re-allocation that networks provide.

To provide capacity

A firm has certain performance capacities as a result of its configuration. If it is part of a customary network, however, such capacity can be considerably extended by involving other network members in the capacity-constrained activity.

To take advantage of opportunities

Networks can be set up to provide speed to take advantage of opportunities that might not exist for long and may require a fast response – the classic 'window of opportunity' that is open for a short period and then shut for ever. An existing network can put together a package of resources and capacities to meet such challenges in a customised response that, in its flexibility and scope, lies beyond the capacity of an un-networked vertically integrated firm.

To provide access to resources and skills not owned by the company itself

Thus, in a network like those found in the clothing industry of Northern Italy (Lorenzoni & Ornati 1988), the strength of one company is a reflection of the strength of its position in its network, and the facility with which it can call on abilities and skills it does not possess itself to carry out tasks necessary to complete a project.

To provide information

Network members gain access to industrial intelligence and information of a diverse nature with far greater facility than executives imprisoned in a vertically

Your notes

integrated company. In such firms, the 'need to know' principle is far more likely to operate than in networks where all members regard information gathering as one of the principle reasons for establishing themselves in networks. Even in companies that recognise the importance of making their knowledge and experience available to all their members (often by appointing Chief Knowledge Officers as does Coopers and Lybrand), the breadth of knowledge may still be more limited than that embedded in a wide network.

Power and trust in strategic networks

If price is the key regulator and dominant factor in markets, and legitimacy in hierarchies, then power and trust are the factors that dominate network relationships as well as the more formal alliances. They are the dominant factors in any political economy, and networks have many of the qualities of such institutional forms.

> The inter-organizational network may be conceived as a political economy concerned with the distribution of two scarce resources, money and authority. (Benson 1975, cited in Thorelli 1986)

To embark on cooperative activity, the domains of companies, i.e. their products, markets, mode of operation and territories overlap, need to contact each other and perceive the benefit of working together. Until a certain critical mass has been achieved in the level of cooperation and exchange transactions, the alliance or network does not merit the name.

Thorelli (1986) identifies five sources of network power for a member: its economic base, technologies and range of expertise, coupled with the level of trust and legitimacy that it evokes from its fellow members. It needs to be differentially advantaged in at least one of these areas. All network members, although formally regarded as equals by virtue of their membership, will not have the same degree of power and it is the linkages between the members and their respective power over each other in causing outcomes that determine the culture of the network.

Although networks accord membership to firms, they are not static, closed bodies. Entry, exit and repositioning is constantly going on in networks occasioned by a particular firm member's success or failure and the strength of demand or otherwise for the contribution other member firms believe it can make to their proposed projects. The ultimate justification for the cost to a firm of maintaining its position in a network is the belief that such network activity strengthens its competitive position in comparison to operating on a purely market-based philosophy.

Even networks themselves, however, wax and wane in power. As Thorelli (1986) puts it:

> In the absence of conscious coordinative management, i.e. network management, networks would tend to disintegrate under the impact of entropy.

Networks depend on the establishment, maintenance and perhaps strengthening of relationships in the hope of profits in the future. In this sense they are different from markets, which exist to establish profit today. It is, therefore, the perceived quality of relationships in networks that matters, since quantitative measures cannot easily be applied to them.

Parts of networks are often appropriable by individuals in a way that technologies and production capacities are not, partly because only the calculative trust stage has been achieved. To that extent, although a firm may join a network to reduce its vulnerability, it may end up replacing one form of vulnerability for another.

The successful corporate finance directors of merchant banks in the City of London depend almost entirely on their networks, and are eternally at risk of being bid away to other institutions through a large enough offer. The net-

work, as opposed to other intra-organisational forms, brings with it its own strengths and vulnerabilities. In a turbulent and global economic world, however, few players can risk being entirely without networks or, conversely, being entirely dependent upon them.

Networks in comparison to other governance forms

Richardson (1972) sees firms as "islands of planned coordination in a sea of market relations". But as Powell (1990) stresses, the sea is by no means clear, and this description of the alternative methods of exchange in economies is of doubtful use. Strong relationships and dense commercial networks have always existed wherever economic exchange occurs, sufficient to make the metaphorical antithesis of solid land and fluid sea an unrealistic one.

It would be extreme, however, to blur the distinctions between markets, networks and hierarchies such that they are rejected as useful categories. At the very least, their underlying philosophies differ in essence. In markets, the rule is to drive a hard bargain, in networks to create indebtedness for future benefit, and in hierarchies to cooperate for career advancement. As Powell (1990) notes:

> Prosperous market traders would be viewed as petty and untrustworthy shysters in networks, while successful participants in networks who carried those practices into competitive markets would be viewed as naive and foolish. Within hierarchies, communication, and exchange is shaped by concerns with career mobility – in this sense, exchange is bound up with considerations of personal advancement.

Powell believes that networks score over other governance forms particularly where flexibility and fast response times are needed, 'thick' information is needed and varied resources are required due to an uncertain environment. He also points out that the social cement of networks is strengthened by obligations that are frequently left unbalanced, thus looking to the future for further exchanges. This differs from other governance forms where the pursuit of exchange equivalence in reciprocity is the norm.

Although trust and its general antecedent 'reputation' are necessary in all exchange relationships, they are at their most vital in network forms. It is true that you need to trust your colleagues in a hierarchy and you need to trust the trader who sells you a product in a market, at least to the extent of believing that the good is of the declared quality. But in these circumstances, tacit behavioural caution and legal remedies can to some degree compensate for doubtful trust in hierarchies and markets respectively. However, without trust and a member's reputation on admission to a network, such a mode of cooperation would soon wither, probably into a market form.

Jarillo – a different view

Jarillo (1993) looks at a network as more than a rather randomly determined set of business relationships created because its members felt uncertain of the future, and believed that knowing particular differentiated trading partners well provides a stronger capability than the flexibility that comes with having only market relationships or the costs involved in vertical integration. In Jarillo's view, strategic networks are merely another, and often better, way of running the 'business system' necessary for the production and sale of a chosen set of products. By business system he means the stages and activities necessary for designing, sourcing, producing, marketing, distributing and servicing a product: a form of analysis similar to Porter's (1985) value chain.

From this perspective, Jarillo's strategic network requires a hub company to provide scope definition and leadership. It decides if it will carry out a particular activity internally or through network subcontractors. His examples of such a network system are Toyota and Benetton. Conditions that make such a sys-

tem the preferred solution to vertical integration are, in Jarillo's view:

- Widely varying optimal scale for different activities in the business system; some activities benefiting from small-scale providers.
- Varying optimal cultures for the most efficient production of particular activities.
- Business systems in which innovation most commonly comes from small entrepreneurial companies.
- Widely varying expected rates of profitability from different business system activities, as a consequence of their positioning in different industry structures as analysed by a five forces method (Porter 1980).

Jarillo bases his theory of the growth of strategic networks largely on the observation of the current trend towards company downsizing, a major component of which is the replacement of internal non-core functions by subcontracted providers, thereby contracting the size of the core salaried workforce. Frequently, the company contracted to carry out the outsourced activities are a newly formed management buy-out from the previously vertically integrated company. Greater motivation is instilled in the subcontractor at a stroke, better services are provided, greater flexibility is achieved by the hub company and the size of the company's required capital base is accordingly reduced. There are, in theory, gains all round although the motivation of those removed from the parent company may often be damaged and the feeling of security of those remaining may be compromised.

Types of strategic network

Davis et al. (1994) confirm this downsizing movement in their description of the decline and fall of the conglomerate firm in the USA in the 1980s. The authors talk of the firm as an institution being increasingly replaced by a reductionist view of the firm as a network without boundaries. They describe firms of the future as no more than "dense patches in networks of relations among economic free agents". This modern construct is developed further by Snow et al. (1992) who also claim that the modern firm is becoming:

> a new form of organization – delayered, downsized, and operating through a network of market sensitive business units – [which] is changing the global business terrain.

This is clearly Jarillo's strategic network in another guise, although Snow et al. go further. They identify three distinct types of network:

1. The internal network. This is a curious identification as a network, since it is described as the introduction of the market into the internal organisation of the firm. Thus, activities are carried out within the firm and then 'sold' to the next stage of the value chain at market prices, with the purchaser having the right to buy externally if he or she can get a better deal. The activity may also in turn develop third-party clients external to the firm.
2. The stable network. This is the firm employing partial outsourcing to increase flexibility and improve performance, with a smaller base of permanent employees. It is similar to the Japanese keiretsu in Western form.
3. Dynamic networks. These are composed of lead firms who identify new opportunities and then assemble a network of complementary firms with the assets and capabilities to provide the business system to meet the identified market need. Dynamic networks are sometimes otherwise described as Hollow Corporations (Business Week, 3rd March 1986), since the entrepreneur lacks the capacity to carry out the range of necessary activities from its own resources.

Your notes

The executive

Snow et al. take the network concept further by observing that the change in organisational form leads inevitably to a change in the required qualities of executives. In markets, traders need above all to be quick witted, street-wise and able to negotiate effectively. In hierarchies, executives need a range of personal attributes including leadership qualities, administrative abilities and diplomatic capacity. An autocratic style, although not fashionable, is not necessarily an inhibitor to success in many company cultures. In setting up and running networks, however, such a style would almost inevitably lead to the failure of the network or at least to the executive's replacement.

Snow et al. identify the broker as the ideal network executive, and they specify three distinct broker roles:

1. The architect. This is the creator of the network or at least of the project in which appropriate firms in an existing network are to be asked to play a part. The architect is the entrepreneur and, dependent upon his or her creativity and motivational abilities, may be instrumental in providing the inspirational vision that brings a network into being, in introducing new members to it or merely in resourcing a project from existing network members.
2. The lead operator. This broker role is often carried out by a member of a downstream firm in the network, according to Snow et al. The lead operator is the manager rather than the entrepreneur and provides the brain and central nervous system that the network needs if it is to function effectively on a defined mission. As the name suggests, this role needs to provide leadership but in a more democratic style than would be necessary in a hierarchy: the lead operator is not the employer of the other team members.
3. The caretaker. This role prevents Thorelli's (1986) famous 'entropy' risk being realised. The caretaker will need to monitor a large number of relationships – nurturing, enhancing and even disciplining network members if they fail to deliver their required contribution.

Snow and Thomas (1993) conducted some qualitative research into the validity of these broker roles in networks and found them to be broadly valid. There is no doubt, however, that the network with a strong hub firm at the centre is very different in nature and character to that which is set up amongst firms with greater claims to mutual equality. Even equal partner firms will inevitably be differentiated in terms of their actual power though, and such power relationships will themselves almost inevitably change over the lifetime of the network's operation.

Two key categories of network

It is difficult to position networks on the cooperative strategy spectrum of ascending interdependence since some networks exhibit firm-like qualities like the Japanese keiretsu, whilst others are little more than media for the fast transmission of informal industry information. However, the problem becomes easier to solve if networks are classified into two distinct categories:

1. The dominated network, where one firm maintains bilateral relations with a number of normally smaller companies.
2. The equal partner network in which a number of firms develop close relationships with each other and work together in variable configurations on a variety of projects.

These forms approximate to Snow's (1992) stable and dynamic networks. His third category, the internal network is regarded as outside the brief of cooperative strategy since it is found in a hierarchy.

Let's look at each of these in more detail, along with an overview of net-

Your notes

works.

The equal partner network

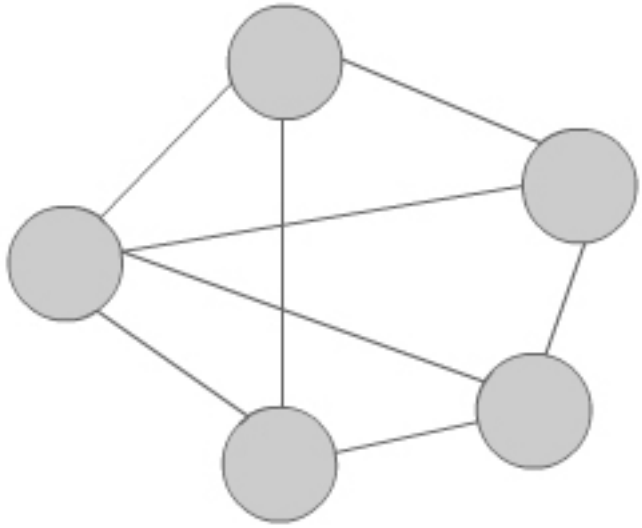
In equal partner networks, firms in Powell's (1987) words, engage in:

> reciprocal, preferential, mutually supportive actions. Reputation, trust tacit collusion, and a relative absence of calculative quid pro quo behaviour guide this system of exchange. In network forms of organisations, individual units exist not by themselves, but in relation to other units.

Yet they do not submerge their personalities in each other or engage in wide exclusive arrangements with each other. In Pfeffer and Salancik's view (1978), such networks are formed to reduce the level of uncertainty in a firm's perceived environment.

Equal partner networks are so named because, unlike in a dominated network, there is no single partner that sets up and controls the network's activities. However, this does not necessarily imply that all partners do in fact have equal power. In all equal partner networks, power relationships are varied and constantly shifting with the fortunes of members. The equal partner network differs from the dominated network also in that it is not a substitute organisational form to the integrated firm. Rather, it is the expression of a set of developed relationships between firms that form a substructure from which competitive organisational entities may emerge.

Figure 11.9 illustrates in a stylised fashion the nature of relationship and contacts between members in equal partner networks in contrast to those in dominated networks.



Source: Child and Faulkner (1998, p. 124)

Characteristics of the equal partner network

Equal partner networks can be configured and reconfigured to meet changing market opportunities, and often with a different lead partner in the ascendant. This is both their strength and their weakness. Whilst it implies great flexibility, and an ability to respond to changing and often turbulent environments, an equal partner network lacks the permanent brain and central nervous system that will ensure it combative ability against an organisation so endowed.

Any organisation hoping to compete with vertically integrated companies, which possess production and sales capacity and strong identifying brand names, needs to convince the public of its enduring existence. It also requires a

leadership capacity to plan and execute strategy, and information systems sensitive enough to convey what needs to be done and to ensure that it is done. This cannot easily be achieved via the loose linkages of an equal partner network, despite its other already identified advantageous qualities.

For this reason, an equal partner network is more of the nature of a dense set of mutually aware capabilities than an actual organisation form. Such networks may therefore often be in transitory forms that will develop into dominated networks, virtual corporations or even integrated companies in due course. In economies where networks traditionally flourish like Silicon Valley, California, the emergence of new firms out of a deeply embedded network substructure does not disturb the basic network characteristics of the economy.

The dominated network

The dominated network is most frequently exemplified by the Japanese keiretsu (Gerlach 1992) in which a major corporation, for example Mitsubishi, exists with a wide and varied network of subcontractors and associated companies that provide it with services on a regular basis.

The network surrounding Rugman and D'Cruz's (1993) flagship firm is similarly a dominated network. The network is regarded by all the institutions concerned as a kind of family with the hub company as the pater familias and the periphery companies as its children. Hub companies often have seats on the boards of the keiretsu companies and may hold a small percentage of their equity. The network structure is used to ensure reliability and quality of supply components and to make production systems like just-in-time logistics easier to administer.

The dominated network owes its recent growth in the West to two major unconnected factors:

1. The international success in certain high profile markets of industrial Japan.
2. The fall from grace of the large vertically integrated multi-divisional industrial corporation and its replacement as a favoured paradigm by the downsized, delayered, core competence-based 'lean and mean' organisation, relying on outsourcing for its production in all functions except those deemed to be strategically vital and close to its core competences.

The Japanese industrial keiretsu represents the archetype of the dominated network. In Gerlach's words (1992):

> the vertical keiretsu are tight hierarchical associations centred on a single large parent and containing multiple smaller satellite companies within related industries. While focused in their business activities, they span the status breadth of the business community, with the parent firm part of Japan's large-firm economic core and its satellites, particularly at lower levels, small operations that are often family-run … The vertical keiretsu can be divided into three main categories. The first are the sangyo keiretsu or production keiretsu, which are elaborate hierarchies of primary, secondary, and tertiary-level sub-contractors that supply, through a series of stages parent firms. The second are the ryutsu keiretsu or distribution keiretsu. These are linear systems of distributors that operate under the name of a large-scale manufacturer, or sometimes a wholesaler. They have much in common with the vertical marketing systems that some large US manufacturers have introduced to organise their interfirm distribution channels. A third – the shihon keiretsu or capital keiretsu – are groupings based not on the flow of production materials and goods but on the flow of capital from a parent firm.

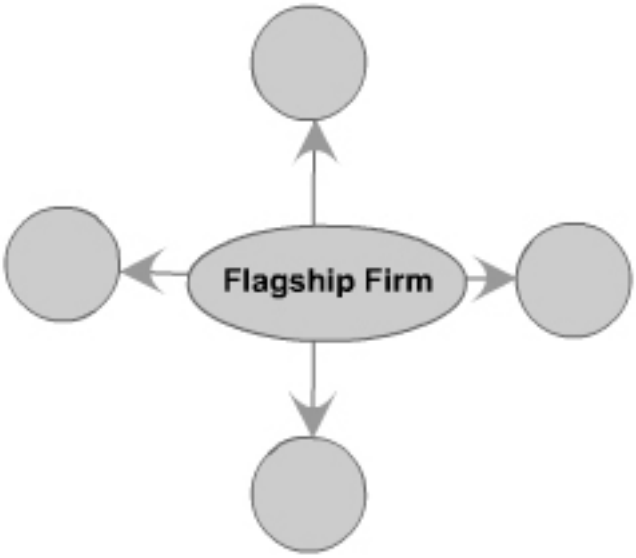
Whilst Gerlach's description of the different types of keiretsu in Japanese industry is clear and categorical, in the complex world of reality the webs of the

Your notes

keiretsu do in fact frequently overlap and it is possible to have keiretsu with dual centres: one a manufacturing or trading centre and the other a bank. It is also not unusual for the outer members of keiretsu to deal preferentially with each other as well as with the core company.

Such dominated networks are not unique to Japan, although they are a strong feature of the Japanese industrial system of production and distribution. In the UK, Marks and Spencer's relationship with its suppliers has many of the characteristic features of the dominated network including control over quality and supply in exchange for large annual order commitments.

Relationships within dominated networks typically take the form illustrated in Figure 11.10.



Source: Child and Faulkner (1998, p. 123).

As you can see from Figure 11.10, there is often only limited networking between satellite companies, except in relation to the business of the dominant company. The dominant company may establish formal links with the satellite through a minority shareholding and/or board membership.

But this is not always or even generally the case. The advantage of such networks from the viewpoint of the dominant company is that it can rely on regular quality supplies at a pre-agreed price without the need to put up the capital and management resources to create them directly. From the satellite's viewpoint, it can economise on sales and marketing expenditure and have the security of reliable orders and cash flow for its planning purposes, which removes many of the risks from its business. Of course, at the same time, it also removes some of the autonomy and if the satellite allows too great a percentage of its business to be with the dominant company it is at risk of ceding all independent bargaining power over such matters as price changes or product development.

An overview of the network

Network theory has become prominent in recent years as the basis for new organisational forms and for the growth of cooperative strategy as a counterbalance to the self-sufficient philosophy underlying competitive strategy theories. At one level, however, networks have always been with us. Shortly after any individual starts up a business or engages in any repeated endeavour, he or she begins to build up a network out of the associates with whom he or she interacts. In the business world, they will be suppliers, distributors and, perhaps to a lesser extent, competitors and customers. The individual will always consider the degree to which he or she should outsource some

of the potential activities, and the level to which customers should be dealt with directly or sales should be developed through a network. In some areas, for example Northern Italy, this has traditionally led to strong specialisation of activity amongst family firms and therefore the network as the fundamental underpinning of business activity. In other areas, notably much of the USA, vertical integration has been more the norm until recently, with cooperative networked activity therefore treated with some suspicion.

Why networks have become more attractive

The degree of prominence networks have received has significantly increased in recent years. This is due largely to the globalisation of markets and technologies, leading to the widespread growth of cooperative activity as a necessary strategy if firms with limited financial strength, focused competences and limited 'global reach' are to be able to compete in global markets.

An attractive characteristic of many networks, then, is that they help members to achieve increased global reach at low cost and with minimum time delay. They are flexible in their membership and able to respond rapidly to changing environmental situations. In an increasingly turbulent world, they reduce uncertainty for their members. They enable synergies between members to be captured and provide the conditions for the achievement of scale and scope economies through specialisation. They are also good vehicles for the spreading of information and all forms of market intelligence. Under conditions of trust between members, they may also reduce transaction costs, in contrast to vertically integrated companies with internally competitive cultures.

Disadvantages of networks

However, networks, if they are to be contrasted with vertically integrated companies and with the arm's-length nature of the pure markets form, do not score well on all counts.

In dominated networks, the risks for the dominant partner are of unlicensed technology leakage, of poor quality assurance, of a possible diffusion of internal feelings of identity and motivation in the outlying companies. There is also the difficulty of communicating tacit knowledge and of achieving a sufficient level of coordination between members in different companies to compete successfully with the systems of integrated companies – the 'singing from several hymn sheets' problem. For the smaller companies in the dominated network, there are the problems of feeling too dominated and thus of loss of autonomy and motivation, of lack of promotion opportunities, of insecurity and of the difficulty in recruiting high-quality personnel to small companies with limited prospects.

In equal partner networks, the primary problems relate to the lack of a brain and a central nervous system. By their nature, they are loosely organised coalitions without a permanent acknowledged leader. Major investment in such networks is difficult to organise and there is the perpetual tension between trust and the risk of prisoners' dilemma defection by partners, i.e. the potential creation of competitors as a result of too much misplaced trust. There is also the difficulty for a network of driving consistently towards a vision of the future, in the way a successful vertically integrated company can and does.

The future

As Michael E. Naylor, one time boss of General Motors, once said: "There are no facts about the future, only opinions". It is, therefore, not possible to tell if the present time is one of transition, in which greater economic turbulence leads to more flexible organisational forms, only to be followed by a period of renewed stability accompanied by the re-emergence of more rigid hierarchies. Or whether the turbulence is here to stay and the resultant need for strategic flexibility will make flexible cooperative forms of economic organisation the dominant ones and ultimately the only naturally selected ones.

The author is inclined towards the second view. The globalising effect of the Internet alone is likely to create a global strategic market for most industries within the next decade. Yet the variety of peoples, tastes and needs is likely to persist outside what are called the staple industries leading to the persistence of economic volatility. In a very large market, a 15% swing in demand can involve very large figures for an individual company. The federated enterprise is therefore likely to grow more common in its many varied forms.

Loyalty to integrated companies, and by those companies to their employees, is likely to continue its decline. Workers will seek security in their skills rather than in paternalistic corporations and those skills will need to be broad-based, multi-applicable and capable of being adapted to meet ever-changing situations and needs.

Summary

Cooperative strategy, whether in the close form of strategic alliances or the more loosely coupled form of networks, requires attitudes and approaches to management quite distinct from those found in hierarchies. It generally emerges when one company finds itself unable to cope with a global or other challenge because of limitations in its resources and competences and seeks an ally to make good its vulnerabilities. Where this new mode of organising its business is approached flexibly and sensitively by the partners, enduring, successful and mutually beneficial relationships can be created and maintained. Indeed there are grounds for believing that the future of these more flexible organisational forms as exemplified in alliances and networks is likely to be bright.

Such arrangements will not survive, however, if partners play power politics with each other, show lack of commitment, distrust and lack of integrity and do not make very positive steps to deal with the cultural differences between the partners that will almost inevitably exist. It is these latter mishandled situations that have led to the reported 50% failure rate of recent alliances. The need is to understand the key factors for success in managing alliances as competently as the lessons from management theory in handling integrated hierarchical corporations. They are as different as the contrast between giving orders from a position of authority compared with developing a consensus for action in a community of equals. Only when this difference is appreciated and translated into changed behaviour, will the failure rate of cooperative arrangements begin to decline.

Task ...

Task 11.1

To check your understanding of the material in this topic, try to answer the following questions. If you have any difficulties, you may wish to go back and revise the relevant part of the topic.

1. When are inter-firm alliances regarded as strategic?
2. What are the two main types of strategic alliance in terms of motivating factors?
3. Companies can engage in cooperative strategies that link their value chains in one of six ways. Name these six linkages.
4. How is value added by a strategic alliance or merger?
5. List the seven strategic contributions of joint ventures.
6. Why do firms cooperate?
7. What are the two main qualities required of a partner when entering into a strategic alliance?
8. To be considered successful, according to McKinsey's criteria, an alliance has to pass which two tests?
9. Can strategic alliances add value if they are not embedded within a wider corporate strategy portfolio?

Resources

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Topic 12

Strategic Networks and the Virtual Corporation

Aims

The purpose of this topic is to:

- show the importance of strategic networks in the modern economy;
- explain the role of power and trust in networks;
- describe the different types of strategic network;
- identify the nature of the virtual corporation;
- explain the limitations of the virtual corporation.

Objectives

By the end of this topic you should be able to:

- understand why networks exist;
- see their strengths and limitations;
- see the growth of the virtual corporation and how it is changing the development of the firm;
- understand why it is likely that the virtual corporation will grow in popularity but probably never replace the integrated firm entirely.

Introduction

Strategic networks differ from alliances in that they generally involve a lower level of interdependence between the members, and the learning factor is rarely so important. Members provide their own skills and leave other members to provide theirs. Table 12.1 below illustrates the differences between different organisational forms on a number of dimensions.

Table 12.1

Key features	Hierarchy	Alliance	Network	Market
Normative Basis	Employment	Secondment	Complementary strengths	Contract
Communication	Routines	Relational	Relational	Prices
Conflict Resolution	Fiat Supervision	Reciprocity & reputation	Reciprocity & Reputation	Haggling & the law
Flexibility	Low	Medium	High	High
Commitment	High	High	Medium	Nil
Tone	Formal Bureaucratic	Committed Mutual benefit	Open-ended Mutual benefit	Precision Suspicion
Actor Preference	Dependent	Interdependent	Interdependent	Independent
Mixing of Forms	Informal Organisation	Equality	Status Hierarchy	Repeat Transactions
	Profit centres Transfer pricing	Flexible rules Recent systems	Multiple partners Formal rules	Contracts

*Source: **adapted from Powell (1990).***

The Nature of Strategic Networks

There is a clear distinction between the idea of a network with its implication of close but non-exclusive relationships and that of an alliance, which, however loosely, implies the creation of a joint enterprise at least over a limited domain. The term network is in fact often very loosely used to describe any relationship from an executive's 'black book' of useful contacts, to an integrated company organised on internal market lines (compare Snow, Miles & Coleman 1992). Johanson and Mattsson (1991) make a useful additional distinction between network theory and the form of strategic alliance theory that is based upon transaction cost analysis. Alliances may be concluded for transaction cost reasons, but networks never are.

Networks, like alliances, generally exist for reasons stemming from resource dependency theory. In other words, one network member provides one func-

Quick summary

The nature of strategic networks

- The term network is in fact often very loosely used to describe any relationship from an executive's 'black book' of useful contacts, to an integrated company organised on internal market lines.
- Networks, like alliances, generally exist for reasons stemming from resource dependency theory.

tion that is complementary to and synergistic with the differing contribution of other members of the network and provides other members with privileged access. Although costs enter into the calculus of who to admit and persevere with as network members, the existence of the network and the loose bonding implied by it emphasises autonomy and choice, in contrast to the more deterministic governance structure and stable static equilibrium applied to alliance theory by transaction cost theorists.

> We think the relationships among firms in networks are stable and can basically play the same coordinating and development function as intra-organizational relations. Through relations with customers, distributors, and suppliers a firm can reach out to quite an extensive network. Such indirect relationships may be very important. They are not handled within the transaction cost approach. (Johanson & Mattsson 1991)

Networks of whatever type arise for a number of distinct reasons.

To reduce uncertainty

Indeed, this motive has been suggested as the prime reason for the development of all institutions. Impersonal relationships in markets are fraught with uncertainty, in that a transaction once made can never be assumed to be repeatable since it implies no more in relationship terms than is contained in the exchange. Networks imply developing relationships and thus promise more in terms of mutual solidarity against the cruel wind of economic dynamics.

To provide flexibility

This quality is offered not in contrast to markets but to hierarchies. Vertically integrated companies establish overheads and production capacity and in doing so forsake the flexibility of immediate resource re-allocation that networks provide.

To provide capacity

A firm has certain performance capacities as a result of its configuration. If it is part of a customary network, however, such capacity can be considerably extended by involving other network members in the capacity-constrained activity.

To take advantage of opportunities

Networks can be set up to provide speed to take advantage of opportunities that might not exist for long and may require a fast response – the classic 'window of opportunity' that is open for a short period and then shut for ever. An existing network can put together a package of resources and capacities to meet such challenges in a customised response that, in its flexibility and scope, lies beyond the capacity of an un-networked vertically integrated firm.

To provide access to resources and skills not owned by the company itself

Thus, in a network like those found in the clothing industry of Northern Italy (Lorenzoni & Ornati 1988), the strength of one company is a reflection of the strength of its position in its network, and the facility with which it can call on abilities and skills it does not possess itself to carry out tasks necessary to complete a project.

To provide information

Network members gain access to industrial intelligence and information of a diverse nature with far greater facility than executives imprisoned in a vertically integrated company. In such firms, the 'need to know' principle is far more likely to operate than in networks where all members regard information gathering as one of the principle reasons for establishing themselves in networks. Even in companies that recognise the importance of making their knowledge and experience available to all their members (often by appointing Chief Knowl-

Your notes

edge Officers as does Coopers and Lybrand), the breadth of knowledge may still be more limited than that embedded in a wide network.

Power and Trust in Strategic Networks

If price is the key regulator and dominant factor in markets, and legitimacy in hierarchies, then power and trust are the factors that dominate network relationships as well as the more formal alliances. They are the dominant factors in any political economy, and networks have many of the qualities of such institutional forms.

> The inter-organizational network may be conceived as a political economy concerned with the distribution of two scarce resources, money and authority. (Benson 1975, cited in Thorelli 1986)

To embark on cooperative activity, the domains of companies, i.e. their products, markets, mode of operation and territories overlap, need to contact each other and perceive the benefit of working together. Until a certain critical mass has been achieved in the level of cooperation and exchange transactions, the alliance or network does not merit the name.

Thorelli (1986) identifies five sources of network power for a member: its economic base, technologies and range of expertise, coupled with the level of trust and legitimacy that it evokes from its fellow members. It needs to be differentially advantaged in at least one of these areas. All network members, although formally regarded as equals by virtue of their membership, will not have the same degree of power and it is the linkages between the members and their respective power over each other in causing outcomes that determine the culture of the network.

Although networks accord membership to firms, they are not static closed bodies. Entry, exit and repositioning is constantly going on in networks occasioned by a particular firm member's success or failure and the strength of demand or otherwise for the contribution other member firms believe it can make to their proposed projects. The ultimate justification for the cost to a firm of maintaining its position in a network is the belief that such network activity strengthens its competitive position in comparison to operating on a purely market-based philosophy.

Even networks themselves, however, wax and wane in power. As Thorelli (1986) puts it:

> In the absence of conscious coordinative management, i.e. network management, networks would tend to disintegrate under the impact of entropy.

Networks depend on the establishment, maintenance and perhaps strengthening of relationships in the hope of profits in the future. In this sense they are different from markets, which exist to establish profit today. It is, therefore, the perceived quality of relationships in networks that matters, since quantitative measures cannot easily be applied to them.

Parts of networks are often appropriable by individuals in a way that technologies and production capacities are not, partly because only the calculative trust stage has been achieved. To that extent, although a firm may join a network to reduce its vulnerability, it may end up replacing one form of vulnerability for another.

The successful corporate finance directors of merchant banks in the City of London depend almost entirely on their networks, and are eternally at risk of being bid away to other institutions through a large enough offer. The network, as opposed to other intra-organisational forms, brings with it its own strengths and vulnerabilities. In a turbulent and global economic world, however, few players can risk being entirely without networks or, conversely, being entirely dependent upon them.

Quick summary

Power and trust in strategic networks

- Power and trust are the factors that dominate network relationships as well as the more formal alliances.
- To embark on cooperative activity, the domains of companies.
- Although networks accord membership to firms, they are not static closed bodies.
- Networks depend on the establishment, maintenance and perhaps strengthening of relationships in the hope of profits in the future.
- Parts of networks are often appropriable by individuals in a way that technologies and production capacities are not, partly because only the calculative trust stage has been achieved.

Networks in comparison to other governance forms

Your notes

Richardson (1972) sees firms as "islands of planned coordination in a sea of market relations". But as Powell (1990) stresses, the sea is by no means clear, and this description of the alternative methods of exchange in economies is of doubtful use. Strong relationships and dense commercial networks have always existed wherever economic exchange occurs, sufficient to make the metaphorical antithesis of solid land and fluid sea an unrealistic one.

It would be extreme, however, to blur the distinctions between markets, networks and hierarchies such that they are rejected as useful categories. At the very least, their underlying philosophies differ in essence. In markets, the rule is to drive a hard bargain, in networks to create indebtedness for future benefit, and in hierarchies to cooperate for career advancement. As Powell (1990) notes:

> Prosperous market traders would be viewed as petty and untrustworthy shysters in networks, while successful participants in networks who carried those practices into competitive markets would be viewed as naive and foolish. Within hierarchies, communication, and exchange is shaped by concerns with career mobility – in this sense, exchange is bound up with considerations of personal advancement.

Powell believes that networks score over other governance forms particularly where flexibility and fast response times are needed, 'thick' information is needed and varied resources are required due to an uncertain environment. He also points out that the social cement of networks is strengthened by obligations that are frequently left unbalanced, thus looking to the future for further exchanges. This differs from other governance forms where the pursuit of exchange equivalence in reciprocity is the norm.

Although trust and its general antecedent 'reputation' are necessary in all exchange relationships, they are at their most vital in network forms. It is true that you need to trust your colleagues in a hierarchy and you need to trust the trader who sells you a product in a market, at least to the extent of believing that the good is of the declared quality. But in these circumstances, tacit behavioural caution and legal remedies can to some degree compensate for doubtful trust in hierarchies and markets respectively. However, without trust and a member's reputation on admission to a network, such a mode of cooperation would soon wither, probably into a market form.

Jarillo – a different view

Jarillo (1993) looks at a network as more than a rather randomly determined set of business relationships created because its members felt uncertain of the future, and believed that knowing particular differentiated trading partners well provides a stronger capability than the flexibility that comes with having only market relationships or the costs involved in vertical integration. In Jarillo's view, strategic networks are merely another, and often better, way of running the 'business system' necessary for the production and sale of a chosen set of products. By business system he means the stages and activities necessary for designing, sourcing, producing, marketing, distributing and servicing a product: a form of analysis similar to Porter's (1985) value chain.

From this perspective, Jarillo's strategic network requires a hub company to provide scope definition and leadership. It decides if it will carry out a particular activity internally or through network subcontractors. His examples of such a network system are Toyota and Benetton. Conditions that make such a system the preferred solution to vertical integration are, in Jarillo's view:

- Widely varying optimal scale for different activities in the business system; some activities benefiting from small-scale providers.
- Varying optimal cultures for the most efficient production of particular activities.

- Business systems in which innovation most commonly comes from small entrepreneurial companies.
- Widely varying expected rates of profitability from different business system activities, as a consequence of their positioning in different industry structures as analysed by a Five Forces method (Porter 1980).

Jarillo bases his theory of the growth of strategic networks largely on the observation of the current trend towards company downsizing, a major component of which is the replacement of internal non-core functions by subcontracted providers, thereby contracting the size of the core salaried workforce. Frequently, the company contracted to carry out the outsourced activities are a newly formed management buy-out from the previously vertically integrated company. Greater motivation is instilled in the subcontractor at a stroke, better services are provided, greater flexibility is achieved by the hub company and the size of the company's required capital base is accordingly reduced. There are, in theory, gains all round although the motivation of those removed from the parent company may often be damaged and the feeling of security of those remaining may be compromised.

Types of Strategic Network

Davis et al. (1994) confirm the downsizing movement you have been reading about in the last section, in their description of the decline and fall of the conglomerate firm in the USA in the 1980s. The authors talk of the firm as an institution being increasingly replaced by a reductionist view of the firm as a network without boundaries. They describe firms of the future as no more than 'dense patches in networks of relations among economic free agents'. This modern construct is developed further by Snow et al. (1992) who also claim that the modern firm is becoming:

> a new form of organization – delayered, downsized, and operating through a network of market sensitive business units – [which] is changing the global business terrain.

This is clearly Jarillo's strategic network in another guise, although Snow et al. go further. They identify three distinct types of network:

1. The internal network. This is a curious identification as a network, since it is described as the introduction of the market into the internal organisation of the firm. Thus, activities are carried out within the firm and then 'sold' to the next stage of the value chain at market prices, with the purchaser having the right to buy externally if he or she can get a better deal. The activity may also in turn develop third-party clients external to the firm.
2. The stable network. This is the firm employing partial outsourcing to increase flexibility and improve performance, with a smaller base of permanent employees. It is similar to the Japanese keiretsu in Western form.
3. Dynamic networks. These are composed of lead firms who identify new opportunities and then assemble a network of complementary firms with the assets and capabilities to provide the business system to meet the identified market need. Dynamic networks are sometimes otherwise described as Hollow Corporations (Business Week, 3rd March 1986), since the entrepreneur lacks the capacity to carry out the range of necessary activities from its own resources.

The executive

Snow et al. take the network concept further by observing that the change in organisational form leads inevitably to a change in the required qualities of executives. In markets, traders need above all to be quick witted, street-wise and able to negotiate effectively. In hierarchies, executives need a range of personal attributes including leadership qualities, administrative abilities and

diplomatic capacity. An autocratic style, although not fashionable, is not necessarily an inhibitor to success in many company cultures. In setting up and running networks, however, such a style would almost inevitably lead to the failure of the network or at least to the executive's replacement.

Snow et al. identify the broker as the ideal network executive, and they specify three distinct broker roles:

1. The architect. This is the creator of the network or at least of the project in which appropriate firms in an existing network are to be asked to play a part. The architect is the entrepreneur and, dependent upon his or her creativity and motivational abilities, may be instrumental in providing the inspirational vision that brings a network into being, in introducing new members to it or merely in resourcing a project from existing network members.
2. The lead operator. This broker role is often carried out by a member of a downstream firm in the network, according to Snow et al. The lead operator is the manager rather than the entrepreneur and provides the brain and central nervous system that the network needs if it is to function effectively on a defined mission. As the name suggests, this role needs to provide leadership but in a more democratic style than would be necessary in a hierarchy: the lead operator is not the employer of the other team members.
3. The caretaker. This role prevents Thorelli's (1986) famous 'entropy' risk being realised. The caretaker will need to monitor a large number of relationships – nurturing, enhancing and even disciplining network members if they fail to deliver their required contribution.

Snow and Thomas (1993) conducted some qualitative research into the validity of these broker roles in networks and found them to be broadly valid. There is no doubt, however, that the network with a strong hub firm at the centre is very different in nature and character to that which is set up amongst firms with greater claims to mutual equality. Even equal partner firms will inevitably be differentiated in terms of their actual power though, and such power relationships will themselves almost inevitably change over the lifetime of the network's operation.

Two key categories of network

It is difficult to position networks on the cooperative strategy spectrum of ascending interdependence since some networks exhibit firm-like qualities like the Japanese keiretsu, whilst others are little more than media for the fast transmission of informal industry information. However, the problem becomes easier to solve if networks are classified into two distinct categories:

1. The dominated network, where one firm maintains bilateral relations with a number of normally smaller companies.
2. The equal partner network in which a number of firms develop close relationships with each other and work together in variable configurations on a variety of projects.

These forms approximate to Snow's (1992) stable and dynamic networks. His third category, the internal network is regarded as outside the brief of cooperative strategy since it is found in a hierarchy.

Let's look at each of these in more detail, along with an overview of networks.

The equal partner network

In equal partner networks, firms in Powell's (1987) words, engage in:

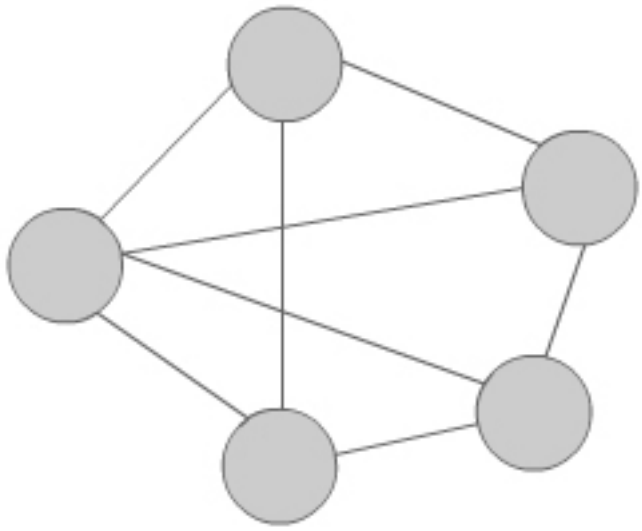
> reciprocal, preferential, mutually supportive actions. Reputation, trust tacit collusion, and a relative absence of calculative quid pro

quo behaviour guide this system of exchange. In network forms of organisations, individual units exist not by themselves, but in relation to other units.

Yet they do not submerge their personalities in each other or engage in wide exclusive arrangements with each other. In Pfeffer and Salancik's view (1978), such networks are formed to reduce the level of uncertainty in a firm's perceived environment.

Equal partner networks are so named because, unlike in a dominated network, there is no single partner that sets up and controls the network's activities. However, this does not necessarily imply that all partners do in fact have equal power. In all equal partner networks, power relationships are varied and constantly shifting with the fortunes of members. The equal partner network differs from the dominated network also in that it is not a substitute organisational form to the integrated firm. Rather, it is the expression of a set of developed relationships between firms that form a substructure from which competitive organisational entities may emerge.

Figure 12.1 illustrates in a stylised fashion the nature of relationship and contacts between members in equal partner networks in contrast to those in dominated networks.



Source: Child and Faulkner (1998, p. 134).

Characteristics of the equal partner network

Equal partner networks can be configured and reconfigured to meet changing market opportunities, and often with a different lead partner in the ascendant. This is both their strength and their weakness. Whilst it implies great flexibility, and an ability to respond to changing and often turbulent environments, an equal partner network lacks the permanent brain and central nervous system that will ensure it combative ability against an organisation so endowed.

Any organisation hoping to compete with vertically integrated companies, which possess production and sales capacity and strong identifying brand names, needs to convince the public of its enduring existence. It also requires a leadership capacity to plan and execute strategy, and information systems sensitive enough to convey what needs to be done and to ensure that it is done. This cannot easily be achieved via the loose linkages of an equal partner network, despite its other already identified advantageous qualities.

For this reason, an equal partner network is more of the nature of a dense set of mutually aware capabilities than an actual organisation form. Such networks may therefore often be in transitory forms that will develop into dominated

Your notes

networks, virtual corporations or even integrated companies in due course. In economies where networks traditionally flourish like Silicon Valley, California, the emergence of new firms out of a deeply embedded network substructure does not disturb the basic network characteristics of the economy.

Your notes

The dominated network

The dominated network is most frequently exemplified by the Japanese keiretsu (Gerlach 1992) in which a major corporation, for example Mitsubishi, exists with a wide and varied network of subcontractors and associated companies that provide it with services on a regular basis.

The network surrounding Rugman and D'Cruz's (1993) flagship firm is similarly a dominated network. The network is regarded by all the institutions concerned as a kind of family with the hub company as the pater familias and the periphery companies as its children. Hub companies often have seats on the boards of the keiretsu companies and may hold a small percentage of their equity. The network structure is used to ensure reliability and quality of supply components and to make production systems like just-in-time logistics easier to administer.

The dominated network owes its recent growth in the West to two major unconnected factors:

1. The international success in certain high profile markets of industrial Japan; and
2. The fall from grace of the large vertically integrated multi-divisional industrial corporation and its replacement as a favoured paradigm by the downsized, delayered, core competence-based 'lean and mean' organisation, relying on outsourcing for its production in all functions except those deemed to be strategically vital and close to its core competences.

The Japanese industrial keiretsu represents the archetype of the dominated network. In Gerlach's words (1992):

> the vertical keiretsu are tight hierarchical associations centred on a single large parent and containing multiple smaller satellite companies within related industries. While focused in their business activities, they span the status breadth of the business community, with the parent firm part of Japan's large-firm economic core and its satellites, particularly at lower levels, small operations that are often family-run … The vertical keiretsu can be divided into three main categories. The first are the sangyo keiretsu or production keiretsu, which are elaborate hierarchies of primary, secondary, and tertiary-level sub-contractors that supply, through a series of stages parent firms. The second are the ryutsu keiretsu or distribution keiretsu. These are linear systems of distributors that operate under the name of a large-scale manufacturer, or sometimes a wholesaler. They have much in common with the vertical marketing systems that some large US manufacturers have introduced to organise their interfirm distribution channels. A third – the shihon keiretsu or capital keiretsu – are groupings based not on the flow of production materials and goods but on the flow of capital from a parent firm.

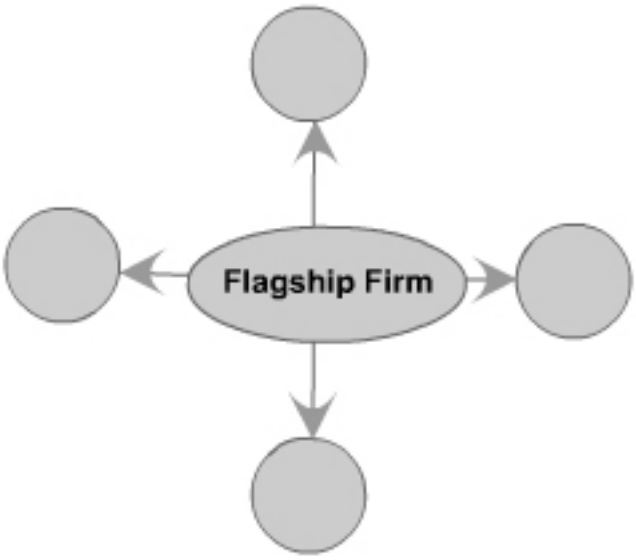
Whilst Gerlach's description of the different types of keiretsu in Japanese industry is clear and categorical, in the complex world of reality the webs of the keiretsu do in fact frequently overlap and it is possible to have keiretsu with dual centres: one a manufacturing or trading centre and the other a bank. It is also not unusual for the outer members of keiretsu to deal preferentially with each other as well as with the core company.

The Toyota organization with all its vast army of subcontractors is a prime example of a keiretsu.

Such dominated networks are not unique to Japan, although they are a strong

feature of the Japanese industrial system of production and distribution. In the UK, Marks and Spencer's relationship with its suppliers has many of the characteristic features of the dominated network including control over quality and supply in exchange for large annual order commitments.

Relationships within dominated networks typically take the form illustrated in Figure 12.2.



Source: Child and Faulkner (1998, p. 123).

As you can see from Figure 12.2, there is often only limited networking between satellite companies, except in relation to the business of the dominant company. The dominant company may establish formal links with the satellite through a minority shareholding and/or board membership.

But this is not always or even generally the case. The advantage of such networks from the viewpoint of the dominant company is that it can rely on regular quality supplies at a pre-agreed price without the need to put up the capital and management resources to create them directly. From the satellite's viewpoint, it can economise on sales and marketing expenditure and have the security of reliable orders and cash flow for its planning purposes, which removes many of the risks from its business. Of course, at the same time, it also removes some of the autonomy and if the satellite allows too great a percentage of its business to be with the dominant company it is at risk of ceding all independent bargaining power over such matters as price changes or product development.

An overview of the network

Network theory has become prominent in recent years as the basis for new organisational forms and for the growth of cooperative strategy as a counterbalance to the self-sufficient philosophy underlying competitive strategy theories. At one level, however, networks have always been with us. Shortly after any individual starts up a business or engages in any repeated endeavour, he or she begins to build up a network out of the associates with whom he or she interacts. In the business world, they will be suppliers, distributors and, perhaps to a lesser extent, competitors and customers. The individual will always consider the degree to which he or she should outsource some of the potential activities, and the level to which customers should be dealt with directly or sales should be developed through a network. In some areas, for example Northern Italy, this has traditionally led to strong specialisation of activity amongst family firms and therefore the network as the fundamental underpinning of business activity. In other areas, notably much of the USA, vertical integration has been more the norm until recently, with cooperative

networked activity therefore treated with some suspicion.

Your notes

Why networks have become more attractive

The degree of prominence networks have received has significantly increased in recent years. This is due largely to the globalisation of markets and technologies, leading to the widespread growth of cooperative activity as a necessary strategy if firms with limited financial strength, focused competences and limited 'global reach' are to be able to compete in global markets.

An attractive characteristic of many networks, then, is that they help members to achieve increased global reach at low cost and with minimum time delay. They are flexible in their membership and able to respond rapidly to changing environmental situations. In an increasingly turbulent world, they reduce uncertainty for their members. They enable synergies between members to be captured and provide the conditions for the achievement of scale and scope economies through specialisation. They are also good vehicles for the spreading of information and all forms of market intelligence. Under conditions of trust between members, they may also reduce transaction costs, in contrast to vertically integrated companies with internally competitive cultures.

Disadvantages of networks

However, networks, if they are to be contrasted with vertically integrated companies and with the arm's-length nature of the pure markets form, do not score well on all counts.

In dominated networks, the risks for the dominant partner are of unlicensed technology leakage, of poor quality assurance, of a possible diffusion of internal feelings of identity and motivation in the outlying companies. There is also the difficulty of communicating tacit knowledge and of achieving a sufficient level of coordination between members in different companies to compete successfully with the systems of integrated companies – the 'singing from several hymn sheets' problem. For the smaller companies in the dominated network, there are the problems of feeling too dominated and thus of loss of autonomy and motivation, of lack of promotion opportunities, of insecurity and of the difficulty in recruiting high-quality personnel to small companies with limited prospects.

In equal partner networks, the primary problems relate to the lack of a brain and a central nervous system. By their nature, they are loosely organised coalitions without a permanent acknowledged leader. Major investment in such networks is difficult to organise and there is the perpetual tension between trust and the risk of prisoners' dilemma defection by partners, i.e. the potential creation of competitors as a result of too much misplaced trust. There is also the difficulty for a network of driving consistently towards a vision of the future, in the way a successful vertically integrated company can and does.

The future

As Michael E. Naylor, one time boss of General Motors, once said: 'There are no facts about the future, only opinions.' It is, therefore, not possible to tell if the present time is one of transition, in which greater economic turbulence leads to more flexible organisational forms, only to be followed by a period of renewed stability accompanied by the re-emergence of more rigid hierarchies. Or whether the turbulence is here to stay and the resultant need for strategic flexibility will make flexible cooperative forms of economic organisation the dominant ones and ultimately the only naturally selected ones.

The author is inclined towards the second view. The globalising effect of the Internet alone is likely to create a global strategic market for most industries within the next decade. Yet the variety of peoples, tastes and needs is likely to persist outside what are called the staple industries leading to the persistence of economic volatility. In a very large market, a 15% swing in demand can in-

volve very large figures for an individual company. The federated enterprise is therefore likely to grow more common in its many varied forms.

Loyalty to integrated companies, and by those companies to their employees, is likely to continue its decline. Workers will seek security in their skills rather than in paternalistic corporations and those skills will need to be broad-based, multi-applicable and capable of being adapted to meet ever-changing situations and needs.

The Effect of Networks

The concept of the embeddedness of networks has become of some considerable interest to researchers of late. All make intuitively sensible points which have the advantage of providing insights that might otherwise go unnoticed. For example Uzzi (1996) establishes from empirical research that high levels of embeddedness of a firm in a network lead to poor performance, as does low embeddedness.

Moderate embeddedness is however helpful to performance. The reasoning runs thus. Deeply embedded firms have their flexibility for strategic choice outside the network severely hampered and suffer for this in diminished performance. However unembedded firms suffer from lack of the knowledge and capability enhancement that belonging to a network can bring. Moderate embeddedness, however, both preserves freedom and flexibility, and also provides access to wider knowledge. Gulati and Zajac (2000) take the concept of network embeddedness and hypothesise that to be embedded in a particular social structure network conditions the alliances that firms form. This both limits and enables the development of those firms and alliances according to the business appropriateness of the social networks which have been formed for something other than business purposes. However they claim such alliances should have a better than average chance of success as the key qualities of trust and cultural congruity are likely to be present in alliances formed out of common social networks.

Coviello and Munro (1997) take a similar line when they claim that the incremental internationalisation of small and medium sized enterprises (SMEs) is often developed rather haphazardly (or more charitably emergently) on the basis of who they know internationally, i.e. on the basis of their existing networks, however appropriate these potential partners may or may not be as rationally chosen partners for international development.

> The network perspective shows that international market development activities emerge from, and are shaped by an external web of formal and informal relationships. (Corviello & Munro 1997)

Networks in the lives of MNCs

Networks can also be somewhat unpredictable factors in the lives and evolution of larger MNCs too as Gauri (1992) shows. He describes how MNCs develop networks both at the centre and regionally as their international activities mature. It may be then that the demands of the local network conflict with those of the centre. In this case, Gauri suggests, the needs of the local network are likely to prevail, and the centre will find great difficulty in enforcing its will. The centre may be behaving rationally according to a predetermined strategy, whilst the regional centre is operating organically and in an evolutionary manner. This may in fact be to the advantage of the MNC in long-term developmental terms.

- Kogut (2000), writing in favour of networks, stresses that a particular network can benefit firm performance in proportion to the range and quality of the information it provides, and by the impetus to development created through being part of an evolving network full of dynamic activity.
- Afuah (2000) looking on the other side of the coin finds that performance

Quick summary

The effect of networks

- The concept of the embeddedness of networks has become of some considerable interest to researchers of late. All make intuitively sensible points which have the advantage of providing insights that might otherwise go unnoticed.
- Moderate embeddedness is helpful to performance. However unembedded firms suffer from lack of the knowledge and capability enhancement that belonging to a network can bring.

is lowered if the capabilities in a network are pooled as a result of technological change with which the network has not kept pace.

- Gulati, Nohria and Zaheer (2000) support this view, stating that although networks provide a firm with access to information, resources, markets and technologies, they may also, if inappropriately constituted, lock firms into unproductive relationships. They conclude therefore that "networks really do matter in terms of firm performance".

Thus we may conclude, perhaps not surprisingly, that being part of a high performing team raises your game, but being part of a loser network drags you down with it. The moral is to choose your network partners carefully. Indeed this is emphasised by Baum, Calabrese and Silverman (2000), whose research shows that the performance of start-ups can be substantially affected by the nature of the networks within which they choose to work.

Baum et al.'s research on Canadian biotech start-ups confirms their hypotheses that early performance can be enhanced by:

1. establishing alliances;
2. configuring them into an efficient network that provides access to diverse information and capabilities with minimum costs of redundancy, conflict and complexity;
3. judiciously allying with potential rivals that provide a good chance of enhancing learning and low risk off intra-alliance rivalry.

The example of Toyota

Dyer and Nobeoka (2000) give further support to the importance of the quality of the networks in their research into Toyota's network of suppliers. Here they pinpoint the creation of a high performance knowledge-sharing network as the keystone to high productivity for the members of the network. Toyota they claim has achieved this by creating a strong network identity, with rules for participation and rules for entry into the network. In Toyota's world it would seem production knowledge is viewed as the property of the network. Thus Dyer and Nobeoka hold that by extension dynamic capabilities can create competitive advantage by extending beyond firm boundaries. Where this is achieved through members accepting and avoiding conflict as a result of clear coordinating rules, the network so created will be superior to a simple firm as an organism for creating and recombining knowledge. This is due to the inevitably larger store of knowledge that resides in a network, in contrast to that in a firm alone. They stress, however, that networks should not have too many members performing similar roles, or there will be a high potential for conflict, and firms with inefficient webs of alliances do not prosper.

The global economy of the future will undoubtedly see a growth of networks in the search for reduced uncertainty in the face of the increasing turbulence of world economic activity resulting from the globalisation of technologies and markets. Cooperative strategy will become more prominent. But it can never replace competitive behaviour in the ultimate market-place, if pressures for efficiencies are to be maintained.

The Virtual Corporation

Just as network theory and the strategic alliance have become the popular phrases to describe the growing intra-organisational forms of the 1990s, it seems likely that the virtual corporation will fill that role in the first decade of the new millennium. The virtual corporation differs from the strategic alliance in that it places its emphasis, not primarily on how two or more firms can work together to their mutual advantage, but on how one firm can be created with flexible boundaries and ownership aided by the facilities provided by electronic data exchange and communication. As Nagel and Dove (1991) put it:

Quick summary

The virtual corporation

- The virtual corporation differs from the strategic alliance in that it places its emphasis, not primarily on how two or more firms can work together to their mutual advantage, but on how one firm can be created with flexible boundaries and ownership aided by the facilities provided by electronic data exchange and communication.

> A virtual company is created by selecting organizational resources from different companies and synthesizing them into a single electronic business entity.

Your notes

However, as with many new concepts, differing understandings develop of what the concepts actually entail, and the distinction between the heavily outsourced company, the strategic alliance, and the virtual corporation is sometimes difficult to discover from the literature. Business Week (February 1993), for example, defined the virtual-corporation organisational form as follows:

> The Virtual Corporation is a temporary network of companies that come together quickly to exploit fast changing opportunities. In a Virtual Corporation companies can share skills and access to global markets with each firm contributing what it is best at.

In this definition no mention is made of the electronic aspect of the corporation, and the outsourced company and the strategic alliance could easily be incorporated within the Business Week definition. It might also be claimed by advocates of the 'nothing-changes' school that such networked enterprises have always existed.

Similarly we have the Doughnut Corporation (Handy 1989) with its small solid core of full-timer staff exhibiting core competences, organising and managing resources, and a large open space with an often fuzzy boundary, full of just-in-time subcontracted resources, consultants, alliance partners, and suppliers. All we need is the panoply of electronic communications and surely we have the virtual corporation.

There is, however, one crucial difference between the strategic alliances and the virtual corporation beyond the electronic aspect of the latter.

- The strategic alliance is generally created to bring about organisational learning. Many commentators highlight the point that successful alliances are not composed of partners involved in skill substitution – that is, one partner produces and leaves the selling to the other. They are concerned to learn from each other, and thus strengthen the areas in which they are weak.
- This does not apply to the virtual corporation. In this intra-organisational form, companies each provide different functions, and are linked electronically. Organisational learning is not a basic objective of the exercise, but rather the creation of a flexible organisation of companies, each carrying out one or more functions excellently to deliver a competitive product to the customer.

Mowshowitz

Mowshowitz (1994) attempts a deeper and more conceptual view of the way in which the virtual corporation differs essentially from earlier organisational forms. He points to the non-incremental changes in society in history (echoes of punctuated equilibrium!). Thus the factory system developed rapidly in the nineteenth century when, owing to the advantages of the steam engine as a source of power, great productivity could be achieved, thereby separating the means of production from other social interaction, in a way that the earlier handicraft workshop did not.

He believes the virtual organisation will have similar dramatic results, bringing equally great social transformation in its wake. Mowshowitz (1994: 270) states:

> The essence of the virtual organization is the management of goal-orientated activity in a way that is independent of the means for its realization. This implies a logical separation between the conception and planning of an activity, on the one hand, and its implementation on the other.

There is, therefore, no problem, as there is in the traditional organisation, with

allowing extraneous matters such as company loyalty or human relationships to enter the equation of how best to realise abstract goals in concrete terms. The concept of infinite switching capacity, which is central to Mowshowitz's virtual-corporation concept, allows such realisation to be achieved from the best combination of inputs, despite their spatial separation. Electronic communication overcomes the problem of the spatial separation of inputs.

Mowshowitz adopts the concept of metamanagement as central to operating the virtual corporation effectively. Metamanagement involves the following steps:

1. An analysis of the inputs needed from outside sources, independent of the examination of particular suppliers;
2. Tracking and analysis of potential suppliers;
3. Revising and improving the allocation procedure;
4. Updating the requirement-supplier table.

He then identifies the three pillars of a virtual organisation.

Standardisation of interaction

Suppliers can be coupled and decoupled with ease to meet changing objectives, and the perceived optimal means of achieving them.

Commoditisation of information

This is necessary to facilitate switching and thus realise the flexibility necessary for the new form of organisation:

> By reducing dependency on the human being as the bearer of knowledge and skill, it is possible to increase the flexibility of decision-making and control to unprecedented levels. Knowledge is a basic factor of production, and if it can be supplied by computer-based artefacts, it can be manipulated and combined with other factors of production in ways that are not possible with human labourers. (Mowshowitz 1994, p. 281)

Abstractification of property

Thus a house is made abstract in the form of its title deeds. Abstract property rights, as Mowshowitz observes, simplify the preservation of wealth over time, and its movement over space. Since switching means functions may be carried out anywhere in the world, the problems of currency and interest-rate risk need to be controlled through such abstract instruments as currency hedging, and the use of currency futures and option contracts

The dehumanising aspects of the virtual corporation

Moving back into the traditional mainstream of organisation theory, Mowshowitz (1994) claims that the virtual organisation is consistent with the contingency-theory approach of Lawrence and Lorsch (1967). The contingencies are, however, not wholly environmental, but are more concerned with the elements that managers can use to craft organisational solutions to meet specific objectives.

Perceived in this way, the virtual corporation has such dehumanising aspects that it invites rejoinders, notably from Walsham (1994), who notes the absence in the concept of any reference to the contribution of the culture of organisations, or to the need for meaning and a sense of identity in a person's working life. He claims that:

> it can be suggested that a human being acting as a 'whole person' is likely to be more economically productive than one enfeebled by the adoption of an amoral role subservient to powerful interests. (1994, p. 291)

Your notes

This is reminiscent of the debates between the Fordists or Taylorists, who would, in the interests of efficiency, break a task down to its component parts, deskill it, and dehumanise the operative. This is in contrast to the more modern ideas of those like Wickham Skinner (1978), who would organise a task to meet the needs of the whole man. This may be the key constraining factor in the growth of the virtual corporation – that is, efficiency may be reduced, rather than increased, if the human interest and motivating factors are removed from the day's work. If so, the Mowshowitz vision will require considerable modification before it can hope to become a dominant organisational paradigm.

Harrington (1991) draws attention to a distinction between perceptual organisation and physical organisation which may attenuate the harshness of Mowshowitz's vision to some degree. Using this distinction, Harrington claims that an organisation needs only to be logically perceived as one to become one. The organisation thus has virtual (logical) qualities and physical existence in its traditional form. The virtual and physical aspects of a firm coexist, and interact with each other.

- Power
- Culture communication
- Knowledge perception
- Self

are seen by Harrington as virtual characteristics, whilst

- Resources
- Management
- Personnel
- Organisation structure
- Information systems
- Production

are seen as epitomes of the physical organisation.

The virtual characteristics are less clearly bounded, and are more dominant in some types of business than in others. An advertising agency may perceive itself to be a single entity, even though most of its contributors may be self-employed. The organisation itself is shaped by the interaction of its virtual and physical parts. Information technology unbalances the firm towards virtuality, which can limit or increase effectiveness, according to how its introduction is handled.

The Harrington concept is more human than the Mowshowitz idea. However, if we are concerned with efficiency and effectiveness of organisational forms, it may be helpful, in assessing the validity of the Mowshowitz twenty-first century vision, to measure it against the identification by Child (1987) of the three key characteristics an organisational form needs if it is to flourish. The three great strategic challenges faced by a corporation in the turbulent, global economy of the current and immediate future are, according to Child, demand risk, innovation risk, and efficiency risk.

Child's three strategic challenges

Demand risk

By 'demand risk', Child means the risk that capacity will have been created to produce and sell in a market that then fluctuates widely, either booming or rapidly melting away. In such circumstances a virtual corporation, or at least one with a relatively limited fixed central core, and a large and flexible periphery, is in a better position to survive, and adjust to changed market conditions than a wholly integrated corporation. Mowshowitz's virtual corporation is then well suited to cope effectively with demand risk. The switching function ensures this.

Innovation risk

By 'innovation risk' Child refers to the risk of falling behind rivals in the race for the new generation of products. There are mixed arguments for the virtual corporation here. Child advances the view that a specialised core, buying in parts outside that specialism, helps innovation by concentrating the specialists on developing new products and technologies related to their area of core competence. Chesbrough and Teece (1992), however, champion the integrated firm in areas of systemic technological innovation, since they argue that only such a corporation will have the will and the funds to risk such major R&D programmes. They relegate the virtual corporation to a position of being able to deal effectively only with what they term autonomous innovations – that is, those that involve far less than a whole system. Chesbrough and Teece would question the ability of the Mowshowitz virtual organisation to cope with systemic innovation as effectively as the more traditional integrated corporation. However, we are in the domain of theory, as there is currently little more than anecdotal evidence to support either argument.

Efficiency risk

By 'efficiency risk' Child alludes to the ever-changing nature of costs as technologies change. Here the virtual corporation would seem to have an advantage over the vertically integrated hierarchy, as virtual companies, coupled on the basis of specialisation, are likely to be well equipped to achieve optimal scale economies and consequently to contribute low-cost parts to aid the production of an aggregatively low-cost product.

Child (1987) also stresses that coordination within such virtual corporations can be achieved only through attention to what Boisot (1986) calls the increased codification and diffusion of information, by means of the increasingly sophisticated channels of modern information technology.

> IT has, in short, changed the economic cost–benefit balance in favour of greatly enlarging the information processing capabilities of organizations. Additionally it has expanded the options for the codification and diffusion of information. The availability of these options makes a significant contribution towards the viability of externalizing transactions. (Child 1987, p. 43)

The Walsham rejoinder to Mowshowitz does, however, give pause to the conclusion that efficiency without motivation necessarily leads to greater productivity than that achieved through a lower level of efficiency coupled with the high motivation achieved from working in a committed dedicated team. So the dominance of the dehumanised virtual corporation is by no means assured.

It is interesting to note the tension that is ever present in a discussion of cooperative strategy between, on the one hand, the identification of the human qualities of compromise, forbearance, consensus development, and trust as keys to success, with, on the other, the dehumanised virtual corporation with its elimination of loyalty, human eccentricities, or even culture as extraneous to efficiency needs. Yet they are two sides of the same coin of cooperation between independent companies in the pursuit of the satisfaction of an economic need.

Using a less purist vision than that of Mowshowitz, we might develop a concept of the virtual corporation based on three premises:

1. Few companies are excellent at all functions. Greater value can, therefore, be created if each company concentrates on performing only the functions which it does best, and relies on cooperating partners to carry out the other functions, rather than by attempting to do all things internally within a fully integrated company.
2. The globalised trading world is increasingly volatile and turbulent. In order to survive, companies need to link together flexibly, and be immediately ready to effect IT-based architectural transformations to meet changing conditions.

3. Cooperative attitudes even between competitors, and the existence of increasingly sophisticated electronic software, make points 1 and 2 possible.

Your notes

Such a model includes those humanistic cooperative aspects of a potential virtual corporation which are so dramatically absent from that of Mowshowitz. Fortune Magazine (1994) endorses this characterisation, seeing the virtual corporation as dependent upon six prime characteristics

Characteristic 1

A repertoire of variably connectable modules built around an electronic information network.

Characteristic 2

Flexible workforces able to be expanded or contracted to meet changing needs. The 'shamrock' (Handy 1989) pattern may well be an appropriate one here, with a small central core and several groups of self-employed workers selling their time as required.

Characteristic 3

Outsourcing but to cooperating firms with strong and regular relationships as in the Japanese keiretsu.

Characteristic 4

A web of strategic partnerships.

Characteristic 5

A clear understanding amongst all participating units of the current central objectives of the virtual corporation. In the absence of such an understanding there is a high risk that the corporation will lack the will and purpose to compete successfully with more integrated corporations.

Characteristic 6

An enabling environment in which employees are expected to work out for themselves the best way of operating, and then to get things done. This is in contrast to the traditional system of working according to orders conveyed with the aid of operations manuals, organograms, and job descriptions.

Such a corporation would be unlikely to work effectively in the pre-electronic age, as failures of communication and computation would lead to unacceptable inefficiencies and misunderstandings within the virtual network. However as Datamation (July 1994) shows, there is nowadays a wide range of software packages and systems in existence able to provide the electronic systems for the virtual corporation, as illustrated in Table 12.2.

Software packages	Purpose
SCM	Supply chain management
ERP	Enterprise resource planning
MRP	Management resource planning
EPOS	Electronic point of sale for market research
DRP	Database resource planning to replenish stock
MPS	Master production scheduling
EDI	Electronic data interchange
CAD	Computer aided design

Source: Datamation.

Subcontracting and multi-firm projects – the basis for the virtual corporation

The virtual corporation is not so much a new concept, as one that has become more fully developed as the electronic age exerts an ever-increasing influence upon how business is managed. For example, the concepts of subcontracting and multi-firm projects have existed as long as business itself.

Entrepreneurial start-ups have always had to rely on subcontracted activities, generally due to lack of adequate capital resources or capabilities to carry out all functions internally. Indeed this has led to their descriptions as 'hollow corporations' in somewhat derogatory fashion. Major construction projects have also been organised in a virtual fashion for decades – for example, hospital projects in the Middle East are traditionally carried out with a lead contractor and an appropriate number of subcontractors to carry out specialist functions.

Some companies such as Sinclair Research or Tonka Toys have always adopted a philosophy of carrying out directly only the functions in which they claim special expertise and subcontracting the others. Even a major corporation like Apple began as a 'hollow corporation', carrying out only a limited number of activities directly, but doing them extraordinarily well. Furthermore, many large management consultancies operate with a relatively small number of salaried employees, and a large network of self-employed fee workers.

However, the fashion in the 1970s for vertical integration has generally been reversed, and the resource-based view of the firm (Wernerfelt 1984) has taken over much of management thinking, with a consequent increased emphasis even amongst large firms of concentrating on the core business, and particularly on exercising the core competences, whilst 'downsizing' its overall employee numbers by subcontracting other functions considered to be less 'core'. The virtual corporation is, however, more 'virtual' than this model, and this is made possible above all mainly through electronics that even non-technically minded executives can handle competently.

Virtual characteristics – some examples

Many companies now have some virtual characteristics, although few have all those enumerated in this section. An illustration of the trend towards the virtual corporation even amongst existing large international companies is Roche in the pharmaceutical industry, which carries out R&D through virtual research teams working in different parts of the world by means of email, video conferencing, and other IT systems, although all are, of course, employed by Roche.

In the USA the insurance industry is becoming increasingly specialised, with risk-taking, back-room processing, and sales all carried out in separate companies linked in a virtual fashion. Virtual companies are common in the computer industry with Dell, Compaq, and Sun Microsystems all configured in a virtual fashion. The Agit Manufacturing Enterprise Forum (AMEF) is a collaboration of eleven companies plus twenty-four other organisations formed to develop a fifteen-year plan to create a high-tech infrastructure. It has many of the characteristics of a virtual corporation.

A Comparison

To appreciate the difference between the integrated hierarchical company and the virtual corporation, it may be useful to look at both organisational forms and contrast them on a number of criteria. Table 12.3 attempts such a comparison on six basic dimensions.

Your notes

Quick summary

A comparison

- In the autocratic hierarchically organised company, employees are paid salaries, and therefore are implicitly bound to accept the orders of those in authority over them, even if they disagree with them.
- Virtual corporations are quite different. Their culture is pluralist and task orientated. Decisions are necessarily consensual, and overheads are minimal. Furthermore the boundaries of the corporation are as narrow or as wide as the personal networks of each member.

Organisational dimensions	Integrated Corporations	Virtual corporation
Organisation structure	Formal & flexible	Flexible network, flat
Decisions	Ultimately by fiat	Discussion & consensus
Culture	Recognisable, employees identify	Pluralist, linked by overlapping agendas
Boundaries	Clear Us and Them	Variable
Management	High overheads	Minimal overheads
Power	From the Board *ex officio*	Through possession of competences in demand Being the brand company

*Source**: adapted from Jarillo (1993).***

The basic differences are of an autocracy and a democracy, if one takes an analogy from the political sphere. In the autocratic hierarchically organised company, employees are paid salaries, and therefore are implicitly bound to accept the orders of those in authority over them, even if they disagree with them. Considerable resources are expended in constructing a governance framework based on motivating devices, sanctions, communications systems, job descriptions, organograms, and layers of middle management that are neither the board of directors nor 'front-line troops'. A culture is established that encourages all employees to 'sing to the same hymn sheet' and identify with the corporations in all possible ways.

Virtual corporations are quite different. Their culture is pluralist and task orientated. Decisions are necessarily consensual, and overheads are minimal. Furthermore the boundaries of the corporation are as narrow or as wide as the personal networks of each member. Core competences are similarly flexible, as new members can always be brought on board without difficulty.

It is the flexible boundary issue in fact that provides perhaps the most attractive feature of the virtual corporation. However, it is important to emphasise that the difference between cooperation and competition is not, as is sometimes suggested, necessarily highly correlated with ownership and the boundaries of the firm. As Jarillo (1993) suggests, there may be competition inside a firm and cooperation outside it, as illustrated in Figure 12.4.

Common ownership	Vertically integrated company Shared goals	Bureaucracy frequently adversarial relationship
No common ownership	Virtual corporation Belief that we are stronger together	Market Arm's length relationship
	Cooperative approach	Non-cooperative approach

Source: adapted from Jarillo (1993).

To follow on from the discussion above, we can see that under common ownership (the firm), there may be cooperation (e.g. the vertically integrated

company united by a common vision and culture), or competition (e.g. many functionally hostile bureaucracies). Similarly, in conditions without common ownership there may be cooperation (e.g. the virtual corporation) or competition (e.g. the market).

There are, of course, limitations and disadvantages too with the virtual corporation: difficulties in achieving scale-or-scope economies, absence of tacit knowledge, problems with proprietary information leakage, and difficulty in financing critical mass level R&D, difficulties in maintaining commitment, and so forth.

The realisation of a virtual corporation

When then should activities be treated through the virtual-corporation format, and when in hierarchies? This question is partly subject to analysis by an analysis of the costs involved. It may be much cheaper to subcontract an activity than to carry it out oneself, since the subcontractor may achieve economies of scale not available to the manufacturer, e.g. tyre makers for automobiles. However, such an analytic technique will only address cost-efficiency issues, and says nothing on matters of strategic vulnerability or competitive advantage.

This quest for an optimal governance form in a given set of circumstances is not of course always the way in which virtual corporations are formed. Industries are populated by firms that have existing networks of relationships. These undergo frequent change in response to changing strategic imperatives – market power, success and failure, and variable levels of ambition. Virtual corporations may, therefore, be realised in a largely incremental way.

- Thus a firm may start out by performing some activities itself and subcontracting others.
- As it grows and establishes trust and commitment relationships with its subcontractors, it may establish single-source relationships not unlike those of the Japanese keiretsu, where a high degree of operational interdependence is developed between firms at different stages of the value chain of activities, but with little if any common ownership.
- The next stage in this electronic age may be the development of a strategic network between the operators, and then ultimately probably the establishment of a corporate identity through some form of joint ownership of profit streams.
- The virtual corporation has arrived, and may be followed as required by lesser or greater levels of integration, and by the development of a variable repertoire of configurations to meet changing market needs.

Virtuality and the value chain

Rayport and Sviokla (1996) extend the concept of virtuality from the corporation to the value chain that depicts graphically the activities carried out by the corporation (Porter 1985). The physical value chain (PVC), as they differentiate it, has typical primary activities of:

- Inbound logistics
- Operations
- Outbound logistics
- Marketing and sales
- After-sales service

These activities are supported by activities such as technology development, human-resource functions, the firm's infrastructure, and procurement. The PVC incurs costs, sometimes very high costs, as activities move from one linkage in the chain to another, and the most efficiently configured PVC takes advantage of what economies of scale and scope exist in the technologies and process of the firm.

Rayport and Sviokla depict a virtual value chain (VVC) that exists in the age of the microchip alongside the PVC. It needs to be managed separately from

Your notes

the PVC, but in concert with it. It does not require the realisation of scale-and-scope economies to achieve cost efficiency.

Often an activity may be moved from the PVC to the VVC with advantage; thus Ford used to conduct product design by gathering an engineering team in a specific location and charging

it with the job of designing a car. This can now be done by a virtual team in different parts of the world operating through cad/cam, email and teleconferencing.

Creating value in the VVC involves five sequential activities:

- Gathering
- Organising
- Selecting
- Synthesising
- Distributing information

If these five activities are applied to each activity in the PVC, then a value matrix is created that can transform the operations of the company, and thus even the 'rules of the game' of the industry. Boeing, for example, has been able to develop a peardrop-shaped aero engine in virtual form, tested it virtually in a wind tunnel, and determined the best design at almost zero cost.

Rayport and Sviokla talk of shifting activities from the market-place to the 'market space'. As they say:

> Managers must therefore consciously focus on the principles that guide value creation and extraction across two value chains (PVC and VVC) separately and in combination. (1996 p. 34)

The virtual corporation – some examples

The benefit of virtuality as a result of the arrival of the information age has then enabled information to be transformed from a support activity in IT departments into a value-creating activity capable of totally changing the way companies compete in an industry.

The case study describes Benetton, a frequently cited virtual corporation

Case Study: Benetton – A virtual corporation?

Benetton is sometimes described as the original virtual corporation, set up in the 1970s when the term had not even been coined. It lacks an essential part of the modern concept – namely, the dependence upon electronic linking, and is also not a virtual integration of equals each contributing what they are good at.

However, it uses electronic communication extensively, and has many of the other key features of the modern virtual corporation, particularly the diffusion of value-chain activities amongst many different contributors and the emphasis on linking entrepreneurs carrying out those activities rather than employing a salariat. The company carries out very few activities directly:

- choice of designs;
- technical advice to manufacturers;
- the dyeing function (strategically critical and needing very specific and expensive assets);
- overall management of the sales team, who are individually all self-employed both sales agents and retailers.

Thus the salaried part of the Benetton team is the visible part of the iceberg, with seven-eighths of the virtual corporation residing below the surface, using the Benetton brand name but running and owning their own businesses.

In Japan, Toyota is often cited as little different from a virtual corporation, with the following comparison cited as justification:

- General Motors of the USA, the archetypal integrated corporation, produced around 8 million cars a year in the 1980s with a wholly employed workforce of 750,000.
- Toyota produced 4.5 million with less than one-tenth as many employees (65,000), as most of its activities were heavily subcontracted. Indeed the Toyota involvement in the manufacturing process does not start before the assembly stage, as the components are subcontracted very widely.

Of course Toyota again is not a real virtual corporation, as the electronic links are not key, and there is no equality between the eponymous company and the component manufacturers. However, it, like Benetton, illustrates an early and very successful form of organisation in which many companies join together under a common banner but retain separate ownership and independence.

Appraisal

Quick summary

Appraisal

- To be a successful virtual corporation it is not sufficient to be able to put together a competent set of value-chain activity performers, able to deliver the required output on time to specification.

To be a successful virtual corporation it is not sufficient to be able to put together a competent set of value-chain activity performers, able to deliver the required output on time to specification. More than this is required for an opportunistic linking to be converted into a virtual corporation.

- First, it is necessary to have a brand name under which to trade, that comes to be accepted as a mark of quality.
- Speed and flexibility are the next essential elements that the virtual corporation needs to pitch against the integrated corporation's established physical presence and proven competences.
- It also needs a brain and a central nervous system. By this is meant a centre from which direction emanates, and which is able to make difficult choices according to a consistent vision. Such a 'nervous system' must also provide a communication system able to convey information and requirements rapidly and accurately, and through which key aspects of quality control systems can be performed.
- It is, therefore, difficult to conceive of a successful competitive virtual corporation that is not dominated by one brand-name company at its centre. As in networks, the dominated network is likely to succeed when in competition with the less directed equal-partner network.

This information architecture, as it has come to be called, normally includes a data highway to link partners, private access for partners to access key data and applications software, the ability to monitor integrity and security, and an appropriate set of communication tools. Given these characteristics, the virtual corporation should be in a position to compete successfully against integrated corporations in many industry segments.

The barriers and risks of virtuality

Why then has the movement to virtuality proved so slow in coming? The technology necessary for virtuality has been in existence for at least a decade.

The strongest factor inhibiting the movement has probably been the secretive and over-competitive psychology of companies. Rigid mindsets wedded to the integrated form have dominated, coupled with a reluctance to single source in the belief that this gives away bargaining power. There has been a similar reluctance to share information with suppliers and distributors, regarding them more as arm's-length relationships than as business partners, part of the same team.

Until recently the global telecommunications network was insufficiently flexible and probably lacked sufficient capacity to cope with a fast-growing number of virtual corporations. However, the growth of the strategic-alliance move-

ment in response to the globalisation of markets and other factors, coupled with major user-friendly improvements in software availability for multiple uses, is now causing the virtual corporation to flourish as an organisational form in many areas.

Your notes

The example of IBM

Such a development is not, however, without its risks for major corporations. When IBM, although far from a virtual corporation itself, decided to make its PC in a virtual fashion, coupling IBM hardware with Microsoft software and an Intel microprocessor, it provided the necessary impetus for Microsoft and Intel to grow from small beginnings to a size larger than that of IBM itself. The company must regret the missed opportunity to make the microprocessor itself, and develop the software in-house, which it clearly had the resources to do. It made the fatal mistake of not doing in-house the things that it was both good at and which had high strategic significance.

Further weaknesses of the virtual corporation

The virtual solution is not a solution to all situations. It has certain inherent weaknesses that are more important in some situations than in others. For example, if an industry is dominated by virtual corporations, it is unlikely to achieve major systemic innovation. This probably requires an integrated firm to take a risk and commit large R&D funds to developing a new technology. It then needs to exercise its market power to change the 'rules of the game' in its industry, as IBM did back in the 1960s with its 360 modular computer. This is very difficult for a virtual corporation to do, as it lacks sufficient legitimacy or reputation.

Chesbrough and Teece (1994) develop a matrix shown in Figure 12.5 in which they differentiate between autonomous innovations and the more major systemic ones.

Capabilities exist in-house	Multi-divisional	Integrated
Capabilities exist outside	Virtual corporation	Alliance
Capabilities must be created	Alliance, integrated	Integrated
	Autonomous	**Systemic**
	Types of Innovation	

Source: adapted from Chesbrough and Teece (1994).

They suggest that for systemic innovations (e.g. compact discs as opposed to vinyl records) integrated companies are generally the more appropriate forms. However, they suggest that, with autonomous innovations within a technological paradigm, virtual corporations are much more appropriate.

Systemic change costs more in resources up-front, and needs the driving force of an existing major player to see it through. A loosely knit coalition with resources belonging to the different partners would find this major activity difficult to achieve, though not, of course, impossible, as Apple Corporation showed with its major innovations in windows and icon-based software. It has been notable, however, that they have been unable to appropriate major long-term benefits from these systemic innovations.

Virtual or integrated – which form will dominate in future?

Your notes

If the communication of 'tacit' (Polanyi 1966) knowledge, or the existence of very effective and efficient internal systems, is the key to success, a virtual corporation is unlikely to compete successfully against an integrated company with similar competences in every other way. Similarly, if there is a need for a high level of high-tech interdependence, an integrated company is more likely to be able to achieve this than a virtual corporation.

Thus, integrated corporations are likely to remain the dominant form of organisation where:

- internal coordination is key;
- innovation is systemic;
- there is a need to establish an industry standard;
- tacit knowledge needs to be communicated;
- the major growth opportunities are the extension of existing activities into neighbouring markets.

In certain circumstances, however, virtual corporations are likely to outperform integrated corporations. These are:

- in markets that do not exhibit the characteristics described in the previous section;
- where considerable turbulence leads to the need for speed of response, robustness, and flexibility;
- where the onset of globalisation demands resources not available to a single firm.

In these circumstances the virtual corporation is likely to exist alongside the integrated corporations over the coming decades as the naturally selected winner in certain markets, and not in others. For many of the reasons outlined above, it may never come to replace the integrated form, and indeed may often exist on the interface between a number of integrated corporations involving parts of them in variable configurations.

Summary

It has been argued that the network form of governance is most appropriate in conditions where partners provide specific assets, where demand is uncertain, where there are expected to be frequent exchanges between the parties, and where complex tasks have to be undertaken under conditions of considerable time pressure.

An example of such conditions is found in the film industry, where 'film studios, producers, directors, cinematographers, and a host of other contractors join, disband and rejoin in varying combinations to make films' (Jones et al. 1997, p. 916). Other examples are frequently found in the bio-technology industry. As Jones and her colleagues state:

> When all of these conditions are in place, the network governance form has advantages over both hierarchy and market solutions in simultaneously adapting, co-ordinating and safeguarding exchanges. (p. 911)

The virtual corporation is often thought of as outsourcing, with electronic information controls and communication. In this sense the growth of the fashion for configurations around key competences with outsourcing has led to the corresponding growth of virtual-corporation theory. This differs from strategic-alliance theory in that the virtual corporation does not have inter-company organisational learning as its prime objective, as does strategic-alliance theory. Virtual corporations are indeed all about putting together a variable configuration company from existing companies with excellent specific skills. No

inter-company learning is necessarily involved.

However, outsourcing has reached such a level that the pendulum threatens to swing back in the other direction. A senior bank economist at Morgan Stanley, after years of advocating downsizing and outsourcing changed his views in a 1996 news interview and now states that cutting back and back eventually ends up with no corporation at all. Even the core competences may be inadvertently outsourced – for example, R&D or design. It cannot be a source of sustainable advantage. Furthermore, as more functions are taken over by what are termed 'contingent workforces', loyalty to the firm and commitment tend to disappear. Indeed a study of several hundred UK companies by PA Consulting in 1996 revealed that they outsource over a quarter of their total budgets for what they regard as their key business processes. There were only three activities that more than 35 per cent of the companies in the survey regarded as 'core' – business strategy, information-technology strategy, and new-product development. This meant that everything else, including R&D, customer service, finance and accounting, and manufacturing were regarded as non-core by two-thirds of the companies surveyed.

This leads to one further thought on the subject. It may be very possible to set up a virtual corporation by identifying a strategically vital centre, outsourcing everything else, and linking the whole by IT packages, with the central core representing the brain, owning the brand name, and maintaining the motivation even amongst the outlier partners by sophisticated relationship development. It is quite another matter, however, to slim down an existing integrated corporation and transform it into a virtual corporation. The demotivation resulting from being cast into the outer periphery, or from fear that one will be the next to go, makes such a transformation fraught with human difficulty and unlikely to lead to a happy and thus competitively successful company.

Task ...

Task 12.1

To check your understanding of the material in this topic, try to answer the following questions. If you have any difficulties, you may wish to go back and revise the relevant part of the topic.

1. What are the major forms of strategic network?
2. How does a network differ from an alliance?
3. Why do networks arise?
4. Why is trust not as important in a network as it is in an alliance?
5. Do all members of a network have equal power?
6. What makes some corporations 'virtual'?
7. How likely is it that virtual corporations will take over from hierarchical one as the dominant corporate form?
8. What problems are there for virtual corporations in facilitating systemic technology change?

Resources

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Topic 13

The Multinational Corporation

Aims

The purpose of this topic is to:

- show how multinational corporations came about and why;
- illustrates the four basic stereotypes of MNC organisations;
- explain the rationale for the international exporter form;
- explain the rationale for the multi-domestic form and identify its limitations.

Objectives

By the end of this topic you should be able to:

- describe how multinational corporations have evolved;
- identify the four characteristic ways in which they are organised;
- gauge the complexities of operating an international matrix structure;
- explain how the international exporter form came about;
- explain the history of the multi-domestic;
- describe how the multi-domestic can be modernised and frequently evolves into a global form;
- identify the circumstances in which the different organisational forms develop.

Introduction

Your notes

The multinational corporation has dominated the international business environment at least since World War II and has been justified in academic circles most popularly by Dunning's (1974) eclectic paradigm. As stated in Topic 10, Porter and Fuller (1986) identify the two key tasks of the would-be international firm as to achieve the optimal form of configuration (where to locate value chain activities) and coordination (how to set up the organisation structure and systems). The configuration and coordination of activities of such a multinational corporation on a global scale provide a more daunting and certainly a more complex task than is involved in carrying out such activities on a purely national scale.

This topic attempts to provide some answers to the question of how MNCs configure and coordinate their international strategies, firstly by examining how earlier theorists have addressed the issue (Melin 1997).

The Multinational Corporation

Dunning's eclectic theorem

The ability of the multinational corporation to set up abroad and outsell local companies is often put down to the operation of Dunning's eclectic theorem. This provides a theoretical basis for the development of the multinational corporation. The framework answers to the acronym OLI. These letters stand for Ownership, Location and Internalisation, and justify a corporation selling outside its own country setting up other functions off shore, i.e. engaging in Foreign Direct Investment (FDI).

Thus a corporation will engage in FDI if:

- it has ownership advantages, such as an international brand name;
- the country in which it intends to invest has locational advantages, such as cheap local labour; and
- the corporation feel the need to internalise its activities for fear of loss of proprietary assets like trade secrets, which inhibit it from engaging in strategic alliances or licensing.

The stage models of internationalisation

Vernon

There are a number of theories on the growth of the MNC, notably that of Vernon.

Vernon's (1979) product life-cycle model of the internationalisation of a firm suggests that the process takes place in stages.

- A product is developed and sold domestically.
- In stage two it is exported and then, as scale developed, FDI will lead to it being produced in the countries in which demand for it proves large. This is the growth stage of the life-cycle.
- In the maturity stage, production moves to the third world to low-wage cost economies and the final stage is decline where the product is imported into the country from which it originally emerged.

This is a very stylised model, which assumes that the firm with the new product is starting out from scratch with no existing international organisation. Its basic contribution to theory is to demonstrate how internationalisation can cause production to move from the home country.

Johanson and Vahlne

A somewhat similar stage model was developed in Uppsala by Johanson and Vahlne (1977). They envisage a firm gradually internationalising through increased commitment to and knowledge of foreign markets. It is likely to enter markets with successively greater psychic distance. Thus, at the outset it sells to countries most like itself. The model depends on the notion that uncertainty increases, and hence so does risk, with increasing psychic distance and unfamiliarity.

The problem with this model is that there are many examples of internationalising companies who have merely gone for the large rather than the familiar markets, and many markets at the same time, for example Sony Walkman, McDonalds, Levis. The contrast is between the so-called 'waterfall' model of global expansion (one country at a time) and the contrasting 'sprinkler' model (many countries at a time). In current markets with ever shortening product life-cycles, there is often insufficient time to adopt the waterfall approach. At all events, both of the popular stage models are highly sequential in their stages and very deterministic.

Studies of the link between strategy and structure in MNCs

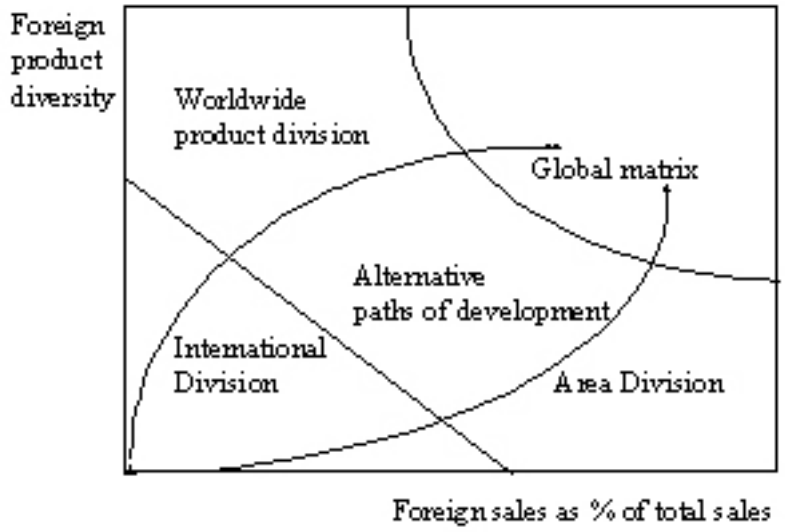
A further theory is that of the 'Structure follows strategy' school first identified with Chandler (1962). This idea emerges from Chandler's seminal book where he describes how a number of major US companies adopt the M (multi-divisional) form of organisation in order to cope better with the need to coordinate activities around the globe.

In 1972, Stopford and Wells, following Chandler's path, developed a simple descriptive model to illustrate the typical stages, whereby companies progressively developed an international organisation structure. They saw this process as analysable on two dimensions:

- The number of products sold internationally, i.e. foreign product diversity.
- The importance of international sales to the company calculated as foreign sales as a percentage of total sales.

You can see an illustration of their model in Figure 13.1.

The Stopford and Wells matrix



Source: Stopford and Wells (1972).

Your notes

Stopford and Wells (1972) suggested that international divisions were set up in the early stage of internationalisation, when the figures were low on both axes (as you see in Figure 13.1). Then, if companies expanded overseas, without increasing product diversity, they tended to adopt a geographical area structure. Those that found that international expansion led to substantial foreign product diversity, tended to adopt a world-wide product division structure. Finally, when both foreign sales and the diversity of products became high, a global matrix emerged.

Thus, the grid structure of the MNC with a geographical and a product group axis became common. Bjorkman (1990), however, unable to correlate structures with performance, concluded that the adoption of new structures was more a matter of fashion than anything else and basically mimetic.

Recent organisational models of MNCs

Doz, Bartlett and Prahalad are of the newer 'process' school of MNCs. They emphasise control through socialisation and the creation of a verbal information network to develop a corporate culture that transcends national boundaries. This school emphasises the global integration/local responsiveness framework, with the individual manager as the basic unit of analysis. All decisions are made with this trade-off in mind.

The emphasis is on the functioning of MNCs not their organisation structure. Bartlett and Ghoshal (1989) believe that environmental forces shape the strategic profile of a business while a company's administrative heritage moulds its organisational form and capabilities. The transnational solution often emerges here.

McKinsey the international management consultants are often cited as a good example of a transnational.

Global Resourcing

Further decisions regarding the configuration of activities on a global scale are concerned with the issue of what part of the value chain for a product should be produced within the company and what outsourced, and where that production should take place: in the home country, the Far East or elsewhere. The configuration profile is influenced by a number of cost-incurring barriers.

- The activity can be outsourced if it is cheaper produced elsewhere and is not fundamentally strategic. For example, it is dangerous for a car company to outsource the engines.
- It is dangerous to outsource to a country with an unstable exchange rate as this may move in an adverse direction by the time the parts are delivered.
- It is dangerous to outsource to a politically unstable country as the parts may never get delivered at all due to a coup or other disruptive event.
- Eclectic governmental regulatory barriers may make an otherwise cost attractive venue no longer so.
- Problems of logistical delivery may also adversely influence distant outsourcing. For example, getting things made locally makes them much easier to control.
- Issues of language, culture and legal systems may also provide problems for the global outsourcer.

The perceived globalisation of markets during the 1980s and 1990s has come about through the marginalisation of the importance of, or complete elimination of many of the traditional barriers to trade. The spread of Western culture through films, videos, travel and satellite television has done much to homogenise tastes. There has even been some movement the other way, with Eastern food, so-called 'ethnic' clothes and objets d'art becoming acceptable and more common in the West. However, overall the movement of value chain functions

Quick summary

Global resourcing

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has been from Western countries to Far Eastern ones, particularly in manufacturing with China becoming an increasingly major supplier.

Controlling the MNC

Organisational forms

It is not just the configuration of the value chain that is the key to international competitiveness; it is also the way in which it is coordinated and controlled. This issue underlies a key part of the firm's global producer matrix (Bowman & Faulkner 1997) and addresses the question of how to run a global enterprise. In fact, in these days when outsourcing, virtual corporations and networks are in the ascendant as modern organisational forms, the core competences of international coordination and control may well be the key competences for international success.

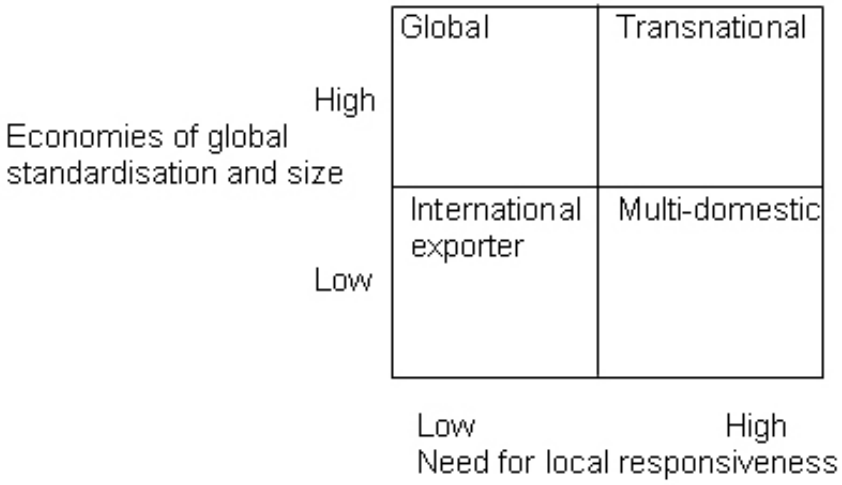
Ghoshal and Nohria (1993) identify four basic types of MNC environments: global, international, multinational (multi-domestic in our terms) and transnational, differentiated by axes of global integration and national responsiveness that need to be coped with by appropriate organisational forms.

- Their research placed the following industries in the global box: construction and mining, nonferrous metals, industrial chemicals, scientific measuring instruments and engines. Little national responsiveness was seen as necessary in these industries.
- International industries low on global scale economies and national responsiveness were metal industries, machinery, paper, textiles and printing and publishing.
- Multi-domestic industries high on the need for local adaptation were beverages, food, rubber, household appliances and tobacco.
- The transnational industries high on both national adaptation and global scale were seen to include drugs and pharmaceuticals, photographic equipment, computers and automobiles.

Of course, as particular industries evolve they may well move boxes. Automobiles, for example, may well be moving into the global box.

Ghoshal and Nohria also highlight the process part of organisation and claim that when process environment and organisational form are correctly aligned, performance is higher than when there is a 'misfit' between them. On the process side, they identify structural uniformity as best suited to global environments and organisational forms. Differentiated structures fit multi-domestic environments, integrated varieties fit with the transnational form and ad hoc varieties fits with international environments.

The four possible configurations of MNC environments are illustrated in the matrix shown in Figure 13.2.



Quick summary

Controlling the MNC

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Source: Segal-Horn and Faulkner (1999).

Your notes

The matrix follows a tradition used and developed amongst others by Bartlett, Ghoshal, Doz, Prahalad and Stopford. Although most authors vary the definitions on the axes to some extent, the underlying principles remain the same.

In international business, there is always a tension between the production efficiency needs for low cost of making a standard product and shipping it around the world with as little variation as possible, and the marketing need to offer a product to a local market that takes into account as sensitively as possible local tastes and culture. This tension exists, of course, in all business beyond the very local at all times, but it is most in evidence when a firm decides to 'go global'.

Tensions and trade-off when 'going global'

The existence of the tension and the need for the trade-off between global standardisation and local adaptation applies in a number of areas. It applies in varying degrees to different industries; for example commodities need no local adaptation, wheat is wheat, oil is oil but a car is not yet an undifferentiated product. It applies also to individual countries. If there is a market for a product in the USA, a similar market may exist in Europe but more adaptation may be needed for India, Africa or the Far East. McDonalds pure beef hamburgers do not sell in India for cultural reasons, for example.

A similar tension exists between business functions. It is possible for a pharmaceutical company marketing world-wide to carry out all its R&D in one major research site in its home-base country. This achieves the greatest economies of scale in terms of running teams of research scientists and having the hardware resources for them to carry out their research. However, if the company is big enough, it may need more than one in different parts of the world to give it the necessary flexibility when the market environment suddenly changes unexpectedly.

The same company may need a small number of production units sited regionally around the world to achieve the minimum economic size for scale economies in production. It may well need one sales force per country to develop and use the local market knowledge needed to achieve effective global reach with its portfolio of products, and to gain national and local acceptance.

If the tension exists for industries, markets and functions, and the trade-off needs to be solved differentially in each contingent set of circumstances, then how should a multi-product, multi-market global company be organised? Clearly there is no simple answer, and as environmental circumstances change so will the organisational pressures and the optimal solutions. Look again at Figure 13.2, which shows each stereotype organisational form in its appropriate box.

There is some confusion in the international business literature over the appropriate term for firms in the bottom left-hand box of Figure 13.2. Bartlett and Ghoshal (1989) describe the relevant configurations for the global and the international models in terms that fit this box. The difference is that, in their view, there may be knowledge transfer from the headquarters unit to local companies in the international model, whereas their global model has a mentality that treats overseas operations as no more than delivery pipelines. Bartlett and Ghoshal also name our multi-domestic as their multinational. It is a company that operates with strong overseas companies and a portfolio mentality.

We believe that the term multinational should be the umbrella term to describe all company forms that trade internationally, and have a presence in a number of countries. In terms of our matrix, this includes the company forms in all boxes of the matrix other than the bottom left-hand box.

The global corporation

In the top left-hand box of Figure 13.2 is the global company producing standardised products for sale around the world, for example Gillette razors. As a global company, Gillette may not have a major problem. Razor blades need little local adaptation, have an established technological production function, have an easily understandable marketing message and therefore only sales needs to be handled locally. The Global firm is close to that implied in the Porter Diamond described in topic 10. As Yetton, Davis and Craig (1995) put it:

> Porter's primary concern with the capacity of the US to compete with Japan leads to a preoccupation with the globally exporting firm, which is the principal form by which Japanese manufacturing firms have competed internationally. He focuses not on the complexity of international operations, but on the characteristics of the home base market as a platform for a successful export strategy. Consequently the 'Global' MNC is his primary interest.

In this model, the global corporation treats overseas operations as delivery pipelines to a unified global market. Most strategic decisions are centralised at the home country base and there is even tight operational control from the centre. There is likely to be very little adaptation of products to meet local needs. Gillette, Coca-Cola or Johnson and Johnson's Band Aid® are examples of such a company.

The classic Global organisation model was one of the earliest international corporate forms that developed, after it became apparent that scale and scope economies were key to international competitiveness in many industries (Chandler 1962). It built global scale facilities to produce standard products and shipped them world-wide. It is based on the centralisation of assets, with overseas demand operations used to achieve global scale in home-base production.

The global corporation may have an international division in order to increase its foreign sales but the international division is very much the poor relation of the domestic divisions, which are probably further sub-divided into product group divisions. The company ships from its home base whenever possible, with very little regard for the differing tastes and preferences of the countries to which it is exporting. This form of organisation was typical of the Japanese exporting companies of the 1970s and is still common in many current USA corporations: the Spalding Sport group is an example of this mode.

The International Exporter

The firm in the bottom left-hand box of Figure 13.2, which you examined earlier, may not think of itself as an international exporter. It exports opportunistically. Domestic customers are its lifeblood, but it will sell abroad if approached by an international customer and, in times of recession when overcapacity looms, it may actively solicit international sales to fill its factory. Generally, however, its home-based export percentage of home-based production is low, as is its foreign production, if any, as a percentage of total sales. For many companies, this may be a transitional form as its markets internationalise.

Spalding the US sports goods manufacturer are often cited as an example of an International Exporter.

The Multi-Domestic

What is a multi-domestic?

The traditional multi-domestic model of the multinational corporation is described by Bartlett and Ghoshal (1989) as:

Your notes

> a decentralized federation of assets and responsibilities, a management process defined by simple financial control systems overlaid on informal personal co-ordination, and a dominant strategic mentality that views the company's world-wide operations as a portfolio of national businesses.

They claim that the multi-domestic was the earliest form of MNC and followed a pattern adopted by companies, particularly British ones, expanding in the period prior to World War II. The role of the centre was largely that of residual resource allocator and coordinator. Systems tended to be rather informal, achieved by delegating operational autonomy to personally known and trusted appointees. Such organisations often developed as a result of 'trade following the flag' policy. In other words, British MNCs tended to develop with strong trade links to the old British Empire rather than in pursuit of obviously strong business opportunities with other forms of competitive advantage in the ascendant.

Bartlett and Ghoshal name this traditional form the multinational organisation model, but in this course we have called it by the more self-evidently descriptive title of the multi-domestic enterprise.

The pure multi-domestic form

In the traditional description of the multi-domestic form, the structure is usually described as a historically early one, which was most common before the onset of globalisation and when major economies of scale and scope were not key to determining competitive advantage in international business. However, the multi-domestic is not necessarily an outdated form where local responsiveness is key, and few, if any, scale economies exist.

The role of the centre

If we look at the form using our corporate role of the centre triangle (as we see in Topic 5), we see that in the first instance, when putting together the corporation, the centre was responsible for the selection of businesses. However, it was less so in subsequent development as each country subsidiary has a lot of control over its own resource allocation. It is also responsible for resourcing its growth by whatever means but certainly through organic development. Acquisitions and alliances may need central approval depending on the size of the deal. As regards control, the centre is responsible for financial control in the sense that it receives the financial reports, but its power to act in relation to them is very limited. Human resource control is very largely in the hands of the country units.

Its characteristics in its pure form are those of a federation of companies, each operating in separate countries but under a common brand name. The centre's role is akin to that of a holding company with the limited purpose of monitoring financial performance in its subsidiaries around the world, deciding when and where to increase or decrease its portfolio of companies and maintaining often largely informal contact with the subsidiaries in a largely political way.

In Porter's and Fuller (1986) view, the multi-domestic corporation can choose where to compete internationally as its strategies will be a series of domestic strategies.

> In a multidomestic industry, a multinational firm may enjoy a competitive advantage from the one-time transfer of know-how from its home base to foreign countries. However, the firm modifies and adapts its intangible assets in order to employ them in each country; and the competitive outcome over time is then determined by conditions in each country. (Porter & Fuller 1986, p. 18)

Its communication pattern is described by Bartlett and Ghoshal (1989) running from the country SBUs (Strategic Business Units) into the centre, which is largely a financial holding operation.

Quick summary

The multi-domestic

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- Bartlett and Ghoshal name this traditional form the multinational organisation model, but in this course we have called it by the more self-evidently descriptive title of the multi-domestic enterprise.

Thus, the pure multi-domestic corporation develops responsiveness world-wide on a country-by-country basis through distributed resources and dispersed initiatives and authority. On a number of criteria, it can be characterised as follows:

- It exhibits few extra national scale economies or experience curve effects or locational economies (Hill & Jones 1997).
- Market shares in one location are independent of those in another.
- R&D and overall capital intensity are likely to be low so that duplication of facilities in each country is not too costly.
- The minimum economic size of production plants will also be relatively small and each will serve only the local market.
- Both product and process standardisation are likely to be low as each country centre will have high autonomy and little coordination with the other country subsidiaries in the group since the markets are different and there is no need for it.

Differentiation

In terms of a differentiation as opposed to a global standardisation strategy as described by Douglas and Wind (1987), the multi-domestic corporation will be at the differentiation extreme of the standardisation–differentiation continuum. In other words, each country will demand and receive a different product specific to its needs, even if the brand name is the same. This differentiation will apply to segmentation of the market and positioning within it. It will apply to the product itself, and its marketing in terms of packaging, advertising and PR and customer and trade promotion. It may even be distributed by different methods from one market to another.

As Ellis and Williams (1995) put it, the dominant power group of executives within the corporation is the country-based national managers as they are in control of the delegated resources, and profits are not normally repatriated to the centre (only dividends). The country managers are therefore in a position to allocate resources for future intra-country development and growth. In many companies, they are known as the country Barons. The corporate culture inevitably places strong emphasis on the subsidiary's independence from the centre.

Characteristics of multi-domestics

Hill and Jones (1997) describe the structure and culture of multi-domestics in the following way. In terms of vertical differentiation, they are decentralised; in terms of horizontal differentiation, they have a world-wide area structure. Their need for internal coordination is low. They therefore have few, if any, integrating mechanisms, have little need for cultural control and little, if any, performance ambiguity. Their performance is there for all to see and measure due to their high autonomy. This is a picture of a set of separate companies linked together only by use of common corporate names and symbols and formal reporting to a common head office.

Ellis and Williams (1995) distinguish multinational organisational forms along four dimensions:

1. Product or service offering
2. Resources, responsibilities and control
3. Dominant power group and culture
4. Location of R&D and source of innovation

On these criteria, the multi-domestic has products developed for local markets, has local autonomy and control of resources, has a power group of country managers and a local culture, and has supporting national R&D facilities and local sources of innovation.

Your notes

Merits and drawbacks of the multi-domestic

Particular merits of the multi-domestic corporate form are that they are good at 'sensing' future possible trends in global products by identifying them early at a local level. They also provide good environments for the advancement of foreign nationals within the corporation, although there may be a 'glass ceiling' inhibiting them from reaching the corporate board at head office in the 'home' country.

This organisational form tended to proliferate during the inter-war years as it was particularly appropriate for a world beset by high levels of trade barriers and conditioned by high global transport costs as a percentage of total costs. When these factors are coupled with only moderate scale economies, the attraction of the form with its high motivational characteristics for local managers is clear to see. In the modern world, however, for it to survive, it needs to evolve into a less pure form and pay due deference to the needs of scale economies and merging market tastes and technologies.

An example

Companies like Philips experienced severe problems in the 1960s with their multi-domestic form as Japanese competitors entered their markets with lower costs brought about by a more global approach to business and the scale economies following from this. The multi-domestic form also made it difficult for Philips to develop a unified global strategy. Individual country barons concentrating on their individual markets were unable to perceive the global threat from the Japanese. A culture founded on the supremacy of the national organisations, self-sufficiency, sales rather than profit orientation and at corporate level the need for consensus and collective responsibility among the barons was ill suited to fight the global Japanese, and the necessary restructuring was painful.

The modern multi-domestic

Yip (2003, p. 184) characterises the modern multi-domestic as having a corporate organisation with dispersed national authority, no domestic–international split, and a strong geographical dimension relative to business and functional dimensions, i.e. country managers are kings, or at least princes. In terms of management processes, there is the transfer of technology from headquarters outwards, but national information systems and national strategic planning, budgets, performance review and compensation systems. The executives are peopled with professional expatriates, while nationals tend to run the local businesses. There is only limited travel. The culture is very varied and reflects the strong autonomy of the subsidiaries.

The role of the centre

In terms of the role of the centre triangle, the modern multi-national concedes more power to the centre where this seems likely to enhance competitive strength. Thus, the centre is likely to play a stronger role than traditionally in resource allocation and the selection of markets. It is likely to have a strong say in technology matters, in R&D and in anything concerning strategic alliances and mergers and acquisitions.

Its corresponding role in control is therefore also likely to be enhanced. It will not only receive financial reports but arrogate to itself the power to take action if the information in them is a cause for concern. The modern multi-domestic is therefore not as much of a loose confederation as its traditional predecessor, but clearly a corporation within which a strong culture of operational decentralisation and product differentiation exists.

The modern multi-domestic – advantages and drawbacks

The advantages of the multi-domestic are that it enables a fully local product to be designed and produced, it retains the resources necessary for product development and it tends to develop local managers strongly committed to the local organisation.

However, it has an inherent inability to exploit competitive interdependencies and global efficiencies. It sometimes needlessly duplicates facilities when one larger regional or global one would be preferable on a cost basis, and it is not well suited to new product diffusion on account of the independence of the subsidiaries. Philips is said to have failed to establish its V2000 VCR format as the dominant design paradigm in the video industry in the late 1970s in opposition to Matsushita's VHS design because its US subsidiary refused to buy the V2000 and bought VHSs instead and then put its own label on them (Hill & Jones 1997).

To overcome these deficiencies, some corporations organised traditionally on a multi-domestic basis have made adjustments to their structure to overcome some of the weaknesses of the multi-domestic in a modern global environment. Where applied sensitively, these adjustments can preserve the multi-domestic as a viable organisational form even in conditions where globalisation is becoming increasingly prevalent.

Nestlé is an example of a corporation that has made such adjustments and thereby retained its international competitiveness. We have already examined the European food industry and seen how cross-border harmonisation has made cross-border strategies viable, and thus created strategic space that can be occupied.

Read the Nestlé case study to find out more about how it has retained its competitiveness.

Case study: Nestlé – multi-domestic or global?

Nestlé, the Swiss-based international food and beverages company, has over 200 operating subsidiaries. It has a philosophy of decentralisation and dispersion of activities. The company has nearly 500 factories around the world and sells its products in over 100 countries. Less than two per cent of its sales are in Switzerland.

The original Nestlé business was based on milk and children's beverages but, over time, numerous other products have been added, some outside the food business entirely. Nestlé produces pharmaceutical and cosmetics products, for example.

The company's organisation structure, systems and culture emphasise the importance of local responsiveness and the considerable autonomy of local managers. As is traditional in multi-domestic companies, the subsidiaries are bonded to the centre by close personal relationships. Nestlé's corporate management is, however, responsible for giving strategic direction to the organisation overall. Nestlé is a modern multi-domestic, however, and its corporate management is responsible in addition for major resource allocation decisions, selection of markets and the initial management of all acquisitions. R&D are also strongly centralised.

Nestlé recognises the increasing convergence of tastes and national regulations in many regions of the world and has developed coordinating mechanisms on a regional basis between its subsidiaries for some product groups. It thus maintains its multi-domestic philosophy of local responsiveness, whilst adapting where appropriate to the needs of the forces of globalisation. Local managers continue to have considerable discretion, and the company continues to have many more factories than would be the case if it were organised as a 'global' company. However, since the Rowntree acquisition, it seems to be moving in

the direction of transforming itself into a global corporation.

Your notes

A principal adaptation of the traditional multi-domestic to meet modern needs is, then, the strengthening of central controls particularly in the area of resource allocation, staffing and performance measurement.

Another area in which it has adapted is that of developing the capability for transferring skills developed in one subsidiary to appropriate other subsidiaries throughout the group. Yetton et al. (1995) emphasise this feature in their empirical research into the viability of the multi-domestic form in Australian MNCs.

They contrast the modern Australian multi-domestic with the global form on four dimensions.

The distinction between inter- and intra-firm competition

Competition can, they claim, be developed amongst the multi-domestic units of a corporation to establish which units are the most efficient. This competition would be rewarded by promotion of executives and allocation of resources to the most successful business units.

The distinction between single and multiple point learning

Organisational learning from units in numerous different environments would be large. A prime determinant of the opportunity to learn is the heterogeneity of the environment as exemplified by the variety of customer need, of factor endowments and of local competitive rivalry. The multi-domestic firm needs to be able to learn from the variety of different environments in which it operates and to transfer knowledge between units.

The distinction between continuous and discontinuous change

Incremental change can be achieved across all multi-domestic locations in a piecemeal fashion. By spreading change over time and different locations, the risk of major discontinuous change would be mitigated and the firm would be protected from the possible adverse effects of this.

The distinction between responding to and selecting an environment

Environments in which to operate can be selected on the criterion of only entering those that offer the potential for competitive advantage.

Achieving competitive advantage

Multi-domestics in which the corporate centre focuses on achieving the four benefits described above may, Yetton et al. (1995) believe, achieve competitive advantage on three counts:

1. Although they may not achieve production scale economies, they do achieve other economies through multiple plant learning.
2. They may also achieve reduced costs of incremental change and reduced risk of careful environment selection.
3. There are also motivational and other benefits from the decoupling of the global functions at the centre from the local ones in the multi-domestic units.

Firms that adopt this organisational form operate in industries where the efficient plant scale is small to medium-sized and therefore the existence of multiple plants in multiple locations does not destroy the possibility of achieving the necessary scale economies.

The other key criterion for success is that local responsiveness does not damage the firms' abilities to achieve global learning or to operate world-wide strategies. As Yetton et al. (1995) put it:

The global component for these firms is the process technology, and not as commonly assumed, the product characteristics. The introduction, maintenance and development of process are co-ordinated and regulated on a global basis, and various mechanisms ensure that the learning that occurs in one location is transferred throughout the network of plants.

Your notes

The argument pursued by Yetton et al. is, then, that multi-domestics are not necessarily firms at an early stage of international evolution, which will later become global or transnational firms. Rather, the multi-domestic is a form that in certain environmental circumstances is one which is competitive as the firm expands globally if certain adjustments are made to the traditionally passive role of the corporate centre to ensure that the identified required benefits are achieved corporation wide.

It is most appropriate in product areas with low tradability, low scale economies and where firms have the option of selecting suitable friendly national environments to roll out a proven formula with low risk.

The role of flexibility in the modern multi-domestic

A third factor needs to be taken note of if the multi-domestic is to be maintained as a modern international organisational form, namely that of flexibility (Buckley & Casson 1998). Administrative heritage plays a large part in the organisational form of large companies, and MNCs are no exception to this. Buckley and Casson discuss the development of new approaches to MNC organisation since the end of the 'golden age', which terminated suddenly with the oil price rise shock of 1973 (Marglin & Schor 1990).

- A new dynamic agenda, they claim, incorporates an understanding of:
- Global market turbulence
- The resultant need for MNC strategic flexibility
- The growth of cooperative strategy
- Entrepreneurship, competences and corporate culture
- Organisational change including mandating subsidiaries and the empowerment of individuals

After 1973 and the second oil price shock in 1978, there was a time lag as MNCs adjusted to the fact that they would be operating in future in a world in which the West had no automatic right to dominance. Subsequently, flexibility, in other words, the ability to reallocate resources quickly in response to change, became the watchword of the 1980s and since.

The main factors responsible for the growth of volatility since the end of the 'golden age' are, Buckley and Casson claim:

- The diffusion of modern production technology and the increase in the number of industrial powers and hence potential sources of political and social disruption.
- The liberalisation of trade and capital markets.
- The improvement of communications that means news travels more quickly.
- The increase in exchange rate volatility, following the breakdown of the international monetary system of fixed exchange rates agreed at Bretton Woods, USA, shortly after the end of World War II.

So every MNC subsidiary experiences more shocks from around the world than in the earlier age, not just from its own national economy but from new import competition, new export competition and new opportunities for co-operation.

Increased flexibility is therefore needed to deal with these shocks. The need for increased flexibility has led to the growth of MNCs with federal structures of operating divisions drawing on a common source of specialist skills but empowered to go outside if it chooses to do so, sometimes leading to a growth

of virtual firms, networks and coalitions. In such developments, the reassertion of the multi-domestic but with modern adjustments is clearly one option, viable so long as the traditional isolation of the units in the form can be overcome. The West has declined partly through industrial over-maturity, but also through loss of comparative advantage in entrepreneurship as a result of inappropriate institutions and culture, Buckley and Casson believe. The increase of global turbulence has emphasised this decline.

The typical US MNC of the golden age was vertically as well as horizontally integrated. The need for flexibility discourages vertical integration since lowest cost (consistent with quality) supply is vital to competitiveness. Open markets both internally and externally have now become more common and managers are able to bypass parts of their own firm thought to be inefficient. So the movement is towards the firm becoming the hub of a network of interlocking joint ventures but the operating parts are still able to tap into headquarters expertise as required.

Further considerations for flexibility

Information also plays an important part in dealing with turbulence.

> Collecting, storing and analyzing information therefore enhances flexibility because, by improving forecasts, it reduces the costs of change. (Buckley & Casson 1998)

Investment in plant must also embody the principle of modularity so that the greatest level of flexibility can be maintained to enhance flexibility.

Organisationally, as turbulence increases, so lateral consultation needs to be increased and the hierarchy flattened, but some hierarchy retained to ensure cohesion of decision-making.

Greater flexibility implies greater costs in promoting a corporate culture that reinforces moral values, Buckley and Casson believe, as much for economic as ethical reasons, since they lead to the justification of the characteristic of trust necessary for operating in the new more loosely bound corporate environment.

Organisational learning is important, but not merely that which improves on existing methods incrementally. The learning that is particularly important is that which consists of techniques for handling volatility. This includes 'unlearning' methods that have served well in the past but are no longer relevant.

> In general the growth of MNCs may be understood as a sequence of investments undertaken in a volatile environment, where each investment feeds back information which can be used to improve the quality of subsequent decisions. In this sense, the expansion of the firm is a path dependent process. (Kogut & Zander 1993)

Regional distribution hubs offer superior flexibility as they provide a compromise location strategy able to deal with situations in which volatile markets lead to varying market demand year on year. An international joint venture strategy combined with a wholly owned regional hub probably offers the best combination of strategies from a flexibility viewpoint. A joint venture-owned hub probably means too great a level of vulnerability to defection by one's partner. An alternative to the local joint venture is, of course, the modern multi-domestic unit reporting to and serviced by the hub.

Achieving optimal performance

Ghoshal and Nohria (1993) emphasise that very closely tailored organisational/environmental fit is necessary for optimal performance, although empirical evidence for this is thin on the ground. A particularly complex environment, as is often found in world markets, therefore needs an organisational structure in an MNC to have a mirrored requisite complexity, so the simplistic models of traditional analysis are only useful in order to explore what specific solu-

tions may be necessary for a particular situation. A multi-domestic form in the modern sense is almost bound to have characteristics of other forms when translated into a real-life situation and will not be the traditional autonomous country unit sharing only a common corporate name with its peers in other countries.

Your notes

How viable is the modern MNC?

The multi-domestic solution to the organisation of the modern MNC is still a viable one in certain circumstances and with certain adjustments to the organisational form from its pure and largely autonomous form.

It is still most appropriate where the most efficient production methods give only limited scale economies, and where local niche demand requires specific locally tailored products or services. However, flexible manufacturing systems and the growth of outsourcing are making scale economies less important than they were in many industries, and only certain industries exhibit global uniformity of tastes. Local cultures remain important in many markets and make the bottom right-hand box of the central integration/local responsiveness matrix, which you examined earlier, a far from empty one.

Where the traditional local autonomy of multi-domestic units can be mitigated successfully by an enhanced role for the centre, the form becomes potentially competitively viable. The centre needs principally to allocate resources effectively, ensure the transfer of skills and new knowledge throughout the group and ensure flexibility of operation, sometimes with the assistance of a regional hub supply centre.

Summary

A corporation will adopt an international strategy if it believes that it can achieve a competitive position on the Customer matrix and the Producer matrix (Bowman & Faulkner 1997) with any of its businesses in the country it decides to target. Use of the Ghoshal strategic objective/competitive advantage organising framework will assist it to take strategic decisions on where to compete, i.e. the selecting task. However, in order to arrive at such a conclusion in this area, the corporation will also need to consider more factors than it would need to consider if it restricted its aspirations to the domestic market, although it will still need to carry out the tasks of promoting, selecting, resourcing and controlling.

In relation to basic costs or potential costs, it will need to carefully consider transport (including insurance) costs and the costs of hedging against the movement of exchange rates. In terms of its overall strength compared with local companies and other international companies operating in the target countries, it will need to evaluate the strength of the various components of its national diamond (Porter 1990); do these give it an advantage or put it at a disadvantage?

It then needs to consider how to configure and coordinate its activities internationally. In order to do this, Dunning's eclectic theorem will assist in determining what activities should be carried out at home and what on foreign soil.

Finally, in coordinating and controlling activities, it will need to consider the steps necessary to become a corporation structured to succeed in a world with increasingly globalised markets, achieving optimal levels of efficiencies, knowledge transfer and local product sensitivities particularly in terms of product adaptation, and review the practicalities and costs involved in such organisational adaptation.

Task ...

Task 13.1

To check your understanding of the material in this topic, try to answer the following questions. If you have any difficulties, you may wish to go back and revise the relevant part of the topic.

1. What is Dunning's eclectic paradigm, and what is its purpose?
2. Why are MNCs generally successful when competing with better networked local companies?
3. What are Vernon's stages of internationalisation for a company?
4. How does the modern view of the growth and development of the MNC differ from the traditional one?
5. What is the international exporter form, and why does this model tend to be transitional?
6. What are the key characteristics of the old-fashioned multi-domestic?
7. What is a modern multi-domestic?
8. Explain the local responsiveness–global integration matrix

Resources

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Topic 14

The Globalisation of the World Economy

Aims

The purpose of this topic is to:

- explain the nature of globalisation;
- show that it applies to both supply and demand sides;
- identify the drivers behind globalisation;
- examine its implication for economies, companies and consumers;
- chart the development of global competition.

Objectives

By the end of this topic you should be able to:

- understand how globalisation has comes about and its implications;
- perceive what effect this has on companies;
- see why it is likely to lead to greater volatility in markets;
- see how in a global industry it is impossible to survive as a purely national producer.

Introduction

Despite the views of the doubters (cf. Rugman 1999) the world is becoming increasingly a global economy. Measured simplistically in terms of the growth in volume of cross-border trade and of foreign direct investment (FDI) the World Trade Organisation (WTO) figures shows these measures to have accelerated dramatically over the last quarter century. Indeed WTO figures (1996) show world trade to have consistently outpaced world output in growth terms since the 1950s. WTO figures (1996) show the ratio of world trade to world output to have increased from 15% in 1974 to 22.5% in 1995. As regards FDI, the United Nations (1996) record a 700% average annual increase from 1984 to 1995 compared with a 24% expansion in world output over that period.

The figures imply that the world economy is becoming more and more interdependent and it is becoming unrealistic to think of national economies as islands unto themselves (Hill 1997). More firms are building global markets for their products, and more firms are dispersing parts of their activities including production to different parts of the world to take advantage inter alia of the best factor costs. As Peter Drucker wrote in the Wall Street Journal in 1987:

> To maintain a leadership position in any one developed country a business increasingly has to attain and hold leadership positions in all developed countries world-wide. It has to be able to do research, to design, to develop, to engineer and to manufacture in any part of the developed world, and to export from any developed country to any other. It has to go transnational.

And this was before the term globalisation came into vogue.

The pattern of trade growth and investment in the process of globalisation is not of course uniform. The FDI outflows are still largely from the developed nations; US, UK, Germany, Japan and France. These countries, particularly the US, the UK and France also benefit most from FDI inflows, and whole areas of the globe get routinely neglected, for example Africa. However, increasingly newly developing nations are appearing as recipients of FDI, notably China, Mexico, Indonesia and Malaysia. This may well be indicative of future trends. With the recent entry of Eastern European nations to the EU, an increase in FDI to those countries in the near future may well be anticipated.

Hill (1997) emphasises that these globalising developments have been facilitated by the almost universal acceptance by trading nations that a liberal international trading regime improves world standards of living, as opposed to the views of the protectionist regimes of earlier times. This philosophy has been encouraged by GATT (The General Agreement of Tariffs and Trade) and its successor the WTO with the result that tariff barriers at least between developed nations have fallen dramatically. The establishment of the major geographical free trade areas, for example the EU, have greatly facilitated this trend.

Globalisation and the New Competitive Landscape

As Child, Faulkner and Pitkethly (2001) put it, "Globalization is the key feature of the new competitive landscape". It is important to bear in mind, however, that globalisation is a trend and not necessarily an already extant condition. As Guillen (2001) points out, many unsubstantiated and sweeping claims have been made about globalisation, and we should treat these with caution.

In particular, globalisation is not spreading evenly across the globe and it is more evident in certain areas of activity than in others (Castells 1996). Secondly, most cross-border integration, through both investment and trade, is actually focused on regional trade blocks (Rugman 2000). We shall therefore use the term 'globalisation' to refer to the trend towards cross-border econom-

Your notes

Quick summary

Globalisation and the new competitive landscape

- "Globalization is the key feature of the new competitive landscape."
- In particular, globalisation is not spreading evenly across the globe and it is more evident in certain areas of activity than in others
- Globalisation is taking place through the international expansion of markets, through the impact of new communication technologies, and through growing economic interdependence with the liberalisation of revenue, capital and trade flows across borders.
- Globalisation is associated in many people's minds with a growing convergence in economic systems, cultures and management practices.

ic and technological integration.

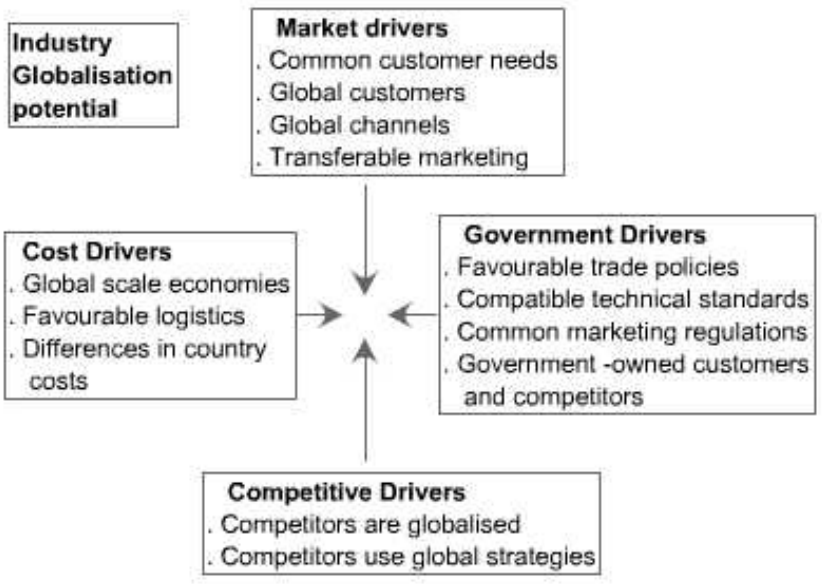
Globalisation has been applied in a variety of ways to describe how the traditional divisions between world markets based on culture and taste are observed to be in decline as communications have improved, and as national trade barriers have been steadily falling through the activities of the World Trade Organization and regional agreements. Globalisation is taking place through the international expansion of markets, through the impact of new communication technologies, and through growing economic interdependence with the liberalisation of revenue, capital and trade flows across borders. Globalisation is therefore associated in many people's minds with a growing convergence in economic systems, cultures and management practices.

As Govindarajan and Gupta (1998) point out, globalisation can be defined in terms of different levels of focus.

1. At a worldwide level, it refers to a growing economic interdependence among countries that is reflected in increasing cross-border flows of goods, services, capital and know-how.
2. At the second level, globalisation refers to the inter-linkages a specific country has with the rest of the world, or the extent to which the competitive position of companies within a specific industry is interdependent with that of companies in other countries.
3. The third level is that of an individual company. Here, globalisation refers to the extent to which a company has expanded its revenue and asset base across countries and engages in cross-border flows of capital, goods and know-how across subsidiaries. The expansion of its revenue and asset base through international M&A increases the globalisation of the acquiring company.

Globalisation Drivers

Today, a global imperative extends beyond developing countries to encompass the emerging markets of transition and developing countries. Given this strategic requirement and the time pressures to achieve it quickly, acquisitions often appear more attractive than arms-length arrangements for purposes of strategic positioning and synergy capture. The homogenisation of markets, and advances in IT support, are also expected to facilitate problems of managing the larger units created by M&A. International acquisitions are therefore seen to be inevitable in order to respond to the increasingly powerful drivers of globalisation. These are market drivers, cost drivers, competitive drivers and government drivers (Yip, 1992).



Quick summary

Globalisation drivers

- The homogenisation of markets, and advances in IT support, are also expected to facilitate problems of managing the larger units created by M&A.
- International acquisitions are therefore seen to be inevitable in order to respond to the increasingly powerful drivers of globalisation. These are market drivers, cost drivers, competitive drivers and government drivers.

Your notes

Different industries of course have different levels of globalisation potential. Yip (1988) identifies what he nominates as the globalisation drivers in Figure 14.1.

On the following pages, we will now examine each of these globalisation drivers in more detail, as interpreted by Child, Faulkner and Pitkethly (2001).

Market drivers

Market drivers are the growth of common customer needs, the emergence of global customers, the development of global channels of distribution, and of marketing approaches that are transferable across cultural and geographical boundaries. Levitt (1983) forecast the convergence of markets as a result of the development of economic and socio-cultural interdependencies across countries and economies. He argued that the new communication technologies are key to the growing homogenisation of markets, reducing social, economic and cultural differences, including old-established differences in national tastes or preferences. This process has forced companies to respond to growing similarities between consumer preferences. He also said quite simply that, if you can make a cheaper better product, cultural barriers will not prevent it becoming acceptable world-wide. The international success of the Japanese consumer electronics industry appears to support this claim.

There has been a long-standing debate about whether global markets are developing as tastes converge across the globe in a widening range of industries. Examples of such convergence include McDonald's burgers, designer jeans, and Coca-Cola. The debate centres on the desirability of standardisation of products or services for broadly defined international market segments. This belief in a homogenisation of tastes coexists with the view that fragmentation may more appropriately describe the trend in international consumer demand. A great deal of discussion has taken place over the opportunities for, and barriers to, such standardisation (Kotler 1985; Quelch & Hoff 1986; Alden 1987; Douglas & Wind 1987).

The argument for global markets does not, however, necessarily signify the end of market segments. It can mean instead that they expand to worldwide proportions. The retail chain Benetton has built its whole strategy on these assumptions. In Benetton there is some adaptation of such things as colour choice for different domestic markets, but such adaptation occurs around the standardised core of Benetton's 'one united product' for its target market segment worldwide. It sells 'active leisurewear' globally to 15- to 24-year-olds.

The impact of branding

Cross-border M&A provides many opportunities for achieving economies of scope from global marketing strategies. Branding provides a useful illustration of this potential. An increasing number of multinational corporations (MNCs) are standardising their brands to send a consistent worldwide message and take greater advantage of media opportunities by promoting one brand, one packaging and uniform positioning across markets. Rather than a patchwork quilt of local brands in local markets, the owners of international brands increasingly favour simplified international brand portfolios. Many local brands have been developed by high advertising spend over years and have established strong intangible switching costs among their local population. Despite this, they are likely to die in the face of a determined global brand assault.

Focusing on fewer strong brands is seen as the best way of addressing fierce competition from other brands and private-label products, as well as getting the best value from expensive investments in advertising. Another way in which brand globalisation is being felt is in the branding of companies themselves; a trend observable as companies become established as MNCs rather than just domestic market champions. Names that are felt to be too parochial or nationalistic are made more universally acceptable.

Examples

Obvious candidates for such treatment have been previously state-owned enterprises, so that British Telecommunications became BT, British Petroleum became BP and the Korean chaebol Lucky Goldstar became the internationally unexceptionable LG. Similarly, the name AXA was chosen to cloak the French origin of this insurance MNC and thereby make it more regionally and globally acceptable. This is the likely fate of many UK companies acquired by foreign multinationals.

Cost drivers

Globalisation offers the advantage of economies of scale and standardisation even for a segmented marketing strategy. In advertising costs, for example, PepsiCo's savings from not producing a separate film for individual national markets has been estimated at $10 million per year. This figure is increased when indirect costs are added, for instance the speed of implementing a campaign, fewer overseas marketing staff, and management time which can be utilised elsewhere.

International standardisation of activities is established by practitioners at points in their value chain where advantages can be derived, even though there may not be a global operation across all functions. Benefits are possible from globalisation in any or all of the following:

- Design
- Purchasing
- Manufacturing operations
- Packaging
- Distribution
- Marketing
- Advertising
- Customer service
- Software development

Globalisation makes possible standardised facilities, methodologies and procedures across locations. Companies may be able to benefit even if they are able to reconfigure in only one or two of these areas. Potential cost advantages such as these are an important incentive to undertake cross-border M&As.

Competitive drivers

Yip (1992) identifies competitive drivers as the movement of competitor companies to compete world-wide rather then purely nationally, and their ability to develop global strategies. The extent of international consumer homogeneity is a central issue affecting the economics of all industries and therefore the most viable strategies of firms competing within those industries.

While there has been a clear trend towards world trade liberalisation and the freer international movement of capital and technology, the thesis that competitive arenas are becoming more global is more questionable. The belief in consumer homogeneity is controversial and probably overstated. In many sectors, significant differences still exist between groups of consumers across national market boundaries and it has been argued by managers and academics alike (Kotler 1985; Alden 1987; Douglas & Wind 1987; Makhija et al. 1997) that the differences both within and across countries are far greater than any similarities.

Secondly, there has been a growth of intra-country fragmentation, leading to increased segmentation of domestic markets.

Thirdly, developments in factory automation allowing flexible, lower cost, lower volume, high variety operations are challenging the standard assumptions of scale economy benefits by yielding variety at low cost. It can be argued therefore that such an approach to global strategies is over-simplified, focus-

Your notes

ing on the benefits of standardisation when the emphasis internationally is more complex, often encompassing global, regional and local approaches simultaneously.

Glocalisation

A contingent approach has long been recommended to allow flexibility between the two extremes of full global standardisation and complete local market responsiveness. Indeed, the two may be used simultaneously to achieve the advantages to be had from global structuring of part of the product/service offering, whilst adapting or fine-tuning other parts of the same offering to closely match the needs of a particular local market. This process of combining the advantages of both global and local operations has become known as glocalisation.

The experience of KFC

The experience of Kentucky Fried Chicken (KFC), an American international fast food chain, illustrates the point. After its initial entry into the Japanese market, KFC soon realised the need to make three specific changes to its international strategy:

1. First, the product was of the wrong shape and size, since the Japanese prefer morsel-sized food.
2. Second, the locations of the outlets had to be moved into crowded city eating areas and away from independent sites.
3. Third, contracts for supply of appropriate quality chickens had to be negotiated locally, although KFC provided all technical advice and standards.

Following these adaptations of product and site, KFC has been successful in Japan. Similarly, McDonald's hamburger restaurants now serve Teriyaki burgers in Tokyo and wine in Lyon. Each of these local market adaptations of the core offering was critical to success, with the global strategy remaining unchanged in its essentials. It is debatable therefore to what extent these companies are pursuing 'global' or 'regional' strategies.

Whether competitive drivers are thought to be global, regional or national has considerable implications for a company's post-acquisition policy. A perception that the company's competitive arenas are global, or at least regional, in scope should encourage it to integrate acquired companies to ensure their maximum conformity and contribution to a common strategy. By contrast, a perception that the company's competitive arenas are nationally or even intra-nationally segmented is consistent with a policy of low post-acquisition integration, in order to allow the new subsidiary to extend the company's competitive portfolio into a market and area of competence distinct from its existing ones.

Government drivers

The most significant advantages of global trading are probably those associated with the size and spread of operations. Economies of scope and scale allow for greater efficiency in current operations (Chandler 1990). Economies of scale provide not just lower unit costs, but also potentially greater bargaining power over all elements in the company's value chain. Economies of scope can allow for the sharing of resources across products, markets and businesses. Such resources may be both tangible, such as buildings, technology or sales forces, or intangible, such as expert knowledge, team-working skills and brands.

Governments have come to recognise these economies, and they have become an important force in the liberalisation of trade policies across the developed world. Protectionist governments employing anything other than the infant industry argument are nowadays in a minority. Most accept, at least in principle, the freer trade argument and its potential benefits. As Yip (1992) observes, this

has led to the development of compatible technical standards across countries, together with common marketing regulations and a world-wide movement by governments to reduce trade barriers such as tariffs and quotas, with the aim of encouraging world trade and hence globalisation. This may well be the most significant overall driving force behind the acceleration of international M&A, as we will see on the next screen.

Your notes

The contribution of international M&As

International M&As contribute towards globalisation as well as being a response to it. There is a continuing interaction between the liberalisation of trade and capital flows and the internationalisation of production that is at the core of the globalisation process. The internationalisation of production is advancing mainly through M&As and strategic alliances. MNCs are key players in this process. They have pressed strongly for trade liberalisation, and they have endeavoured to take advantage of new global opportunities in markets, sourcing and innovation.

Multinationals are particularly concerned to secure a strategic and competitive position within the global economy. In almost every area of economic activity, corporations are now scrambling to establish themselves as global oligopolists. In this frantic race, various forms of integration with other companies offer the most rapid means for MNCs to move towards their strategic objective – through alliances, mergers and acquisitions. The extent to which these corporations can secure an oligopolistic position through M&As varies greatly according to the number of new entrants and the pace at which new technology platforms are being introduced; there has been far less concentration in the knowledge-based sectors than in traditional manufacturing industries. Nonetheless, the opprobrium that attaches to oligopoly recalls the fact that acquisitions today are judged as much by their social effects as by the returns they promise to shareholders.

Thus an industry is more likely to become global if the four types of Yip driver point it in that direction. The market drivers need to show some convergence both in national tastes and in the distribution infrastructure that enables the product to be delivered to the market. The cost drivers need to enable economies of scale to be achieved. The competition also needs to be globalising in its operations, and the various governments need to have globalisation and compatibility of standards and technologies as priorities in its statutory trade regulations and objectives.

Angwin's globalisation drivers

Angwin (2002) takes a similar approach in identifying the drivers of globalisation. He identifies four areas in which the drivers are to be found:

1. Political
2. Technology
3. Social
4. Competitive factors

The current political factors are the global drive towards free trade seen in the activities of the WTO, the EU, and other free trade areas. The social factors are the convergence of tastes, the increase in travel, the influence of TV and movies particularly in spreading the US culture, the development of global brands like Levis or Coca Cola, and what he terms the 'californiasation' of society. Other factors are the prevalence of high technology and 'low' culture spreading around the world, and the ability of VCRs, PCs, mobiles, and digital cameras to aid this spread.

Angwin's third driver is technology itself, seen not only in its miniature 'gadgets' but in improved costs of transport and communication. Modern technology also leads to the cost economies of scale that result from selling on a global

scale, which in turn encourages a wide public to develop a taste for particular hi-tech products.

Finally there are the competitive factors that become increasingly important as more and more industries become oligopolistic, and size becomes increasingly a passport to power and success. In an increasing number of industries concentration is increasing and global competitors are dominating to the exclusion of smaller local operators.

The Globalisation of the World Economy

Many current authors claim to identify a fundamental change in the world economy, rather like the punctuated equilibrium (Tushman & Anderson 1987) of technology change. It has been depicted by Dicken (1992) as Global Shift. Although few would claim total globalisation of tastes, it cannot be contested that the products of Coca Cola, Levi jeans, the Sony Walkman and McDonalds hamburgers have a substantial market in all parts of the world. The world of converging tastes has moved on from the late 1980s when it could be claimed that no more than 8% of products were truly global (Faulkner 1993).

As Hill (1997) puts it:

> Two factors seem to underlie the trend towards globalisation of markets and production. The first is the decline in barriers to the free flow of goods, services and capital that has occurred since the end of World War II. The second factor is the dramatic developments in communication, information, and transportation technologies in the same period.

Technological change

"Whereas the lowering of trade barriers made globalisation of markets and production a theoretical possibility, technological change made it a tangible reality" (Hill 1997).

The micro-processor

The micro-processor enabled cheap, reliable and rapid communication on a global basis, thereby enabling the costs of coordinating and controlling a global organisation to plummet. Differences of taste and culture have no impact where modern technology is concerned. A micro-processor in Japan is the same (alphabet excluded) as one in America or Europe. In this area therefore the tension between local responsiveness and global integration cease to be important, and the maximum economies of scale can be achieved and the lowest prices, thereby setting up a virtuous circle. More microprocessors means lower prices hence better communications and then even lower prices and higher effectiveness. Moore's law says that the power of micro-processor technology doubles every eighteen months and its costs of production halves.

The Internet and the World Wide Web (www)

In 1990 there were under 1 million users of the www. By 2000 there were over 100 million and rising. There is now virtually no factual information that a powerful search engine like Google cannot retrieve in a matter of seconds. The world and its decision-takers have gone from having insufficient information, to having an excess of it in less than a decade. The problem has gone from being unable to find something out, to the difficulty in sifting all the information to discover the key bits. As a result a truly global market-place for all kinds of goods and services is thereby created. Not only is such a market-place created but the means is provided to service it as a result of cheap effective communication technology. Just as it is difficult to find anyone without a mobile phone today, it is equally difficult to find someone without an email address.

Transportation technology

Quick summary

The globalisation of the world economy

- Many current authors claim to identify a fundamental change in the world economy, rather like the punctuated equilibrium of technology change. It has been depicted by Dicken as Global Shift.
- Although few would claim total globalisation of tastes, it cannot be contested that the products of Coca Cola, Levi jeans, the Sony Walkman and McDonalds hamburgers have a substantial market in all parts of the world.
- The world of converging tastes has moved on from the late 1980s when it could be claimed that no more than 8% of products were truly global.

The previous two points illustrate modern technology in miniaturising mode. In transportation the technology is at the other extreme. Jumbo-jets can carry large numbers of people around in no more than a day. This causes markets to converge as more people see how others live and makes production coordination easier as producer executives fly to visit their global subsidiaries.

Your notes

The components of globalisation

Eden identifies three main components of globalisation (Eden 1991, p. 213).

1. The first is described as convergence, the trend for underlying production, financial and technology structures to approach a common average standard. O'Doherty refers to this simply as 'the development of world markets, regulated by universal standards' (O'Doherty 1995, p. 15).
2. The second component is synchronisation, the increasing tendency for the Triad economies (EU, North America and Japan) to move in tandem, experiencing similar business cycle patterns.
3. The final element delineated by Eden is interpenetration. This refers to the growing importance of trade, investment, and technology flows within each domestic economy.

Globalisation is manifest through the rapid growth in international trade and international financial flows; as well as the way in which economic booms spread more readily from one country to another, as do recessions. Moreover, interest rates in one economy may now affect investment in others (The Economist, 7 October 1995, p. 15). It is also manifest through the growing incidence of mergers and acquisitions and of strategic alliances.

New jargon of international economic shifts

International economic shifts always tend to be accompanied by new jargon. The relative shift in power to East Asia during the 1980s and 1990s has thus been conceptualised through the idea of globalisation. Witness this joint statement from the Chairman and President of the Toyota Motor Corporation, presenting their idea of the 'global village':

> This is our town. It's the global village. We live here, you do too. We're neighbours. We will do our part to bring the world together by building up the global auto industry. This means that we will build major plants everywhere we can. And more, that we will do all we can to foster the development of our local parts suppliers. And of their suppliers. And of theirs. By helping in this way to create an auto infrastructure around the world, we will be helping to create the conditions for widespread prosperity.

Globalisation and its effect on state power

Globalisation has undoubtedly enfeebled the state – significantly limiting the economic sovereignty of countries. As a former UK Chancellor of the Exchequer put it:

> The plain fact is that the nation state as it has existed for nearly two centuries is being undermined … the ability of national governments to decide their exchange rate, interest rate, trade flows investment and output has been savagely crippled by market forces. (Nigel Lawson, The Economist, 7 October 1995)

Transnational corporations (TNCs or MNCs) are the engineers or agents of increased international interdependence, and thus, the systemic actors most accountable for the weakening of state power in the global economy. TNCs now dominate all the underlying structures and substructures of the global economy: production, finance, technology, security, energy and trade. As John Kenneth Galbraith (1973) has argued, transnational corporations – not markets – control the way in which the flow of capital, finance, products, and technol-

ogy crosses national boundaries.

Approaches to globalisation

To summarise this section, you can see that to develop a typology of globalisation is a complex matter. Globalisation affects most, if not all, aspects of society, culture, business, and politics. In this topic, we are emphasising those manifestations which impinge directly on the activities of companies.

We can categorise the different approaches to globalisation as:

1. The globalisation of finances – deregulation of national financial markets and subsequent internationalisation of capital flows.
2. The globalisation of competition and of the firm – geographical shifts in the world economy and the changing organisation of international companies.
3. The globalisation of technology – the role of technology (especially IT) in integrating national economies and corporate activities.
4. The globalisation of regulatory capabilities – nation states losing power to the international system.
5. The globalisation of tastes and markets.

Whilst acknowledging the importance of all five approaches listed above, this topic is concerned specifically with strategic management. As such, we have focused on the second globalisation approach, i.e. the globalisation of competition and of the firm.

The Emergence of Global Competition

In this topic it is important to distinguish between the existence of a global economy and global competition on the one hand, and of global companies on the other. We have already discussed the notion of a global economy. Global competition, by distinction, may be described simply as:

> Global competition exists when competitive conditions across national markets are linked strongly enough to form a true international market and when leading competitors compete head-to-head in many different countries. (Thompson & Strickland 1993, p. 136)

In a globally competitive industry, a company's competitive position in one country both affects and is affected by its position in other countries. In global competition, a firm's overall competitive advantage grows out of its entire world-wide operations (Thompson & Strickland 1995, p. 136). Some examples of industries where global competition exist include automobiles, consumer electronics, commercial aircraft, photocopiers, semiconductors, and telecommunications equipment.

Certain industries can have segments which are globally competitive and segments which compete only within specific nations. An example would be the hotel industry, where the low to medium priced end of the spectrum is generally characterised by single country competition, whereas the business and luxury end of the market incurs more global competition.

The global corporation

By the end of the 1970s, the ongoing economic recession, continuing restructuring efforts, runaway investments from the main industrialised economies, and the rise of the newly industrialising countries (NICs), all implied that the simple logic and explanatory power of Vernon's product life-cycle theory (see Topic 13) came under increasing criticism. The assumption that products are essentially independent of each other, and that every innovation would lead to an entirely new product life-cycle, became increasingly difficult to hold. Fur-

Quick summary

The emergence of global competition

- In a globally competitive industry, a company's competitive position in one country both affects and is affected by its position in other countries. In global competition, a firm's overall competitive advantage grows out of its entire world-wide operations
- Certain industries can have segments which are globally competitive and segments which compete only within specific nations.

thermore, the difference between 'high'-tech industries or products (located at the first part of the product life-cycle) and 'low'-tech or 'mature' industries was often very difficult to establish.

For example, supposedly mature sectors such as the car industry have continued to serve as a testing ground for new product and process technologies. This led to the emergence of several new models of internationalisation, which tackled internationalisation from the perspective of the company rather than from one product. Some authors argued that the global corporation was emerging:

> The new global corporation is the result of the complex process of interlocking between the relatively autonomous development sequences of subsidiaries, branches and affiliates, especially as multinationals acquire foreign and domestic firms that themselves have foreign subsidiaries, branches, and affiliates. Some multinationals therefore grow into quite formidably complex international economic networks. (Taylor & Thrift 1982).

Emerging from this discussion is a simplistic definition of a global company as a firm able to manufacture its goods wherever it can find the best combination of price and quality, and distribute them wherever it can discover or create a demand. The concept of 'world production centres' was coined to encapsulate this type of activity. The problem with such definitions of a global company is the tendency to over-emphasise corporate structure and organisation as the basis for creating a global company and under-emphasise ownership, management culture and other key variables in the strategy-making process. To be a truly global company, a firm must globalise more than just its production and distribution systems.

Strategy making in the global company

Strategy making is about changing perspectives and/or positions. Internationalisation – the process of increasing involvement in international operations across borders – comprises both changed perspectives and changed positions. Thus, internationalisation is a major dimension of the ongoing strategy process for most business firms. The forces driving firms to globalise are multifarious, emanating from a combination of industry and market pressures, government deregulation policies, and internal cost recovery and cost reduction motives (Figure 8.2).

Companies of all sizes and in most industries are experiencing one or more of the above pressures to globalise their enterprise. How the way they pursue this strategy varies, and there is no one right way to proceed.

Ellis and Williams (1995, pp. 308–309) contend that to manage a company on an integrated global basis, it is necessary to reshape the organisation along three dimensions:

1. Product
2. Geography
3. People/process

if global competitive advantage is to be exploited.

The global player has the opportunity to integrate and coordinate business functions across multiple regions/countries and draw on people/processes in a fashion unmatched by a business operating at an earlier stage of international business development. The internationalisation process is a gradual development, taking place over a relatively long period of time.

Your notes

Summary

Globalisation, however defined, signifies the increasing homogenisation of the commercial world and the diminishing importance of distance. Global organisation structures and global markets and tastes are therefore appearing in an increasing number of industries. This gives rise to many cost economies of scale. In some areas localisation is still important, and not all products can be successfully standardised. The global corporation has inevitably evolved on the commercial scene. The emergence of the transnational N form is less inevitable, and is most likely to survive where it does emerge in the service rather than the manufacturing sector where flexibility of production is easier to achieve.

Task ...

Task 14.1

To check your understanding of the material in this topic, try to answer the following questions. If you have any difficulties, you may wish to go back and revise the relevant part of the topic.

1. What is Dunning's eclectic paradigm, and what is its purpose?
2. Why are MNCs generally successful when competing with better networked local companies?
3. What are Vernon's stages of internationalisation for a company?
4. How does the modern view of the growth and development of the MNC differ from the traditional one?
5. What is the international exporter form, and why does this model tend to be transitional?
6. What are the key characteristics of the old-fashioned multi-domestic?
7. What is a modern multi-domestic?
8. Explain the local responsiveness–global integration matrix

Resources

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Topic 15

The Global and Transnational Organisational Forms

Aims

The purpose of this topic is to:

- chart the emergence of the global corporation;
- show its limitations in terms of local responsiveness;
- illustrate how the transnational form can overcome some of those limitations;
- in turn illustrate the problems of the transnational;
- show how networks now strongly inform international organisations.

Objectives

By the end of this topic you should be able to:

- distinguish between economic globalisation and corporate globalisation;
- define and distinguish between different forms of international business structures;
- establish the differences between multi-domestic (multinational) and globalisation strategy;
- advance competing views of globalisation strategy;
- consider the implementation of effective globalisation strategy;
- discuss the cultural dimension of globalisation;
- describe the nature of the transnational corporation.

Introduction

It is vital from the outset of this topic to differentiate between the globalisation of economic activity and production structures on the one hand, and the globalisation of corporate strategy on the other. If the former has occurred, it does not necessarily follow that the latter has or will also.

'Globalisation' is a much-used but often ill-defined concept. It is both vaguely and diversely interpreted.

The Globalisation of the World Economy

Eden identifies three main components of globalisation (Eden 1991, p. 213).

- The first is described as convergence, that is the trend for underlying production, financial and technology structures to approach a common average standard. This may be referred to simply as 'the development of world markets, regulated by universal standards'.
- The second component is synchronisation, i.e. the increasing tendency for the Triad economies (EU, North America and Japan) to move in tandem, experiencing similar business cycle patterns.
- The final element delineated by Eden is interpenetration. This refers to the growing importance of trade, investment and technology flows within each domestic economy.

Globalisation is manifest through the rapid growth in international trade and international financial flows, as well as the way in which economic booms spread more readily from one country to another, as do recessions. Moreover, interest rates in one economy may now affect investment in others (The Economist, 7 October 1995, p. 15). It is also manifest through the growing incidence of mergers and acquisitions and of strategic alliances.

International economic shifts always tend to be accompanied by new jargon. The relative shift in power to East Asia during the 1980s and 1990s has thus been conceptualised through the idea of globalisation. Witness this joint statement from the Chairman and President of the Toyota Motor Corporation, presenting their idea of the 'global village':

> This is our town. It's the global village. We live here, you do too. We're neighbours. We will do our part to bring the world together by building up the global auto industry. This means that we will build major plants everywhere we can. And more, that we will do all we can to foster the development of our local parts suppliers. And of their suppliers. And of theirs. By helping in this way to create an auto infrastructure around the world, we will be helping to create the conditions for widespread prosperity.

Globalisation and the weakening of state power

Globalisation has undoubtedly enfeebled the state – significantly limiting the economic sovereignty of countries. As Nigel Lawson, a former UK Chancellor of the Exchequer, put it:

> The plain fact is that the nation state as it has existed for nearly two centuries is being undermined…the ability of national governments to decide their exchange rate, interest rate, trade flows investment and output has been savagely crippled by market forces. (Nigel Lawson, The Economist, 7 October 1995)

Multinational corporations (MNCs) are the engineers or agents of increased international interdependence, and thus the systemic actors most accountable for the weakening of state power in the global economy. MNCs now dominate all the underlying structures and substructures of the global economy: produc-

Quick summary

The Globalisation of the world economy

- Three main components of globalisation
  - convergence
  - synchronisation
  - interpenetration
- Globalisation is manifest through the rapid growth in international trade and international financial flows, as well as the way in which economic booms spread more readily from one country to another, as do recessions.
- International economic shifts always tend to be accompanied by new jargon.

tion, finance, technology, security, energy and trade. As John Kenneth Galbraith (1973) has argued, MNCs – not markets – control the way in which the flow of capital, finance, products and technology crosses national boundaries.

To develop a typology of globalisation is a complex matter. Globalisation affects most, if not all, aspects of society, culture, business and politics. For the purposes of this topic, we will emphasise those manifestations that impinge directly on the activities of companies. Look at Figure 15.1 to see how to categorise the different approaches to globalisation.

The globalisation of finances – deregulation of national financial markets and subsequent internationalisation of capital flows.

The globalisation of competition and of the firm – geographical shifts in the world economy and the changing organisation of international companies.

The globalisation of technology – the role of technology (especially IT) in integrating national economies and corporate activities.

The globalisation of regulatory capabilities – nation states losing power to the international system.

The globalisation of tastes and markets.

Whilst acknowledging the importance of all five approaches listed in Figure 15.1, this topic is concerned specifically with strategic management. As such, we will focus on the second globalisation approach, i.e. the globalisation of competition and of the firm.

The Emergence of Global Competition

In this topic, it is important to distinguish between the existence of a global economy and global competition on the one hand, and of global companies on the other. We have already discussed the notion of a global economy. Global competition, by distinction, may be described simply as:

> Global competition exists when competitive conditions across national markets are linked strongly enough to form a true international market and when leading competitors compete head-to-head in many different countries. (Thompson & Strickland 1993, p. 136)

In a globally competitive industry, a company's competitive position in one country both affects and is affected by its position in other countries. In global competition, a firm's overall competitive advantage grows out of its entire worldwide operations (Thompson & Strickland 1993, p. 136). Some examples of industries where global competition exist include automobiles, consumer electronics, commercial aircraft, photocopiers, semiconductors and telecommunications equipment.

Certain industries can have segments that are globally competitive and segments that compete only within specific nations. An example would be the hotel industry, where the low- to medium-priced end of the spectrum is generally characterised by single-country competition, whereas the business and luxury end of the market incurs more global competition.

Defining a global company

By the end of the 1970s, the ongoing economic recession, continuing restructuring efforts, runaway investments from the main industrialised economies and the rise of the newly industrialising countries (NICs) all implied that the simple logic and explanatory power of Vernon's product life-cycle theory came

Quick summary

The emergence of global competition

- In this topic, it is important to distinguish between the existence of a global economy and global competition on the one hand, and of global companies on the other.
- In a globally competitive industry, a company's competitive position in one country both affects and is affected by its position in other countries.
- Certain industries can have segments that are globally competitive and segments that compete only within specific nations.

under increasing criticism. The assumption that products are essentially independent of each other, and that every innovation would lead to an entirely new product life-cycle, became increasingly difficult to hold. Furthermore, the difference between 'high'-tech industries or products (located at the first part of the product life-cycle) and 'low'-tech or 'mature' industries was often very difficult to establish. For example, supposedly mature sectors such as the car industry have continued to serve as a testing ground for new product and process technologies.

This led to the emergence of several new models of internationalisation, which tackled internationalisation from the perspective of the company rather than from one product. Some authors argued that the global corporation was emerging:

> The new global corporation is the result of the complex process of interlocking between the relatively autonomous development sequences of subsidiaries, branches and affiliates, especially as multinationals acquire foreign and domestic firms that themselves have foreign subsidiaries, branches, and affiliates. Some multinationals therefore grow into quite formidably complex international economic networks. (Taylor & Thrift 1982)

Emerging from this discussion is a simplistic definition of a global company as a firm able to manufacture its goods wherever it can find the best combination of price and quality, and distribute them wherever it can discover or create a demand. The concept of 'world production centres' was coined to encapsulate this type of activity.

The problem with such definitions of a global company is the tendency to over-emphasise corporate structure and organisation as the basis for creating a global company and under-emphasise ownership, management culture and other key variables in the strategy-making process. To be a truly global company, a firm must globalise more than just its production and distribution systems. Indeed a truly global company by our definition must provide a range of global products with little differentiation in offering by country (e.g. Gillette razor blades).

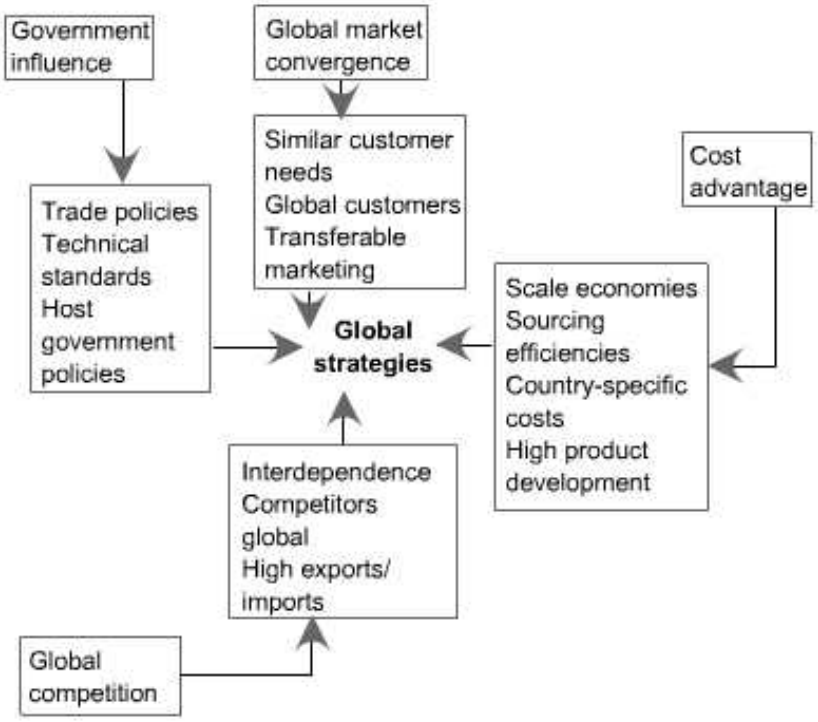
The drivers of globalisation

Strategy making is about changing perspectives and/or positions. Internationalisation – the process of increasing involvement in international operations across borders – comprises both changed perspectives and changed positions. Thus, internationalisation is a major dimension of the ongoing strategy process for most business firms. The forces driving firms to globalise are multifarious, emanating from a combination of industry and market pressures, government deregulation policies, and internal cost recovery and cost reduction motives. See Figure 15.2 for an illustration.

Ellis and Williams (1995, pp. 308–309) contend that to manage a company on an integrated global basis, it is necessary to reshape the organisation along three dimensions – product, geography and people/process – if global competitive advantage is to be exploited. The global player has the opportunity to integrate and coordinate business functions across multiple regions/countries and to draw on people/processes in a fashion unmatched by a business operating at an earlier stage of international business development. The internationalisation process is a gradual development, taking place over a relatively long period of time.

Companies of all sizes and in most industries are experiencing one or more of the above pressures to globalise their enterprise. The way they pursue this strategy varies and there is no one right way to proceed.

Your notes



Source: Based on Yip (1992).

Multi-Domestic versus Globalisation Strategy

When competing internationally, larger companies are generally confronted with a choice between pursuing a multi-domestic or a global strategy. As a rule of thumb, a multi-domestic strategy is appropriate for industries where multi-country competition dominates; a global strategy is most effective in markets that are globally competitive or beginning to globalise (Thompson & Strickland 1993, p. 138).

Figure 15.3 advances some clear differences between, and cases for and against, multi-country (multi-domestic/multinational/transnational) strategy and global strategy. A global corporation is more appropriate where there are major scale economies to be achieved from standardised products.

	Multi-country strategy	Global strategy
Strategic arena	Selected target countries and trading areas	Most countries that constitute critical markets for the product or service
Business strategy	Custom strategies to fit the circumstances of each host country situation; little or no strategy coordination across countries	Same basic strategy worldwide; minor country-by-country variations where essential
Product-line strategy	Adapted to local needs	Mostly standardised products or services sold worldwide

Quick summary

The financial mechanics

- When competing internationally, larger companies are generally confronted with a choice between pursuing a multi-domestic or a global strategy. As a rule of thumb, a multi-domestic strategy is appropriate for industries where multi-country competition dominates; a global strategy is most effective in markets that are globally competitive or beginning to globalise

Production strategy	Plants scattered across many host countries	'World production centres' – plants located on the basis of wherever the firm can find the best combination of price, quality and favourable structural conditions
Sources of supply for raw materials and components	Suppliers in host countries preferred (local facilities meeting local buyer needs)	Attractive suppliers from anywhere in the world
Marketing and distribution	Adapted to practices and culture of each host country	Much more worldwide coordination; minor adaptation to host country situations if required
Company organisation	Form subsidiary companies to handle operations in each host country; each subsidiary operates more or less autonomously to fit host country conditions	All major strategic decisions are closely coordinated at global headquarters; a global organisational structure is used to unify the operations in each country

*Source: **adapted from Thompson and Strickland (1993, p. 139).***

The more diverse national market conditions are, the stronger the case is for a multi-domestic strategy. However, whenever national differences are relatively insignificant and can be fairly easily accommodated within the context of a global strategy, such an approach is preferable because of its broader-based competitive advantage potential. With global strategy, a firm can pursue sustainable competitive advantage by locating activities in the most cost- and location-advantageous countries, and coordinating strategic actions worldwide; a domestic-only competitor forfeits such opportunities.

To substantiate this comparison, Rodrigues (1996, p. 100) advances six tangible advantages of global strategy over multi-domestic strategy.

- First, by pooling production or other activities for two or more nations, a firm can increase the benefits derived from economies of scale.
- Second, a company can cut costs by moving manufacturing or other activities to low-cost countries.
- Third, a firm that is able to switch production among different nations can reduce costs by increasing its bargaining power vis-à-vis suppliers, workers and host governments.
- Fourth, by focusing on a smaller number of products and programmes than under a multi-domestic strategy, a corporation is able to improve both product and programme quality.
- Fifth, worldwide availability, serviceability and recognition can increase preference through reinforcement.
- Finally, the company is provided with more points from which to attack and counter-attack competition.

Globalisation strategy: a US interpretation

Theodore Levitt of Harvard Business School was one of the first to use the term 'globalisation'. Globalisation in his view would lead to:

Your notes

> The emergence of global markets for standardised consumer products, enabling firms to benefit from enormous economies of scale in production, distribution, marketing, and management … The global corporation operates with resolute constancy – at relatively low cost – as if the entire world were a single entity; it sells the same things in the same way everywhere. (Levitt 1983)

The above factors are the reasons for a firm choosing to pursue a globalisation strategy. Such interpretations of corporate globalisation emphasise benefits through achieving greater economies of scale but neglect benefits through enhanced economies of scope. Levitt and others argued that the impact of technology would be towards a further standardisation of production, rather than towards more customised production. While acknowledging that technological development could generate flexible manufacturing systems producing smaller batches of one good with different characteristics, these commentators downplayed the chance of technology promoting economies of scope.

As we know from experience, both eventualities can and have occurred. This conceptualisation basically stressed the rise of one world market, rather than of one world production system as envisaged by Vernon. The principles of globalisation strategy in this meaning have been espoused by many (mainly US) managers. For example, Ford has several times tried to launch a world car. Its second attempt in the early 1990s was the Mondeo model, which should be marketed (although under different names) in all developed markets.

Globalisation strategy: a Japanese interpretation

A Japanese interpretation of the globalisation concept also emerged during the 1980s. Kenichi Ohmae, former head of McKinsey Japan, is the leading exponent of this version.

Ohmae distinguishes five steps in the globalisation of a firm. Each of these steps involves the transfer of activities in the business chain to a foreign location.

1. Export. The entire range of activities is performed at home. Exports are often handled by an exclusive local distributor.
2. Direct sales and marketing. If the product is received favourably in the foreign market, the second step entails the establishment of an overseas sales company to provide better marketing, sales and service functions to the customers.
3. Direct production. The establishment of local production activities. In this stage, overseas sales and production are not yet integrated but still report individually to headquarters.
4. Full autonomy. All activities of the business chain – including R&D, engineering and financing – are to be transferred to the key national markets (or trade blocs). By now, the company can compete effectively with local producers on an equal footing. It can respond to local customers' needs and has become a fully fledged insider.
5. Global integration. In the ultimate stage of globalisation, companies conduct their R&D and finance their cash requirements on a worldwide scale and recruit their personnel from all over the world.

Ohmae presented a vision, or a desired end result, rather than a present reality. This conception of globalisation is the opposite of the previous Levitt model in that it stresses the advantage of expanding economies of scope.

Globalisation strategy: a European interpretation

Wisse Dekker, former CEO of Philips, distinguishes a set of stages in what he prefers to call the transnationalisation of business (seeing the global enterprise as merely a stage towards becoming transnational). Dekker defines globalisation as a relatively early stage in the internationalisation of a firm. Until the

Your notes

1980s, Philips was a multidomestic firm, but since the mid-1980s, it has transformed itself into a global firm with some transnational characteristics.

Philips suffered greatly as a multi-domestic, since it was forced to compete in electronic goods with the major Japanese electronics companies such as Mitsubishi. They had global organisational forms with little if any 'local-responsiveness', and were therefore able to be very cost and price competitive as a result of taking advantage of the scale of economies a global standardisation strategy afforded them. Ultimately Philips reorganised itself from a multi-domestic with country 'barons' to a global organisation with global product groups. However, by retaining some local responsiveness, it took on some of the characteristics of a transnational.

Global Strategies in Action

Taking an example from the financial services sector, there are two key issues in establishing and managing a global fund management business. These involve deciding on the best approach to:

1. Standardisation versus flexibility
2. Centralisation versus local operation

The main challenge is to decide what activities should be carried out at which level and where to have regional or global centres. Becoming global also requires overcoming other challenges such as cultural differences, measuring profitability and dealing with different regulatory and tax regimes.

The following case studies illustrate how two organisations approached these challenges.

Case Study 1: MTV – attaining global reach

On 1st August 1981, MTV Music Television became the first 24-hour rock music video network in the United States, with a start-up base of 1.5 million subscribers. By the early 1990s, MTV, which is owned by Viacom International Inc, had more than 55 million subscribers on over 7700 cable affiliates. Being aware of the huge opportunity for growth in the international market-place and the advantages of establishing a strong, early position in foreign markets, led MTV to expand its programming efforts overseas. Using the universal language of music, MTV moved forth in expanding its influence on pop culture by becoming the first global network when it entered into a licensing agreement in 1984 with Japan's Asahi Broadcast Company to broadcast on a limited basis in Japan. Since then, MTV has expanded into Europe, Australia, Brazil and Asia, and MTV International. These global affiliates reach more than 200 million households in over 70 countries. MTV's philosophy is 'think locally, act globally'. Each affiliate adheres to the style of MTV, but supports local tastes and talent – the majority of programming is unique to each network.

Source: adapted from Carl Rodrigues (1996, p. 24).

Case Study 2: Goodyear's think and act global philosophy

In the early 1970's, France's Group Michelin shocked America's leading tyre makers – particularly Goodyear Tire & Rubber Co. – by invading the US market. Goodyear, which was serving French and other European markets before Michelin even existed, viewed the French company's presence as a frontal attack. Goodyear responded immediately. It didn't limit its retaliation to the US, where only a small fraction of Michelin's business was concentrated. Instead, Goodyear attacked in Europe – the source of much of the French firm's profits. Goodyear's counter-assault didn't bring Michelin's expansion plans to a halt but it did slow its penetration into the US considerably. Michelin was forced to divert its financial resources to defend its home-front market. The result was

that Goodyear remained the Number One tyre producer in the US and in the world. Ever since that market attack/counterattack, Goodyear has insisted that all of its managers and employees, domestic and foreign, think and manage 'globally' without regard to national borders.

Source: adapted from Carl Rodrigues (1996, p. 97).

From these different sets of regionally/nationally derived interpretations, we can see how easily globalisation can be used to serve rhetorical objectives. Often, globalisation is advocated or rejected merely to justify a particular strategy or policy. Indeed, what we call 'globalisation' may in fact only be 'Triadisation', given that the vast majority of international production, trade, technology and investment flows and so forth still occur within and between North America, Europe and East Asia. Other regions of the world have been largely excluded from the supposedly 'global' restructuring process. Nonetheless, the globalisation of national economies has proceeded at a steady and rapid rate.

Whether to globalise and how to globalise have become two of the key strategy issues for managers around the world. As Yip (1989) argues, many forces are driving companies to globalise by expanding their participation in foreign markets. Almost every product market – whether computers, fast food, or nuts and bolts – has foreign competitors.

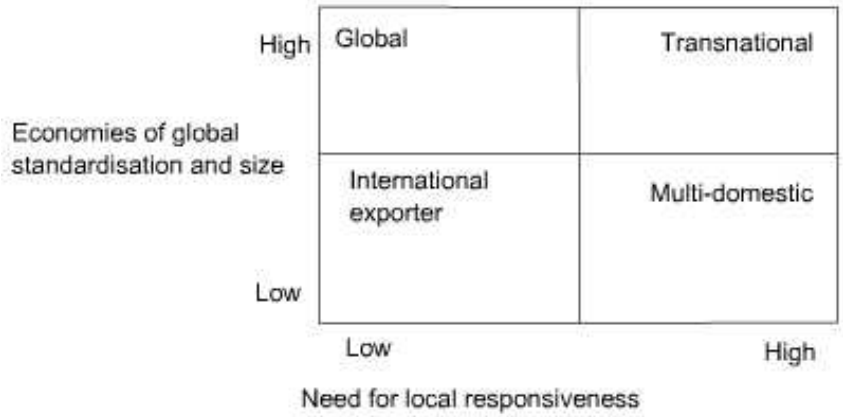
Trade barriers are also falling with the creation of the North American Free Trade Agreement, the completion of the European Union's Single Market and the ongoing deregulation of the Japanese economy. Maturity in domestic markets is also driving companies to seek international expansion. Moreover, companies are seeking to integrate their worldwide strategy. We are witnessing a move away from the traditional multinational or multi-domestic approach whereby companies established foreign affiliates that catered for the market needs of specific countries. Instead, international corporate players are increasingly viewing the world as one market (with some national product and market variations) and wish to tailor their corporate strategy accordingly.

The distinguishing feature of the worldwide competitor is the recognition of the need to find a balance between a responsive and flexible local approach and effective global coordination (Ellis & Williams 1995, p. 307). Few if any companies have achieved a satisfactory solution to date. To globalise requires a complex mix of organisational capabilities and cultural diversity. As Williams and Ellis (1995, p. 307) argue, having the structure and culture, which enables knowledge transfer from one country to another, can provide a key source of advantage for global competitors.

The Global Multinational Corporation

The global company resides in the top left-hand box of the global integration–local responsiveness matrix, which you examined in Topic 13.

Look again at Figure 15.4 (Figure 13.2 in Topic 13), which shows each stereotype organisational form in its appropriate box.



Source: Segal-Horn and Faulkner (1999).

Your notes

The global company is philosophically the antithesis of the multi-domestic company. It is founded on the belief, with Theodore Levitt (1962), that if a product meets a need at an acceptable quality at a low price, local taste differences soon cease to matter. Many of the modern global products in the consumer electronics industry seem to bear out this hypothesis. Read the following case study, which illustrates Gillette's view on the matter.

Case study: Gillette – a global corporation

Al Zeien, chief executive of Gillette, refuses to pay tribute to cultural differences. He believes Gillette is a 'global' company in the way few corporations are … 'We know Argentina and France are different, but we treat them the same. We sell them the same products, we use the same production methods, and we have the same corporate policies. We even use the same advertising, in a different language, of course.'

The company's one-size-fits-all strategy has been effective. Gillette's net income has grown 16% a year in the past five years and its share price has risen by an average of 33% a year since 1987. The group makes items almost everyone in the world buys at one time or another, including shavers, batteries and pens. It aims to dominate the markets it operates in: its share of the worldwide shaving market, for example, is 70%, which the company hopes to increase by the launch of a new razor for men.

Scale and flexibility are the main advantages of reverse parochialism, says Mr Zeien. R&D cost less when applied to a world market. Global companies may be better positioned to leverage intellectual capital as well. Good ideas are worth more when applied to global operations rather than to a single factory. Globalisation also makes the company more nimble. For instance it responded to the Asian crisis by slicing spending on marketing there … There are few companies, says Mr Zeien, that take globalisation as seriously as Gillette – perhaps Coca-Cola, and the Band Aid division of Johnson & Johnson … To make sure the managers worldwide are on the same wave-length, Mr Zeien insists they move from country to country and division to division … The company's commitment to standardisation, moreover, costs it customers in niche markets within countries. Mr Zeien long ago decided the drawbacks were worth suffering.

Source: Financial Times, 7th April 1998.

The role of the centre in a global company

In terms of the role of the centre, the corporate headquarters plays a very hands-on role. It is instrumental in selecting the businesses and markets to be in and in deciding where the various functions are carried out, i.e. the locations for production, R&D and the other activities of the value-added chain. In short, it determines the configuration and the method of coordination of all activities and corporate assets. It also decides on how assets and activities are to be resourced, whether through internal development, alliances or acquisitions, and it exercises control not just in a financial way but also through a centrally determined and administered human resources policy. Strategy and major operational decisions all emanate from the centre.

The structure of the global company

To be a leader in an industry with global products, a firm must develop and implement a strategy that integrates its activities in various countries, although even in these circumstances some activities like sales and perhaps marketing must take place in each individual country. Generally, however, competition in one country in global industries will be strongly influenced by competition in others. In contrast to the multi-domestic with its decentralised federation of semi-autonomous units, the global company can be depicted as a central-

ised hub organisation with spokes radiating from the centre, building and exploiting global efficiencies through the centralisation of resource allocation, strategy and decision-making.

Your notes

Standardising the product

The most appropriate conditions for a global configuration to develop are those in which a standard product is recognisable and acceptable in all or most markets worldwide, and in which there are substantial cost economies to be achieved from large-scale production. Although a strong brand name may well be important to sales, as it is with Gillette, the product sells on price in the last resort and thus the advantages of scale and often scope are critical to competitive advantage.

In comparison with the multi-domestic form described earlier in Topic 13, the global business typically operates in markets that have a high level of interdependence, that are capital intensive and require a high level of research and development expenditure. Both product and process standardisation is likely to be high and activities are directed and coordinated strongly from the centre, i.e. from the company's 'home' country.

Yip (1992) identifies four categories of benefit that come from global product standardisation.

Cost reduction

These include development, purchasing, production and inventory costs. The greater the development costs, e.g. ethical pharmaceuticals, the greater the driver to market the product worldwide. Considerable economies can also be achieved by standardising and hence reducing product lines, gaining large purchasing discounts for volume items and minimising inventory through standardised product ranges.

Improved quality

The fewer the lines in which quality needs to be achieved and maintained, the greater the focus that can be applied to each line. Multiple product lines incur quality risks.

Enhanced customer preference

Where customers prefer to find the same product when travelling as they find at home, their preference is enhanced by access to standardised global products, e.g. Louis Vuitton luggage, Benetton woollenware or American Express travel services.

Competitive leverage

The possession of global low-cost products helps companies increasing their global reach to achieve market entry to new countries easily. Their brand names are already recognised.

In Douglas and Wind's (1987) terminology, the global corporation tends to have a uniform segmentation of its market and positioning within it. The product is standard, as is the packaging (except for language). Advertising and PR, and customer and trade promotion methods vary little from country to country, and even distribution methods are likely to be uniform.

We shall now look in more detail at two different types of global corporation: the traditional and the modern.

The traditional global corporation

The classical global form in modern times was to be found most typically in the Japanese corporations of the 1970s, which caused so much anxiety in the West as they took advantage of vast scale economies and, with lean produc-

tion and just-in-time inventory methods, flooded the world with very reliable, low-priced consumer goods, particularly in the electronics sector. Often, however, it is the industrial rather than the consumer goods sectors that are the most appropriate for the global corporation as they meet a need rather than satisfy a (sometimes-variable) taste. Thus Intel, Texas Instruments and Motorola are all characterised by global organisational forms, since they sell basically standard products in all markets.

In the archetypal Japanese global corporation, strategy and control were strongly centralised. Overseas units were sales outlets used to build global scale. The mentality in the global corporation was to regard the world as a single economic entity (Bartlett & Ghoshal 1989) serviced through delivery pipelines. The culture of the corporation tends to be clearly identified, set from the centre and of a dependent nature in the sales units.

Hill's (1997) analysis of the global corporation is of one likely to be organised into worldwide product markets, to be high in the need for coordination, to have many formal and informal integrating mechanisms to make it operate effectively, to have a high level of performance ambiguity and to exhibit high need for cultural controls.

The traditional global corporation had production concentrated principally in the home country for ease of control and quality assurance, although this factor has been considerably relaxed in recent years. R&D tends to be centralised also, and therefore new product development. This is the simple global strategy, exemplified by Toyota in the 1960s and 1970s as it sought to achieve the advantages of the low-cost producer as its competitive advantage to achieve 'global reach' (Emmott 1992).

Toyota capitalised on the industry's huge potential for manufacturing scale economies, leading it to develop a tightly coordinated centrally controlled operation that emphasised worldwide export of fairly standardised models from global-scale plants in Toyota City, Japan (Bartlett 1986, p. 371).

The advantages of the traditional global corporation

With concentrated production facilities reporting to the centre, and with a role limited to simple assembly, the traditional global corporation had the advantages of low costs due to scale economies, and global scale efficiencies. In addition, its centralised functional organisation enabled resources to be so concentrated that new products could be quickly developed and then equally speedily diffused worldwide (Ellis & Williams 1995). However, it had the corresponding limitations that it was not able sensitively to reflect local tastes, and due to its single 'home' culture and great distance from point of sale to decision takers, found it difficult to react in a timely fashion to external stimuli for new products first identified in foreign markets.

Changes from a traditional to a modern model

As the forces for globalisation have gathered and grown since the 1980s, the concept of the global strategy has moved apart from that of the traditional centralised ethnocentric global corporation. To have a global strategy, it is no longer necessary to have an organisational form with vast scale factories located somewhere like Toyota City, and a culture spanning the world, but clearly emanating from the 'home' country. The need for standardisation and low cost is still the primary driver of a global strategy. However, the watchword of the modern global corporation is no longer ethnocentrism but polycentrism, albeit with strong coordinating mechanisms able to achieve low cost but with a varied global configuration of activities by no means always dominated by the original 'home' country.

The modern global corporation

With the dramatic improvement in information technology, in communications more generally, and in flexible manufacturing systems, plus the growing volatility of world economic conditions as global deregulation takes place in many markets, the rigid paradigm of the global corporation has been transformed. Porter (1990) points out the advantage of operating from a strong national 'diamond'.

This is something of a late twentieth-century restatement of the eighteenth-century Ricardian concept of national comparative advantage. However, if the USA represents a strong diamond, there is nothing to prevent a Japanese 'transplant' taking advantage of it and exporting back into world markets. Similarly, the cost advantages of assembly in South East Asian countries can be taken advantage of by US-based global corporations. As Kogut (1995) points out, succeeding internationally comes from locating functional activities in countries with comparative advantage in order to achieve a value-added chain able to give international competitive advantage.

The meaning of the global corporation, then, is changing. Up until the 1980s, it was focused on operational integration from a home base founded on four dominant concepts:

1. A strong and low-cost sourcing platform
2. Efficient factor costs
3. Global scale
4. Product standardisation

Since then, it has become more sophisticated, focusing on strategic coordination with the integration of skills and disciplines worldwide, as the key factors for global success, such as scale and home country control, become less critical considerations. Thus, it has come to be recognised that even in the global corporation all functions are not equally international in scope.

A global network that serves the business

It therefore follows that not only may it be appropriate to locate a particular function in a country or countries other than the 'home' country, but some activities, e.g. sales, may need for greatest effect to be duplicated country by country even in so-called 'global' corporations. As Yip (1992, p. 104) puts it:

> Global activity location means deploying one integrated, but globally dispersed, value chain or network that serves the entire world-wide business rather than separate country value chains or one home based value chain …

… as in the traditional global corporation.

Features of the modern global corporation

Yip (1992, p. 184) characterises the modern global corporation as having an organisation structure based on a centralised global authority, no domestic–international split and strong business dimensions relative to geography and function. Management processes involve extensive coordination processes, global sharing of technology, global strategy information systems and global strategic planning, budgets, and performance review and compensation systems. Its employees have multi-country careers. Foreign nationals operate both in home and third countries and are involved in extensive travel. The culture is one involving a global identity and strong interdependence, far removed from the single country culture of the traditional global corporation.

Your notes

Production flexibility

The concept that you have been reading reveals a distinct change from the origins of the traditional global corporation where the activities and power of the home country were dominant. The growing volatility of world markets in the 1980s and 1990s has led to the need for the global corporation to disperse production around the globe. This ensured flexibility in the face of changing exchange rates, varying factor costs for labour and raw materials and the inevitable political risks inherent in global operation.

Examples

If Ford met labour relations problems in the UK in the 1980s, it could switch production to Germany or at least threaten to do so. Japanese companies, the archetypal centralised global role models, even found it appropriate to locate 'transplant' in overseas locations and set about building offshore supply networks to mirror their domestic keiretsu. To locate plants in the EU also had the advantage of enabling them to duck under Common Market tariff barriers. From the USA viewpoint, locating factories in the Far East enabled the global corporation to take advantage of the lower wage rates prevailing in that part of the world. Indeed, had they not done so, they would have found it impossible to compete on price with Far East products in international markets.

Rangan (1998) demonstrates through empirical research that MNCs do in fact change their production locations to take note of changes in exchange rates that they consider to be long term. Such changes they add, however, are only at the margin, probably because of the influence of sunk costs in already established locations. Their research, however, confirms the importance of, in Rugman's (1986) terms, location-specific advantages, in the minds of decision takers in global companies faced with the issue of incremental functional activity location. The expansion of the firm is inevitably a path-dependent process (Kogut & Zander 1993). An alternative route to this same end of production flexibility to take advantage of the best exchange rates is to subcontract a significant proportion of production (Buckley & Casson 1998).

Further examples of dispersion of functions

Dealing with the volatility of globalised business leads global companies also to establish warehousing hubs in nodal points of transport networks (Buckley & Casson 1998) thus enabling them to withdraw from particular markets and enter others as economic conditions and opportunities suggest.

Casson, Pearce and Singh (1991) also extend the dispersion movement to R&D laboratories as they claim that in many global MNCs the 'central' research laboratories of high-technology MNCs were either closed down, shifted to the divisions or forced to operate as suppliers to "internal customers in competition with outside bodies such as universities", although this movement is by no means universal.

All of the above suggests a considerable movement of the mindset and recognition of decision-making options of the global company in relation to its mode and nature of operation at the end of the twentieth century. Such changes can usefully be considered under Porter's (1996) categorisation of issues of configuration and of coordination. A modern global configuration will take into account the perceived nature of firm-specific and location-specific advantages in identifying the best way to achieve global competitive advantage, and this will be considered individually by function.

Configuring world wide production

Thus, in deciding how to configure production worldwide, the global corporation will assess the optimal size production unit required to achieve the greatest scale economies, as cost remains the critical factor for a global company. It will then choose locations that give the best balance between factor

costs, especially labour costs. It will deal in all probability with exchange rates by selecting locations with the best rates in relation to the alternative of home country production, and will handle the inflexibilities resulting from sunk costs by ensuring that a sizeable proportion of production is subcontracted. It will ensure flexibility and cost efficiency of distribution by operating through regional warehousing hubs.

Your notes

The location of R&D

It will pay strong attention to firm-specific advantages in deciding on the location of R&D facilities and is unlikely for eclectic internalisation reasons to subcontract these, although it may consider the option of limited dispersion to the divisions. New product development and design may therefore not be as uniformly carried out in the home country as was traditionally the case.

Sales

Downstream, sales as always will probably remain a country responsibility, although in the case of smaller markets there may be some grouping of activity here; similarly in marketing. Here, the activity may be local but the thinking will be carried out on a global scale and the message will be developed and coordinated globally to enhance the corporation's global image. But the modern global corporation recognises that, even if tastes are converging, they still vary by market and, in most cases, note needs to be taken of this if success is to be achieved. Ketchup in the UK is sweet; on the continent it is spicy; in the USA it is vinegary (Riesenbeck & Freeling 1991). Margarine is made to taste like butter in the UK, but not in Holland.

Personnel

With regard to personnel, a modern global firm will reflect its nature in the variety of its personnel and will not as traditionally be dominated by personnel from the 'home' country.

Modern global coordination

Modern global coordination is still likely to be based on the traditional M form of organisation, i.e. the multi-divisional form (Chandler 1990) dominated by worldwide product groups, as compared with the country managers of the multi-domestic. There is likely, however, to be some loosening of the degree of control from the centre to allow the development of networks and alliances outside the firm in key markets and wherever this appears valuable for the achievement of competitive advantage in the area.

Systems will remain strongly tied to the centre, however, since the headquarters unit regards the world in all its interdependent nature as its market, and is ever at pains to develop a message, an identity, a mission and key products that are recognisable in all markets, as the Gillette case study, which you read earlier, underlines. This means central strategic planning, backed up by monitoring of performance, and executive career development and compensation run from the centre. It also means the ability to disseminate around the worldwide corporation information skills and new methods developed in specific areas but recognised as having more general applicability.

The Transnational Corporation

In this topic, we have discussed two contrasting but dominant models of the MNC: the multi-domestic (Porter 1986) and the global (Yip 1992). In this section, we continue our review of strategy and organisation structure for MNCs by exploring a different type of organisational model for multinationals that began to emerge in the late 1980s and has driven forward the debate on the most effective strategies and structures for competing across borders in the turbulent environment of the 21st century. This is an approach within international strategy that most closely resembles the contingent, conditional

school of management research. This emergent model has become known as the transnational.

Developed first in the work of Bartlett and Ghoshal (1989), it is perhaps more useful to think of a transnational as an idea or a mindset rather than an organisation structure. Thus, the transnational is probably best understood as a state of mind. It is a state of mind that is adaptable, and it sees efficiency across international boundaries as something that companies achieve through responsiveness, flexibility and the ability to learn. Thus, decision-making is approached at whatever level, and in whatever geographic context, is most appropriate for the international objectives of the firm. Achievement of goals, rather than protection of turf, country managers' pet assumptions or the historical traditions of the firm, is what should influence decisions.

Bartlett in Competition in Global Industries (Porter 1986) and with Ghoshal (1989) in Managing across Borders suggests, in the concept of the 'transnational' enterprise, a modern form for the MNC quite similar to that of the strategic alliance. It is located in the top right-hand box of the matrix that you examined in the last section, with a high percentage of home-based exports but also a high percentage of foreign production. It is, however, not strongly directed from the home base country. As Bartlett and Ghoshal (1989) put it:

> Managers are being forced to shift their thinking from the traditional task of controlling a hierarchy to managing a network.

The three integrated flows of the transnational

The transnational organisation seeks to overcome the weaknesses of more traditional models. To be globally competitive, it must be locally responsive, see learning as a key requirement for success and achieve optimal global scale and scope efficiencies. This can only be done by adopting new attitudes: knowledge must pass in all directions as appropriate and the firm should be truly global in mindset and not be, say, a Japanese or US-based company with foreign subsidiaries. It may indeed have three or more head offices like NEC, as suggested by Nonaka (1989).

In Bartlett and Ghoshal's words, the transnational form recognises three flows that have to be integrated.

- First, the company has to coordinate the flow of parts, components and finished goods.
- Second, it must manage the flow of funds, skills and other scarce resources among units.
- Third, it must link the flow of intelligence, ideas and knowledge that are central to its innovation and learning capabilities.

The transnational – a new and sophisticated organisational form

The transnational is, to date, more an aspirational form than an existing one although some organisations such as ABB or NEC are often quoted as examples of the form. It is, however, the model upon which optimal coordination processes should be based to achieve global competitive advantage. The transnational is characterised by the fact that it is a truly global enterprise, neither owned in one country nor controlled from one unified corporate headquarters.

> Increasingly the management of complexity, diversity, and change is the central issue facing all companies. (Bartlett & Ghoshal 1989)

Formal organisation charts are only one aspect of the glue that binds the organisation together. It is held together more strongly by the managerial decision-making process, which depends on the information flows. Bartlett and Ghoshal believe it is not a new organisational form that is needed to meet the needs of the future, but a new philosophy that will achieve global competitive advantage, local differentiation and global learning by transforming the anat-

omy, physiology and the psychology of the global enterprise.

Clearly, the transnational is a new and very much more sophisticated concept than earlier organisational forms for the international enterprise. With its emphasis on a network philosophy and the absence of domination by a home country-based head office, the philosophy can embrace the enterprise based on a network of alliances equally as well as it can the integrated corporation. It can be seen, for example, in Fujitsu's approach to the development of the global Fujitsu 'family' of companies.

The transnational – dealing with a turbulent environment

Interestingly, a similar philosophy is emerging amongst strategic theorists in Japan. Nonaka (1989) in 'Managing Globalization as a Self-Renewing Process' sees information as the key to success. Information is of two types: syntactic, i.e. bare data; and semantic, i.e. information with meaning and concepts. The creation of meaning (semantic information) is an inductive process and, to have a good chance of success, needs to have considerable redundancy of information. Deductive management (syntactic information) needs no redundancy of information but it is basically uncreative.

> Globalization comes about through the interaction of articulated globalised knowledge and tacit localised knowledge, partly through the hybridisation of personnel and consequent internalization of learning. (Nonaka 1989)

Nonaka calls this 'compressive management', an interesting echo of Ansoff's (1990) 'accordion' management, similarly devised to deal with the uncertainties of the modern turbulent environment. This process can also lead quite acceptably to hybridisation of the company's headquarters with perhaps one headquarters in Japan, another in the USA and maybe a third in Europe. As Contractor and Lorange (1988) point out:

> One model of the MNC sees it as a closed internalized administrative system that straddles national boundaries. An alternative paradigm is to view the international firm as a member of various open and shifting coalitions, each with a specific strategic purpose.

There is considerable congruity between the philosophical standpoints of Bartlett and Ghoshal, Contractor and Lorange and of Nonaka in their rejection for the future of the rigid hierarchy of the traditional MNC, strongly controlled from its home base, even when allowing for local product variation. A world of sometimes shifting but continually renewing strategic alliances and even more informal networks fits well within this philosophy.

McKinsey – an illustration

Few companies meet all the criteria for the pure stereotypes, and there are transitional paths whereby companies restructure themselves from one form to another to meet the changing needs of their global market. The following illustration may help, however, to clarify the mindsets behind each of the stylised forms using the international strategic consulting firm, McKinsey, as a case.

First of all, take another look at the matrix that you examined on page 10 (Figure 15.4) to remind yourself of the four organisational forms.

The international firm

If this were to have happened in the early 1960s, it may have reached the firm when it was basically an 'international' company (bottom left-hand box of the matrix). The request would have been transmitted to the New York head office. If won, the project would have been staffed from New York and led by a New York consultant. US models would have been used largely unadjusted for local conditions, and London people would have been used to provide the necessary local intelligence.

Your notes

The global firm

If McKinsey were a 'global' firm (top right-hand box of the matrix), the UK office manager would negotiate the job and global models would be used, i.e. not purely US ones but certainly standardised ones. A New York engagement manager would probably come over with a team to run the study. The UK consultant would be invited to New York for training and indoctrination in the ways and products of the firm. (This was largely the situation when one of the authors was a member of the firm in the early 1970s.)

The multi-domestic firm

If the firm were a largely multi-domestic company (bottom right-hand box of the matrix), the McKinsey name would be used to get the study, but it would then be staffed and run from London developing a specifically British solution of a bespoke nature without necessarily any contact with the USA. The performance of the London office would be judged by its sales and profits record. Firm-wide training programmes would not be held.

The transnational firm

Currently, McKinsey fits pretty well with the criteria for a transnational firm (top right-hand box of the matrix). In this case, there is complex multi-path information flow globally. Projects are staffed from where the expertise is. Centres of excellence in particular specialist areas develop around the world led by expert individuals and teams. Technological and marketing centres of gravity move as a result often of forces exogenous to the corporation in search of better, if only temporary, fit with particular markets. In our imaginary illustration, the City assignment would be negotiated from London with an international expert on hand. It would then be internationally staffed with the 'best' personnel available who would be personally 'bonded' by their identification with the firm culture, as developed in particular through international training meetings and international work on projects. The recommendations would be sensitively tailored to the specific situation but based on firm-wide expertise and experience.

Let us suppose that a financial industries company in the City of London approaches the McKinsey London office with a 'request for proposal' mandate for a reorganisation study.

The transnational – a response to uncertainty

The notion of contingency theory as a framework for making sense of the management of international organisations has a deep appeal given the permanent fluidity and changeability, the fundamental dynamic character of the international business context. It is, however, an approach that rejects certainties and prescriptions and thereby it places great strains on international business managers. It is natural to look for certainty as the reassuring basis for action, and deeply disconcerting to find only continuous uncertainty. But to seek to impose certainties where few exist is a recipe for failure in any business context. It remains more helpful, therefore, to accept the discomfort and try to find more and better ways of interpreting and acting within it. It is in response to these uncertainties that the transnational form has emerged.

A simple way of illustrating this continuous dynamic of uncertainty, and therefore of the need for an organisational model that can transform itself as the requirements of its context change, is to state how much the idea of globalisation itself has changed. The issues that are debated with regard to global strategies have moved on.

As discussed earlier, the meaning of 'global' has changed from an emphasis on operational integration to its current emphasis on strategic coordination and local responsiveness. In the earlier simple globalisation phase, the focus was on globalisation affecting products and components. The dominant con-

cepts in this phase were:

- Global operational scale advantages
- Factor costs
- Product standardisation
- Global sourcing platforms

In its later complex globalisation phase, the focus was on globalisation of skills and capabilities. The dominant concepts in this later phase were:

- Flexibility
- Systems to give variety at low cost
- Regional autonomy
- Risk avoidance
- Deep understanding of customer needs

This shift in emphasis as globalisation became more complex meant that, in the place of the centralised hubs of the early simple global organisation structures, more complex decentralised structures were emerging to meet the need to operate locally, regionally and globally simultaneously, for different sets of market and industry conditions. Gradually, then, has been emerging what Bartlett and Ghoshal (1989) termed "the transnational solution".

Flexibility and the transnational

Greater transparency of information has created an increasing requirement for uniformity and consistency in quality, delivery and marketing of products and services across borders. Not all companies will be able to allocate the resources or develop the capabilities for such management of quality and responsiveness across geographic boundaries. Integration and coordination bring great benefits, but many companies are insufficiently skilled to implement them effectively.

We will now introduce two examples of companies in quite different businesses who have both been attempting, in the context of their own business needs, to implement the ideas of flexibility, responsiveness and shared resources firm-wide that are at the heart of the discussion in this topic. Interestingly, both Cap Gemini (CGS) and Novotel are service businesses.

Service firms are characterised by particular combinations of resources and capabilities different from those characteristic of manufacturing firms – the most obvious difference being the importance in assessments about quality in service organisations of the interface between the front-line staff and the customer.

Also noteworthy in both these examples is the importance of the creation and sharing of knowledge-based resources. Knowledge sharing and organisational learning are regarded increasingly as among the most critical capabilities for all MNCs, not just generating knowledge but, just as importantly, spreading it through the organisation (as an economy of scope). It is particularly helpful for service industries, since most services are heavily dependent on knowledge-based resources in both the design and delivery of the service, and especially on the tacit knowledge underpinning the routines of the staff, whether software consultants (in CGS) or hotel receptionists (in Novotel).

Case Study : Cap Gemini Sogeti – a transnational organisation

Cap Semini Sogeti (CGS) is Europe's biggest computer software and services group. Since 1975, CGS has grown to Europe's number one position in computer services and consulting. It has taken all available means to pursue growth, developing by means of organic growth and acquisitions, as well as by alliances. It has a complex organisation structure that reflects the nature of its history, its varied requirements and tensions, and its aim to be a modern transnational company.

Your notes

CGS grew from a merger of Cap, a computer services group, and Sogeti, a business management and information processing company. This merger brought with it operations in the UK, the Netherlands, Switzerland and Germany, with a head office in France. It then acquired a large number of small groups in Europe and some in the USA. This expanded its service coverage to IT consulting, customised software, and education and training. The acquisition of SESA in 1987 broadened its culture from its origins as a computer 'body-shop'. Its current mission is to assist clients to get the highest possible benefit from the opportunities afforded by state-of-the-art information technology.

As an organisation, CGS is strongly decentralised and when any of its branches reaches 150 personnel, it splits it in two. In order to be able to respond to variations in local demand, it has gradually extended its range of business services to cover the full range of computer services. These divide into four distinct businesses:

1. Facilities management, spearheaded by its acquisition of Hoskyns based in the UK.
2. Systems integration, which develops packages of hardware and software to meet the clients' needs, e.g. it will automate a factory or computerise an invoicing process.
3. IT consultancy, which was the original service base of CGS.
4. Management consultancy, which is led by Gemini. This was created as a professionally independent group by bringing together three leading consultancy firms: the MAC group, United Research and Gamma International. Gemini has been structured to be legally, organisationally, and culturally separate from CGS, although obviously part of its 'family'.

CGS has developed information pooling systems to ensure that innovative solutions developed in one country or business are rapidly communicated to the others. These include electronic bulletin boards, and extensive electronic and voice mail facilities. In addition to these, there are also the informal networks developed by committed professionals working frequently together, repeatedly, in project teams, within the context of a deliberately enabling culture.

A major part of CGS's growth strategy is to increase its representation in a greater number of international markets. To facilitate this, and strengthen existing international operations, it has created an international support division.

In 1991 CGS developed a strategic alliance with Mercedes Benz, in which the German company took a 34% holding in CGS for $585 million, and which includes a joint venture with Debis Systemhaus, Daimler-Benz's software company. In 1992, CGS established a Benelux presence through an alliance with Volmac. It created Cap Volmac with 4,000 staff and annual turnover of about $500 million.

For this fast-growing transnational, the challenges are to integrate its wide variety of organisations into a group capable of acknowledging a complex web of ownership relationships, whilst benefiting from the strengths of its 'family' of semi-autonomous professionals. The reinforcement of a common culture, the creation of effective cross-selling activities and the leveraging of its wide range of professional expertise across the firm to meet the needs of cross-border clients all represent tasks of considerable magnitude and complexity.

In pursuit of those objectives, and despite extremely tough competitive conditions and poor business results throughout the mid-1990s, CGS's managers pushed ahead with a major internal overhaul. Nicknamed 'Genesis', it was intended to turn CGS from a loose federation of companies into a tightly knit global group. In particular, it involved giving worldwide responsibility for particular industries to country managers. Thus, CGS's French operation now handles telecoms while its American operation handles oil and gas. Though Genesis took much longer to implement than expected (nearly two years), its business purpose was to help the disparate group find the most appropriate

way of meeting both internal and external pressures. Internally, the need was for better clarity and coordination in roles, objectives, systems and the use of resources, especially of its skilled professional staff. Externally, the need was to meet both market and industry changes, and to be able to meet the needs of its clients more responsively. This could be taken as the goal for all 'transnational solutions'.

Source: compiled by Segal-Horn and Faulkner (1999) from various press articles.

The second example analyses the process of long-term capability building within a multinational hotel chain, Novotel. It looks at the accumulation of skills and learning mechanisms within the firm. The analysis provides an illustration of the organisational structures, processes and routines that attempt to create both consistency and flexibility across the company's international operations. The international strategy task for Novotel is to create processes for meeting customer expectations in all its hotels worldwide. It must, therefore, achieve consistency plus responsiveness, i.e. enabling all front-line and managerial staff to deal sensitively and helpfully with divergent customer needs worldwide.

Case study Novotel: A multinational hotel chain as a learning network

The first Novotel hotel was opened by two entrepreneurs near Lille airport in France in 1967. The first Novotel outside France was opened in 1973. By 1995 the chain had grown to 280 hotels in 46 countries around the world. The hotels provide 43,000 rooms and employ 33,000 people. Novotel is just one of the hotel chains belonging to the Accor Group of France, which operates more than 2,000 hotels worldwide offering more than two million rooms at different ratings and service levels. Other chains in the group include Sofitel, Mercure, Ibis, Formule 1. These range from 4-star (Sofitel) to 1-star (Formule 1).

The fundamental characteristic of the Novotel hotel concept is international standardization of the offering in its positioning as a 3-star chain worldwide. For standardization, consistency is required of the offering in every location worldwide. This means putting in place a system that is robust enough to generate consistent service standards to satisfy customer expectations, irrespective of local conditions or infrastructure. Some of the physical elements of standardization are easily realizable. The design, style and layouts of the hotels are reproduced to precise specifications. For example, bedroom size is standard throughout Europe at 24 square metres although this does differ for Novotel Asia. Certain types of bedroom furniture, fixtures and fittings, or outside amenities such as swimming pools and amounts of free car parking space, are standard.

However, the more interesting elements of the Novotel offering for the purposes of this discussion are the management processes which enable standard service levels to be delivered at all locations worldwide. Since hotel design and guest bedrooms are standardized, basic housekeeping and maintenance functions can in turn be standardized. That means that the training of staff in all basic functions may be simplified and training procedures themselves standardized. Indeed, one of the features of Novotel's parent company the Accor Group, is the 'Académie Accor', set up in 1985 as the centre for all staff training within the group. Its 'campus' is located on the site of group corporate headquarters just outside Paris. From there, all training is designed and delivered. Standardized procedures and centrally designed training programmes are one of the core mechanisms for achieving consistency.

However, maintaining universal quality standards as the chain grew rapidly over a 25-year period became more and more problematic, especially when many new staff were recruited from other hotel groups with different working practices. A system to monitor standard procedures was introduced in 1987. It regulated the thirteen main points of staff/customer interaction. These

Your notes

were: reservation, arrival/access, parking, check-in, hall, bedroom, bathroom/WC, evening meal, breakfast, shops, bar, outdoor games/swimming-pool and check-out. Each of these key interaction points was divided into a series of compulsory directives for staff, e.g. how to set out a bedroom, lay a place setting in the restaurant or welcome a guest. A booklet containing all 95 of these compulsory directives was issued to all staff and was a mainstay in the induction of new staff. The booklet became known as the '95 bolts'. An internal team of inspectors visited each hotel approximately twice each year to monitor standards. They functioned in the same way as 'mystery shoppers' in that they made reservations, arrived, stayed and departed incognito. On completion of their stay they would make themselves known to the General Manager (GM) for review and discussion. Percentage grades were awarded and recommendations made. This system, while helping Novotel to control and consolidate after a period of rapid growth, gradually became over-rigid and procedural in orientation.

At a meeting in 1992 for Novotel managers, the relationship of hotel GMs and their staff teams was redefined from hierarchical to enabling. A new corporate slogan 'Back to the Future' ('Retour vers le futur') was adopted to reflect the outlawing of the bureaucratic style of standardization and a return to Novotel's entrepreneurial roots. Inter-functional groups were set up across hotels and countries. GM groups were established which clustered together special interests across countries, to share ideas, innovations or best practice. These GM interest groups were constructed around common hotel types within the Novotel chain, e.g. all GMs of motorway locations, or airport locations, or city centre locations. The 95 directives were abolished as too rigid and replaced by three simplified general measures of performance – clients, management and people. One and a half layers of management were eliminated, leaving only one direct reporting layer between GMs and the (then) two co-presidents of Novotel. (One of these, Gilles Pellison, a son of one of the founders of Accor, left in 1995 to take on the challenge of vice-president at Eurodisney in Paris.)

After 1992, the role of the GM was rethought and redefined as capturing the spirit of 'maitre de maison', much closer to the social role of a ship's captain. This led to a need for redevelopment of all GMs, who were required to go through an assessment activity incorporating role-play in such situations as conflict resolution with subordinates or guests. Not all GM's were re-appointed.

It is also worth noting the continuous active involvement in the redevelopment process of the two original founders of Novotel (by then, co-presidents of the Accor Group), as well as the visible public involvement of the two current co-presidents of Novotel.

Source: adapted by Segal-Horn (1995); Baden-Fuller and Hunt (1995).

Being Truly Multinational

The phrase 'truly global' has been popularised by Kenichi Ohmae (1990) in developing his view of what he sees as an increasingly and inexorably 'borderless world'. However we prefer the term multinational to avoid confusion with the specifically standard product corporation.

In the 1990s, global and globalising firms became more significant than ever before. In part, this is because there are so many of them – about 38,000 companies at the last count by UNCTAD. These companies control about a third of all private sector assets in the world and have worldwide sales of about $5.5 trillion, which is not much less than the GDP of the USA.

The other important development for modern MNCs is how they see themselves as organisations and how they are attempting to organise themselves. Their objective is to be able to fully utilise any resource, wherever it is located, against its competitors and for its customers. That means not only moving production facilities around to benefit from the best expertise or the most

Quick summary

The financial mechanics

- In the 1990s, global and globalising firms became more significant than ever before.
- The other important development for modern MNCs is how they see themselves as organisations and how they are attempting to organise themselves.
- This new approach to being multinational is based upon two ideas about modern business life.

productive labour anywhere in the world, but it also means breaking down internal barriers to the free movement of people and, particularly, of ideas (for example to benefit from economies of scope in learning).

This new approach to being multinational is based upon two ideas about modern business life.

- The first idea is that, if continuous innovation is the key to long-term success, an organisation that relies on one culture for its ideas and treats its foreign subsidiaries just as output locations, might as well hire subcontractors or outsource.
- The second idea is that technology is making geographic space and physical distance irrelevant. Software writers in Bangalore, India and Palo Alto, West Coast USA, work together on programmes in different time zones, and the programmes may then be specially tailored for local markets.

Reorganisation of the multinational

This new approach has huge implications for company management and organisation structures. Most MNCs are having to think through massive reorganisation programmes to reach these changed objectives for the organisation and enabling different internal ways of operating to establish themselves.

- AT&T (US telecommunications giant) paid $347 million in consultant's fees in 1994 to help with its global reorganisation.
- Gillette (US consumer goods firm) has developed a 'federalised' global management system that the company thinks of as operating in 'over 500 states'.
- Matsushita and Sony (both Japanese consumer electronics giants) announced publicly that to become 'truly global' they must have cultural diversity in their top management. Sony began appointing non-Japanese personnel to its board of directors in 1989 and now aims to give the top job in each of its subsidiaries to a manager from that country.
- Ford (US motor company) has spent most of the 1990s on a massive worldwide restructuring to turn itself into a borderless firm.
- Royal Dutch/Shell (Dutch/UK oil giant) is another MNC often regarded as truly multicultural, having about 38 nationalities at its head office in London and having announced in 1998 its intended closure of its most prestigious European offices (including the flagship London headquarters) in favour of their dispersal to a larger spread of smaller locations closer to its refineries. Royal Dutch/Shell, like other MNCs such as Citicorp, rotates managers around its businesses in different parts of the globe to develop a more international frame of reference. However, it is still noticeable within Royal Dutch/Shell that to get to very senior positions it certainly helps to be either Dutch or British.
- Bertelsmann, the German global media and entertainment MNC, despite its global positioning, is at a much earlier stage in struggling with how to be 'truly multinational'.

The central dilemma

The companies that you read about above, as well as all the others far less down the multicultural road, are all struggling with the global–local dilemma.

Global firms can shift huge volumes of goods at high speed, whilst standardisation offers huge advantages of scale, speed and lower unit costs. Standardised products require fewer plants, buy from fewer suppliers and reduce duplication. This can cut unit costs by 20 to 30%.

However, local knowledge is also essential, as we have already seen in earlier examples of the size of Procter & Gamble's baby diapers for the Japanese market or Johnson Wax's wrong-smelling cleaning polish. As a result of its international experiences, Procter & Gamble no longer imposes managers from headquarters on overseas subsidiaries. Local knowledge is essential not only

Your notes

to tailor products and services to local market preferences and conditions, but also to get access to local expertise. Few of the patents granted to US or European MNCs are granted for work done by overseas operations, representing a wasted knowledge resource opportunity to the parents.

Since this global–local dilemma will not disappear, MNCs must find sophisticated ways of surmounting it or, preferably, harnessing it to their advantage, which is where the search for the transnational organisation begins. It is an organisational approach based on complexity and flexibility, so much so that many managers have claimed it to be hopelessly unworkable in practice. However, it is at the very least an approach that accepts, and attempts to face head on, the challenges of combining the strengths of global with the strengths of local at the same time, rather than regarding them as trade-offs.

The matrix structure

Most multinationals have adopted matrix structures, in which each unit reports simultaneously to a product-group headquarters and a country headquarters. It is a structure designed to avoid the dangers of parochialism or NIH ('not invented here') often occurring in multi-domestic organisations. Such multi-domestic structures frequently developed powerful country general managers often with vested interests in providing minimal cooperation to other national subsidiaries. Professional service firm partnership structures often exhibited similar symptoms, as when one national practice refuses to make a star consultant with a valuable specialist expertise available to another national practice to assist on a particular client project. The example of Philips cited above is a case in point, where the parochialism of the multi-domestic nearly led to the bankruptcy of the company.

The reason for this non-cooperation was usually to be found in the two separate profit pools of the two separate national practices. They constituted a disincentive to lending a high-yield senior consultant to improve their national profit pool rather than yours. Under these systems, inevitably the need to 'staff up' to meet client expectations of service levels to international clients, and the structure of the national practices, were on a collision course. Following these experiences, many professional service firm (PSF) MNCs are abandoning their cherished partnership structures to transform themselves into corporations, with their inherently different possibilities for corporate governance.

Matrix structures were intended to address these multi-domestic organisational psychoses. Following from Stopford and Wells' (1972) descriptive research described earlier, MNCs and consultants started to apply their ideas prescriptively, and the matrix structure was the result. Matrix structures emerged at the point in international expansion of the firm when it had both high presence in a range of international markets and extensive spread of international product range, as a means of simultaneously managing the demands of both. As an organisation structure, the matrix is an arrangement that combines two (or three) types of responsibility:

- Geographic regions and product groups, or
- Product groupings and functional responsibilities.

The matrix as a solution to the dilemma

The matrix is a structure that relies on a dual command system that is intended to facilitate the development of a more globally or regionally oriented management mindset than the national domestic market mindset often fostered by the multi-domestic multinational. Since regional managers have responsibility for total levels of business within their region covering all of the MNC's products or services, and product managers have responsibility for the profitability of a particular product line or group of products, their responsibilities are different but require coordination if either is to achieve objectives. Most operational managers within such a system therefore report to two bosses.

That illustration describes only the simplest of matrices. Often there may be three-dimensional covering lines of responsibility for products, regions and functions. One of the major potential benefits of such a multi-dimensional matrix structure is that it forces the company to face up to the balancing acts often required to deal with complex business issues, such as a decision concerning location of a global production function, whilst simultaneously trying to appreciate the effect this will have on a regional market and the company's ability to resource particular product lines for its individual business units.

Prahalad and Doz (1987) argued for the matrix structure as the solution to the MNC's central dilemma of the need for efficient global integration of functions and processes, combined with the need for flexible responsiveness to national needs.

Problems with the matrix structure

Problems with the matrix structure in MNCs lie in its complexity. In particular, the dual reporting structure, rather than facilitating, frequently leads to confusion over responsibilities and decision-making. To avoid such confusion requires a very high number of meetings between the groups and individuals involved in each decision.

Bartlett and Ghoshal (1989) suggest that clarity of the firm's basic objectives, continuity in the company's commitment to those objectives over time, and consistency in how the various divisions of the organisation work together, are what is needed for good matrix management. If these 'three Cs' are present then the matrix structure can be very effective.

ABB has always been referred to as an exemplary, well-managed matrix MNC, whereas Philips has historically had problems managing its matrix, whether it was geographically or product-division focused. The classic well-known story of Philips' problems with lack of corporate consistency was the rejection (in the 1970s) by Philips North American subsidiary of Philips own V-2000 VCR videocassette format, in favour of the rival VHS format from Philips' Japanese rival Matsushita. The subsidiary (geographic region) simply refused to support the parent company's international VCR (product) strategy. That destroyed any chance of establishing Philips' video format in the huge American market. Matsushita's VHS format became the industry standard. A similar situation was faced by Bertelsmann in 1998 concerning book retailing on the Internet (discussed earlier in this topic).

Further problems with the matrix structure

Not surprisingly, another problem with this type of structure is the amount of management time taken by meetings and the elapsed time managers need to understand how the structure works in order to contribute to it effectively. If the MNC experiences a high degree of staff turnover, this can exacerbate such difficulties. Some MNCs have abandoned the matrix structure and gone back to more simple reporting lines, with clear responsibility being given to geographic managers.

- Citicorp (US global financial conglomerate, which merged in 1998 with US Travellers Group to become Citigroup) was a well-known example of a company that had invested years of management time and billions of dollars in building its matrix, only finally to abandon the structure. Instead of a flexible structure, containing multiple perspectives and able to shift the balance of power between products, markets and functions as commercial need required, the matrix amplified any differences in perspective.
- Digital Equipment Co. (DEC, a US computing MNC) also abandoned its matrix system in 1994 and spent $1 billion (shedding 20,000 jobs in the process) in moving to a global structure. The dual reporting structure of the matrix often prevented resolution of differences between managers of different views but overlapping responsibilities (see also Bartlett & Ghoshal 1989, Ch. 2).

- Even ABB in 1998 decided to restructure.

Your notes

Resolving the central dilemma?

A matrix, then, may sometimes be a route through which the MNC can move to another different form of hybrid organisation, which it may find more effective in managing across borders. Some organisations have constructed networks of different clusters of specialist local firms in order to benefit from local variations (Ghoshal's 'benefiting from local differences' again).

One example is Nike (US sportswear manufacturer), which subcontracts the manufacture of its athletic shoes and clothing to 40 separate locations, mostly in Asia, using a technology-mediated network. Designs are sent to a plant in Taiwan; a prototype is then built; the final plans are faxed to subcontractors throughout Asia. Rather than attempting to meet all global/local requirements internally, some MNCs have opted to build external networks of strategic alliances. However, like all other complex organisational forms, these too are difficult to manage on a global scale and require their own knowledge and experience to work effectively.

Running a 'borderless corporation' in a borderless world is about endlessly struggling to resolve the paradox of our central dilemma. In their article 'Beyond the M-form', Bartlett and Ghoshal (1993) are attempting to develop a new managerial theory of the firm able to incorporate the management of high degrees of complexity and flexibility, and new ways of integrating activities and resources across borders.

The difference between the two earlier dominant organisational structural types in international strategy (which you examined in the matrix earlier in the topic) – centralised global hubs (top left) and decentralised multi-domestic federations (bottom right) – and the transnational organisation (defined here as an integrated network, the N-form) has been demonstrated above.

The diagrammatic representation in Figure 8.1 is intended to highlight two particular differences in the new form compared to the old: multi-lateral communications between all levels and layers, replacing top-down or bottom-up communication; and the idea that resources, responsibilities and decision-making are dispersed across all types of units, not just concentrated either at the centre (central headquarters) or at the periphery (autonomous national subsidiaries). Each separate small box in the main diagram might represent an entirely different type and size of resource unit. One may be a global distribution hub based in Europe, while another may be a small project team working on the design of a new product or service, staffed by employees from a mix of international locations. The project team may be disbanded after six months and a different unit formed, for a different purpose, somewhere else in the organisation.

These resource units are thus asymmetrical in both size and duration. That is what Bartlett and Ghoshal (1993) mean by 'beyond the M-form', where 'M' stands for multi-divisional. Instead, an 'N-form' organisation appears to be emerging, with 'N' standing for network. Particularly noteworthy is the stress they place on, first, the importance of 'coordinating mechanisms' in the N-form and, second, the changed role of senior management.

Coordinating mechanisms

There are many diverse examples of coordinating mechanisms. Many firms are, for example, redesigning incentive systems to reward employees who help sister companies. IBM has introduced performance measures that reward managers for cooperating with colleagues around the world. Procedures for global account management are a sophisticated illustration of one type of 'coordinating mechanism'. They illustrate the internal consequences of network management and the capabilities required by managers in terms of systems and processes for dealing with it. These must ensure alignment of both the

internal and the customer-facing processes.

In addition to the emphasis on coordinating mechanisms, the N-form promotes a changed role for senior management: to provide shared corporate purpose. This echoes points made by Senge (1990) concerning the new role of the corporate leader: as designer, teacher and steward, surfacing, designing, challenging and building new mental models and complex systems. Figure 8.2 summarises this view of the 'new model' of the roles of management appropriate to N-form network organisations, contrasting it to requirements in earlier organisational forms.

There is consistency between the 'new model' exemplified in Figure 8.2 from Bartlett and Ghoshal's work and that of Senge. They are searching for simple ways of capturing the behavioural complexity, the structural complexity and the organisational complexity that are essential in a transnational MNC. Now that centralised headquarter bureaucracies have fallen into disfavour:

> the favoured form of the firm has become a federal structure of operating divisions drawing on a common source of internal expertise, but where each division belonging to the federation is free to outsource expertise if it so desires. (Buckley & Casson 1998, p. 28)

Comparing the N-form and the M-form

> The N-form logic is one of multiplication and combination rather than of division. It also implies role assignments differing from those inherent in the M-form, at all levels of the firm. (Hedlund 1994, p. 74)

Both the multi-divisional (M-form) and the network (N-form) are ways of managing large, diverse organisations, which MNCs always are. In earlier work (Hedlund, 1986) coined the term 'heterarchy' to describe what he saw as a new organisational paradigm emerging for MNCs.

Heterarchies are heterodox, heterogeneous, non-uniform and uncomfortable. They operate in non-hierarchical ways because they have different organisational objectives and are trying to achieve different things. In comparing these two organisational forms at the heart of discussion in this topic, it may be useful for us to follow Hedlund's (1994) six contrasting themes for hierarchies and heterarchies. Hedlund (1994, p. 82) notes that differences between the two organisational forms may be made sense of by considering the following attributes:

1. Whether the organisation focuses on combining things or dividing things in how it puts things together.
2. Whether the organisation puts people together in temporary groupings (teams) or permanent structures (departments).
3. Whether the organisation makes use of people at lower levels within the organisation or always handles coordination through 'managers'.
4. Whether the organisation has more lateral dialogue or only vertical communication.
5. Whether the organisation uses senior managers as technical, human and knowledge catalysts or as monitors and resource allocators.
6. Whether the organisation focuses its development on combining rich areas of knowledge rather than diversifying into separate organisational units.

No organisational form is ever the last word in methods of corporate governance. New forms emerge as needs and requirements for what the organisation must accomplish, and the context in which it must operate, shift over time in accordance with industry and competitor dynamics.

Your notes

The assumption of earlier work on organisation structure appeared to be that organisations would continue to be structured within some form of hierarchy, albeit steeper or flatter hierarchies, simply to 'get things done'. What appears to be happening at the end of the twentieth century is the beginnings of non-hierarchical organisational forms, which are instead networks.

These infant N-form organisations are all responding to:

- the fact of geographic spread of resources and leadership roles;
- the need to work in richer partnership with other overseas subsidiaries;
- the necessity for cross-border communication and sharing;
- the imperative to utilise knowledge and experience from a multiplicity of diverse organisational units;
- the poverty and ineffectiveness of purely formal methods of organisational communication;
- new emergent relationships between organisational centres and their subsidiary and related parts.

Although the concepts on which these organisational ideas are based have been around for a long time in organisational research (Burns & Stalker 1961), the current practical attempts at constructing these non-hierarchical transnationals has emerged in response to an increasingly resource-based view (Grant 1991; Prahalad & Hamel 1990) of international strategy. This had led to recognition that MNCs have to search for better ways of harnessing their scarcest resources within the firm.

The scarcest resource is broadly now assumed to be knowledge, and any MNC organisation structure now must be such that it can optimise knowledge creation, knowledge capture and knowledge distribution across the firm to ensure its future survival. If it is able to do this is, it can at the same time remove the unit's isolation and preserve its motivation and local competitiveness.

Summary

Globalisation, however defined, signifies the increasing homogenisation of the commercial world and the diminishing importance of distance. Global organisation structures and global markets and tastes are therefore appearing in an increasing number of industries. This gives rise to many cost economies of scale. In some areas, localisation is still important and not all products can be successfully standardised. The global corporation has inevitably evolved on the commercial scene. The emergence of the transnational N-form is less inevitable and is most likely to survive where it does emerge in the service rather than the manufacturing sector where flexibility of production is easier to achieve.

Task ...

Task 15.1

To check your understanding of the material in this topic, try to answer the following questions. If you have any difficulties, you may wish to go back and revise the relevant part of the topic.

1. What do we mean by globalisation?
2. What are the major forces leading to the development of global markets?
3. What is the global integration–local responsiveness matrix, and what is its purpose?
4. What are the four principal international organisational strategies?
5. What are the key characteristics of a global corporation?
6. What is a transnational corporation?
7. What are the key characteristics and limitations of a transnational?
8. How does the M-form of organisation differ from the N-form?
9. To what extent have global tastes and preferences converged and why?
10. What are the strengths and limitations of a global strategy?

Resources

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Topic 16

Strategies for Managing Cultural Diversity

Aims

The purpose of this topic is to:

- explain how national and corporate culture informs the behaviour of companies;
- emphasise how particularly important it is in MNCs;
- consider the work of some key academic writers on culture;
- show how cultural differences overlay the four principal European markets.

Objectives

By the end of this topic you should be able to:

- consider the importance of cultural values in determining working relationships and organisational values;
- assess the linkage between cultural norms and corporate structure and strategy;
- identify the ways in which corporate culture and strategy overlap;
- discuss the philosophies that underpin specific cultural models;
- consider the association between the cultural origins of an organisation and its market success.

Introduction

There is cultural diversity in the world of international business. Different cultures support different preferences, and these are not only reflected in the market demands of different countries. They are also reflected in the predispositions of managers in those countries towards the adoption of particular forms of organisation. The strategies and structures they favour, their preferred managerial styles, and their orientations towards the requirements for change and ethics of conduct are influenced by their culture.

Different cultures foster different beliefs, different priorities of values and different modes of reasoning. Societies, of course, are not uniform entities. They are pluralistic. Individuals within them differ in terms of their levels of commitment to the dominant societal beliefs and values. This does not negate the fact that different national cultures have fostered different kinds of work-related values. These are reflected in the preferred approaches to strategy, structure, organisation and control displayed by their corporations and in the different types of business culture that they develop. Diversity of opinion can arise between individuals in any society in relation to evaluations of circumstances and interpretations of events. This fact does not prevent us from being able to distinguish the models of thought that predominate in different parts of the globe.

The rational planning models of the strategy process, for example, are a reflection of Western modes of thought. In particular, much of the received wisdom in the field of strategic management is American in origin. However, as the Japanese author Nagashima notes, most Japanese people appear to believe that the Western way of thinking is radically different from their own. He highlights the fact that, in the West, people tend to value thinking that is objective, analytical, logical, consistent, impersonal, absolute and intellectual. By contrast, in the East, people are more likely to be subjective, synthetic, non-logical, inconsistent, personal, relative and emotional. He sums up the differences between the West and the East in terms of the scientific and logical versus the instinctive and subjective.

The rigid distinction between rationality and non-rationality is unique to the West (Hoecklin 1995, p. 9). In Europe, the British way of thinking is closer to that of the Americans than to most of the other European countries. The German way of thinking is closer to the Japanese. Such differences as these have a variety of strategic implications for the international corporation, some of which are discussed in this topic.

Schein's Model

One of the most well-known and influential models of culture is that proposed by Schein (1984; 1985). He offers a diagram that highlights what he considers to be the basic interacting components of an organisational culture. See Figure 16.1 for an illustration of his model.

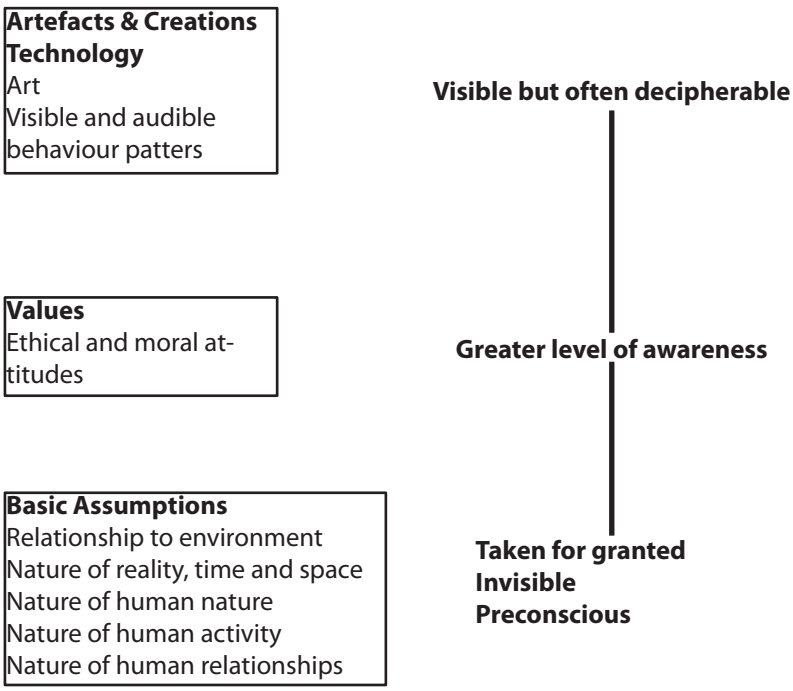
In Schein's model, basic assumptions are at the heart of culture. They are clearly relevant to the mindsets with which people operate, the models of competition they follow and their perceptions of the organisation and its environment. However, although Schein indicates that his three main categories of cultural components influence one another, he does not give an in-depth account of the dynamics of culture or how a culture may change.

It is to be considered that Schein, in his original formulation of the concept of basic assumptions, did not explore in depth the fact that assumptions and values are underpinned by two different types of belief. They are beliefs that something is the case and beliefs in values.

Quick summary

Schein's Model

- Schein offers a diagram that highlights what he considers to be the basic interacting components of an organisational culture.
- He does not give an in-depth account of the dynamics of culture or how a culture may change.
- Also, he did not explore in depth the fact that assumptions and values are underpinned by two different types of belief.



Source: adapted from Schein (1985).

- The first type is termed mundane belief. These are the kinds of beliefs that influence intentions. Mundane beliefs are readily changed. People can change their minds about matters of expediency.
- The second type is termed ideological belief. An ideological belief is a belief in a set of values relating to some aspect of the organisational experience. Ideological beliefs are the kind of belief that motivate commitment. They enable people to make their minds up as to where they stand in relation to others and their activities. Research has shown that changes in these kinds of belief are necessary to mobilise employees around new strategic intents. However, the suggestion is that small changes in ideological beliefs can lead to large changes in attitudes and behaviour (Carlisle & Baden-Fuller 1995).

Hatch (1993) has adapted the well-known but essentially static model of organisational culture that was developed by Schein (1985) to incorporate the concept of cultural dynamics.

The point is that if one of the central problems in achieving creativity in organisations, as Senge (1990) suggests, is the fact that established managerial mindsets are an inhibiting factor, culture change is required. As noted on the previous screen, culture change requires some change in ideological beliefs and values and many changes in mundane belief. These kinds of changes are liable to require new managerial appointments. Achieving the kinds of changes that are conducive to organisational learning, flexibility and continuous innovation are one thing. Maintaining the momentum in the face of an ongoing need for change is another. As was noted earlier, Senge pointed to the risk that some kinds of strategic vision can be accomplished and that this can lead the organisation to revert to defensive strategies.

Hofstede's Schema

Hofstede (1980) has provided a framework of analysis within which organisations in different countries can be considered in relation to four dimensions of organisational culture. Exactly where an organisation is located along each of these dimensions will depend upon which work-related values are prioritised.

Your notes

Hofstede (1980, 1991) demonstrates that values are important determinants of the nature of working relationships and that they affect the way in which subsidiaries in different countries are coordinated and controlled. His book, Culture's Consequences (1980), is now a classic in the field of international business culture research.

It describes research conducted in a number of IBM subsidiaries throughout the globe. The fact that he studied the subsidiaries of a single corporation is important because it meant that the differences he detected at the organisational culture level of the subsidiaries could not be attributed to their different corporate cultures.

IBM was also a good choice of corporation. IBM has been described as having a 'strong' corporate culture (Peters & Waterman 1982). This means that corporate members held a core of guiding values in common. The fact that IBM had fostered and promoted strong corporate values suggests that the corporate culture would have been more uniform at the time it was studied than the corporate cultures of some other firms. This makes the differences Hofstede found at the level of its subsidiaries all the more significant.

It should be noted, however, that there have been deep criticisms of Hofstede's methods and findings, and the counter argument to the choice of IBM executives only is that it is clearly wrong to regard this company as being adequately representative of a national culture, if such a thing can be said to exist in any scientific sense. Despite these criticisms, however, Hofstede's work remains influential in the management field.

The power-distance dimension

In an effort to conceptualise the influence of the different national cultures of the subsidiaries upon their organisational cultures, Hofstede offered a categorisation of countries based on four dimensions of difference. The first is the power-distance dimension. See Figure 16.2 for an illustration of how this affects business areas.

Low Power Distance	High Power Distance
Less centralisation	Greater centralisation
Flatter organisational pyramids	Steep organisational pyramids
Managers are seen to make decisions after consulting subordinates	Managers are seen as making decisions autocratically and paternalistically
Close supervision is negatively evaluated by subordinates	Close supervision is positively evaluated by subordinates
Managers like to see themselves as practical and systematic; they admit a need for support	Managers like to see themselves as benevolent decision-makers
Higher educated employees hold less authoritarian values than lower educated ones	Higher and lower educated employees hold similar values about authority

Source ***: taken from Hoecklin (1995, p. 31).***

Power distance. This dimension describes the degree of formality that is customary in relationships between superiors and subordinates. Those countries that exhibited high power distance tended to foster organisations in which subordinates were more likely to defer to superiors on the ground of status alone.

One ramification of the power-distance attribute is that in some countries the opinions of superiors are less likely to be challenged by subordinates than others. In countries where power distance is low, subordinates accept the

Quick summary

Hofstede's Schema

- Hofstede has provided a framework of analysis within which organisations in different countries can be considered in relation to four dimensions of organisational culture. Exactly where an organisation is located along each of these dimensions will depend upon which work-related values are prioritised.
- It should be noted, however, that there have been deep criticisms of Hofstede's methods and findings, and the counter argument to the choice of IBM executives only is that it is clearly wrong to regard this company as being adequately representative of a national culture, if such a thing can be said to exist in any scientific sense.

positional power of superiors but are more likely to challenge their opinions on the basis of an independent evaluation. The reverse is true of high power-distance countries

The uncertainty avoidance dimension

Hofstede's second categorisation is termed uncertainty avoidance. See Figure 16.3 for an illustration of how this affects business areas.

Low Uncertainty Avoidance	High Uncertainty Avoidance
Greater readiness to live by the day	More worry about the future
Less emotional resistance to change	More emotional resistance to change
Less hesitation to change employers	Tendency to stay with the same employer
Loyalty to employer is not seen as a virtue	Loyalty to employer seen as a virtue
Managers should be selected on grounds other than seniority	Managers should be selected on grounds of seniority
There is more risk-taking	Less risk-taking
There is hope of success	There is fear of failure
Managers need not be experts in the fields they manage	Managers must be expert in the fields they manage
Conflict in organisations is seen as natural	Conflict in organisations is undesirable
Delegation to subordinates can be complete	The initiative of subordinates should be kept under control
Employees are optimistic about motives behind company activities	Employees are pessimistic about the motives behind company activities
Rules may be broken for pragmatic reasons	Rules must not be broken

Source ***: Hoecklin (1995, p. 32).***

This dimension reflects the degree to which people will tolerate uncertainty. In some countries, there is more of a tendency to avoid ambiguity than in others.

One way in which lack of tolerance for ambiguity is reflected is in the degree to which rules and procedures are strictly formalised and adhered to. Bureaucratic structures are, in this respect, compatible with a low degree of tolerance for uncertainty and ambiguity. As in the case of the power-distance dimension, uncertainty avoidance is reflected in a number of areas of business.

The individualism–collectivism dimension

Hofstede's third category is referred to as the individualism–collectivism dimension. See Figure 16.4 for an illustration of how this affects business areas.

Low Individualism	High Individualism
Involvement of individuals with organisations is primarily moral	Involvement of individuals with organisations is primarily calculative

Employees expect organisation to look after them like family; can become alienated if family dissatisfies them	Organisations are not expected to look after people from the cradle to the grave
Organisation has great influence on members' well-being	Organisation has a moderate influence on members' well-being
Employees expect organisation to defend their interests	Employees are expected to defend their own interests
Promotion from inside based on seniority	Promotion from inside and outside and based upon market value
Less concern with fashion in management ideas	Managers try to be up-to-date and endorse modern management ideas
Policies and practices vary according to relations	Policies and practices apply to all employees equally
Belief in group decisions	Belief in individual decisions
Emphasis on belonging to the organisation: membership ideal	Emphasis on individual initiative and achievement: leadership ideal
Private life is invaded by organisations and clans to which you belong	Everyone has a right to a private life and their opinion

Source: ***Hoecklin (1995, p. 36).***

This is the dimension that describes whether individual achievements are valued over collective achievements or vice versa. High individualism countries are more likely to pay individual bonus based on personal performance rather than firm performance.

The masculinity–femininity dimension

Hofstede's fourth category is labelled the masculinity–femininity dimension. See Figure 16.5 for an illustration of how this affects business areas.

Low Masculinity	High Masculinity
Less occupational segregation by gender	Some occupations are typically male and others female
Greater belief in equality of the sexes	Less belief in equality of the sexes
Some young men and women want careers, others do not; not making a career is not necessarily equated with failure	Young men expect to make a career, women often do not; young men who do not make a career see themselves as failures
Organisations should not interfere with people's private lives	Organisational interests are a legitimate reason for interfering in people's private lives
More women are better qualified and in better paid jobs	Fewer women are better qualified and in better paid jobs
Lower job stress	Higher job stress
Less industrial conflict	More industrial conflict

Your notes

Appeal of job restructuring permitting group integration	Appeal of job restructuring permitting individual achievement.

Source ***: Hofstede (1980).***

According to Hofstede (1980), 'masculine' societies prioritise work goals over personal goals. Work goals include such ambitions as advancement in the job and high earnings. Members of 'masculine' societies are argued to be more assertive and aggressive, whereas members of 'feminine' societies value a friendly atmosphere. Congenial working relationships are important in such societies and its members are supposedly less assertive and aggressive.

On the basis of an analysis of these four dimensions, Hofstede (1991) suggests that there are four kinds of organisational culture. He suggests that organisations can be like pyramids, machines, markets or families, depending upon the work-related values that predominate. As different cultures tend to foster the prioritisation of different values, some of these types of organisational cultures will be common in some countries and not in others.

As was noted earlier, Hofstede's studies were conducted on a worldwide scale. They serve to indicate the extent and variety of the differences in beliefs and values between clusters of national groupings at one level and individual countries at another. They reveal the fact that such differences are significant in shaping what is or is not likely to be considered acceptable work practice.

Implications of Hofstede's research for the multinational

Hofstede's research has implications for the multinational corporation wishing to transfer home country practices and procedures to its subsidiaries. Clearly some home country practices will be more acceptable and easier to transplant in some countries than others. It may also be the case that people from some countries will tend to be able to perform certain types of activity better or less well than people from others. For example, high-risk activities may not be best located in countries that exhibit a low degree of tolerance for uncertainty, ambiguity and risk. Motivational issues are also highlighted.

How, for example, do you motivate teamwork in countries, like the USA, that place a higher priority on individual achievement? The study suggested that even within the context of a company like IBM, which became renowned for its 'strong' corporate culture (Peters & Waterman 1982), different beliefs and values that derived from the national level were powerfully influential in reflecting cultural differences between the subsidiaries in different countries.

Trompenaar's Model of Culture

Trompenaars, like Schein, has three levels for culture: implicit culture, which includes basic assumptions and norms and values, and explicit culture, which is exemplified by artefacts and products. He speaks of these factors as the inner, middle and outer layers of a culture.

In his 1993 book with Hampden-Turner, he devises five dimensions in Hofstede mode:

- Universalism vs Particularism
- Rules as opposed to relationships
- Communitarianism vs Individualism
- The group as opposed to the individual
- Neutral vs Emotional
- A measure of the range of feelings expressed
- Diffuse vs Specific
- The range of involvement
- Achievement vs Ascription
- How status is accorded

Your notes

Quick summary

Trompenaar's Model of Culture

- Trompenaars, like Schein, has three levels for culture: implicit culture, which includes basic assumptions and norms and values, and explicit culture, which is exemplified by artefacts and products. .

The authors then proceed to characterise nations according to these dimensions in Hofstede fashion.

Cultural Differences in Internationalisation Strategy

The orientation of the international company is one in which the world is treated more from a geographical perspective than from a home business perspective. Such national firms often develop the capabilities to operate very efficiently as global business systems. Even though they are not initially oriented towards managing global business units, over time they may be obliged to bow to the pressures in their export markets to adopt foreign manufacturing facilities. When this occurs, they tend to be reluctant to locate core activities outside their home base. The strategies they adopt tend to be 'product push' as opposed to 'market pull'. Fundamentally, they are reluctant internationalists.

Culture and corporate globalisation

Many multinational enterprises are trying to improve integration between national companies by developing global business areas or product lines. ABB and Philips are examples of such companies (Schneider & Barsoux 1997). Many European companies consider themselves in the best position for going global and incorporating cultural differences, as they are more accustomed to living closely with neighbours of different cultures:

> More than many Americans or Japanese, Europeans are often very comfortable in international situations. The better run companies – like Nestlé – have corporate boards that closely resemble the UN Security Council… our diversity is a huge asset … Europeans are better equipped for globalisation. (Schneider & Barsoux 1997, p. 218)

American companies, by comparison, whilst open to global competition and foreign companies, have a penchant for standardisation and universalism. Japanese companies, meanwhile, due to cultural norms of conformity and a discernible ethnocentrism, tend to have problems in becoming managerially diverse and truly global in terms of organisational culture.

It is, therefore, no accident that most companies that come closest to being classified as truly global are European in origin. Companies like Nokia and Nestlé have all succeeded in achieving a degree of diversity in their organisational culture virtually unparalleled elsewhere in the industrialised world. Cultural diversity, or the notion of a 'multicultural multinational', translates into competitive advantage in several ways, including greater sensitivity to differences in national markets and therefore more effective responsiveness to different customer needs. It also translates into a more dynamic and innovative corporate environment, resulting in strengthened distinctive capabilities.

Standardisation vs local responsiveness

An important tangential point is the extent to which globalisation means homogenisation. Even global products can have different consumer perceptions. While consumer tastes may be converging internationally, many companies deny that convergence means homogenisation (Schneider & Barsoux 1997). The Germans and the British may be drinking more wine, and the French and the Italians more beer, but the Germans still consume six times as much beer per capita as the Italians, and the French six times as much wine per capita as the British.

> Going global does not make things simpler by reducing everything … to one standardised reality … if anything, it makes them more complex. (Schneider & Barsoux 1997, p. 218)

This means having to create a more complex menu of options and possibilities

Quick summary

Cultural Differences in Internationalisation Strategy

- The orientation of the international company is one in which the world is treated more from a geographical perspective than from a home business perspective.
- Even though they are not initially oriented towards managing global business units, over time they may be obliged to bow to the pressures in their export markets to adopt foreign manufacturing facilities.

and deciding which elements to standardise, as well as leaving local managers more space for autonomy and creativity.

'Going global' means more than operating in markets in many countries or having products that sell around the world. Having global products, like Levi jeans and McDonald's hamburgers, or having sales offices and bank branches in the far reaches of the world, or having done business internationally for over 200 years is no indication of an international mind-set:

> The real test of a global company is the extent to which strategic thinking actually benefits from cultural diversity…The mark of a truly global company is not the tradition of operating abroad, nor a product that appeals around the world, but the multiple nationalities of the top and senior management ranks involved in formulating strategy, not just in implementing it. (Schneider & Barsoux 1997, p. 224)

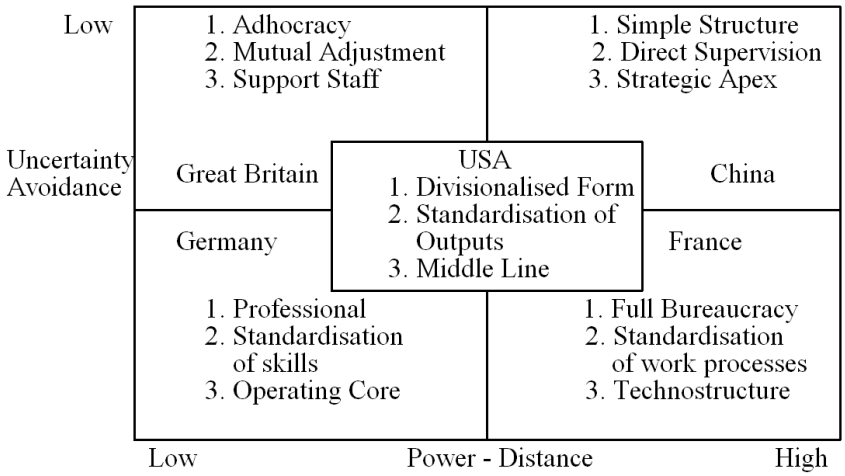
Whatever the organisation structure chosen by the MNC, there is always a degree of tension between the standardisation, scale economies, global integration drive and the need for local responsiveness in meeting culturally diverse consumer needs.

Corporate Strategies, Structures and Country of Origin Values

Hofstede (1980), whose work you examined earlier in this topic, did not have a great deal to say about corporate or competitive strategy and structure. However, in a later work (1991) he considered how power distance and uncertainty avoidance influence strategy and structure in the USA, Great Britain, China, Germany and France. He considers structures in relation to Mintzberg's configurational analysis of organisation structure.

Key:

1. Preferred configuration
2. Preferred coordination mechanism
3. Key part of the organisation



Source: adapted from Hofstede (1991, p. 152).

Corporate strategies and structures, he suggests, tend to reflect the values of the corporate culture of origin. Donaldson (1985) has pointed out one sense in which the term multinational is a misnomer. He notes that multinational corporations are chartered in their countries of origin and commonly employ a high proportion of home country senior managers. Corporate strategies are therefore likely to be heavily influenced by home country beliefs and values

Quick summary

Corporate strategies, structures and country of origin values

- Hofstede, in a later work) he considered how power distance and uncertainty avoidance influence strategy and structure in the USA, Great Britain, China, Germany and France. He considers structures in relation to Mintzberg's configurational analysis of organisation structure.
- Corporate strategies and structures, he suggests, tend to reflect the values of the corporate culture of origin
- Corporate strategies are likely to be heavily influenced by home country beliefs and values in the majority of multinationals.

in the majority of multinationals. This, of course, begins to change as transnational attitudes become more prevalent.

Your notes

Organisational culture and corporate strategy

The linkages between corporate culture and strategy are most clearly expressed by Mintzberg et al. (1998). These authors advance five ways in which the two concepts overlap.

Decision-making style

Culture influences the style of thinking favoured in an organisation as well as its use of analysis, and thereby influences the strategy formation process.

Resistance to strategic change

It is culture's very deeply held beliefs and tacit assumptions that act as powerful internal barriers to fundamental change.

Overcoming the resistance to strategic change

Regular auditing and verbalisation of an organisation's cultural attributes can help managers and workers to conceptualise their shared beliefs and values and better understand how and why these may need to change. Radical changes in strategy must be based on fundamental change in culture.

Dominant values

Successful companies are dominated by 'key cultural values', such as service or quality, which in turn provide competitive advantage.

Culture clash

Important strategy choices such as merger, acquisition or joint venture are significantly affected by organisational culture. As we discussed in Topic 10, cultural difference between firms may serve to derail unions which may, from a rational perspective, appear very plausible.

Source: adapted from Mintzberg et al. (1998, pp. 269–272).

Examples from the United States

Elashmawi and Harris (1993, p. 86) asked groups of managers, engineers and marketers from the American corporation AMD (Advanced Micro Devices) about their company's cultural values. They shared a view of the company as one that had a short-term profit orientation, but which valued aggression, risk taking, individual achievement and independence. AMD was described as an entrepreneurial organisation that was confrontational. The willingness to challenge new ideas from alternative perspectives is, of course, one way of ensuring that risks are reduced because the implications of pursuing particular courses of action will have been more thoroughly thought through.

The authors note that these values are typically American and that it is usual for American corporations to be ethnocentric in that they try to implant home country guiding values into their foreign subsidiaries. In their efforts to promote a more unified corporate culture, some companies have published lists of corporate values. Apple (Elashmawi & Harris 1993, p. 79) is an example. Apple management have circulated a document known as 'Apple Values' throughout the company. Perhaps not surprisingly, it reveals values that are commonly associated with America.

Examples from Japan

Elashmawi and Harris (1993, p. 88) also explored Japanese corporate values. For Mitsui, Matsushita and Mitsubishi, they provide the following lists.

Mitsui Corporate Values

- group harmony

- long-term relationships
- high quality
- cooperation
- conservation

Matsushita Corporate Values

- policy orientation
- customer satisfaction
- contribution to society
- co-existence
- co-prosperity

Mitsubishi Corporate Values

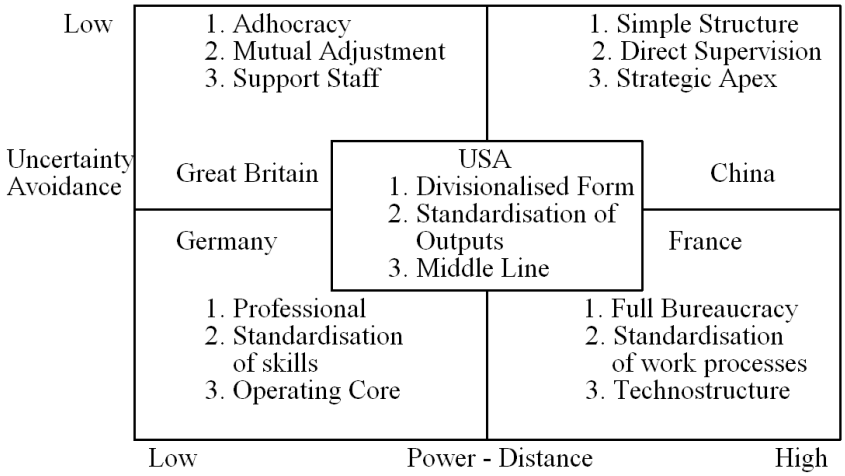
- fair play in business
- employee orientation
- high morale
- concern for individuals
- non-risk taking

In common with their US counterparts, Japanese corporations also attempt to foster in their foreign subsidiaries the kinds of attitudes that are compatible with Japanese values.

The European approach

In considering European corporations, there is less uniformity. Despite the fact that it is common to speak of the industrial triad of the USA, Japan and Europe, there is a great deal of cultural diversity in Europe. Four of the world's seven most industrialised nations (G7) are European, namely Germany, France, Italy and the UK. The dominant philosophies underpinning thought in each of these countries are different. However, in the same way as American and Japanese values shape the managerial approaches that are evidenced in American and Japanese corporations, so do the values of the various European countries shape the managerial approaches of the corporations that originate in them.

Lessam and Neubauer (1994) conceptualise the American and Japanese styles of management as being at opposite ends of a spectrum. They locate those of Europe's four most industrialised nations in relation to these two extremes in Figure 16.6 which you saw earlier on in this topic.



Key:

1. Preferred configuration
2. Preferred coordination mechanism
3. Key part of the organisation

Source: adapted from Hofstede (1991, p. 152).

Despite the fact that Europe is regarded as one of the trading blocs in the in-

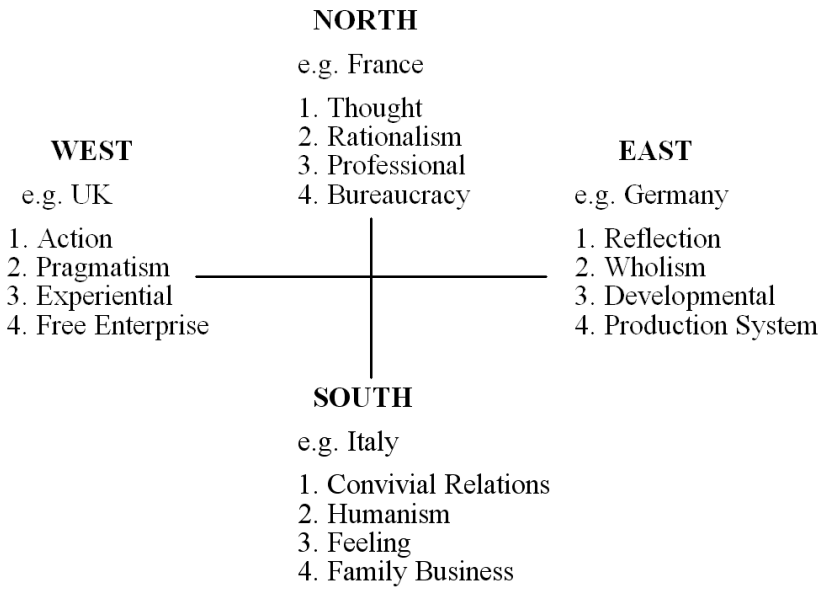
dustrial triad, and regardless of the emergence of pan-European production and marketing strategies in multinational corporations competing in the EU, there are significant differences in the beliefs and values and modes of thought which can be evidenced in these four major European countries. Notwithstanding the European integration project, significant cultural differences remain across western Europe. As Schneider and Barsoux (1997) argue:

> A European melting pot was expected in 1992, when with the creation of an economic union all business people would look and act alike … but the magic moment came and went, adding little to the creation of a common European culture. (Schneider & Barsoux 1997, p. 4)

Even so, European business cultures, modes of thought and values share common features and are, in general, different from those prevalent in the US and Japan. Child, Faulkner and Pitkethly's (2001) research into the behaviour of US, Japanese, UK, French and German companies in managing their newly acquired UK subsidiaries found the following. The US were identity destroying integrators. The UK were similar but less rigorously so. The Japanese were Japanese culture facilitators and coaches. The French were 'colonialists', and on the international stage the Germans were uncertain, unwilling to be tagged as autocrats like their caricature.

The Four Business Cultures of Europe

Lessam and Neubauer (1994) have explored European business cultures and attempted to provide a framework within which European diversity can be understood. They describe a 'European business sphere' in which there are in their view four different aspects.



Key:
1. Predispositions fostered
2. Philosophy
3. Type of manager
4. Preferred mode of business operations

Source : adapted from Lessam and Neubauer (1994).

Lessam and Neubauer (1994) recognise that diversity in European modes of thought has manifested itself in different styles of managing, organising and controlling corporations and that such diversity is an important aspect of the European business context. They aim to provide a means of appreciating differences in modes of European thought in terms of dominant philosophies in different European regions. Their effort may be commended as an attempt

Quick summary

The four business cultures of Europe

- Lessam and Neubauer have explored European business cultures and attempted to provide a framework within which European diversity can be understood, described as 'European business sphere'.
- They recognise that diversity in European modes of thought has manifested itself in different styles of managing, organising and controlling corporations and that such diversity is an important aspect of the European business context.

to provide a theoretical model that explains diversity in European management thought. There are, however, some details that need to be treated with caution, as we shall explore on the next screen.

Philosophies underpinning thought

Lessam and Neubauer (1994) argue that in the case of the UK, the dominant philosophy that underpins modes of thinking is pragmatism. This is an individually centred experientially based outlook on life, which is shared to a degree by the Scandinavians and the Dutch. It is opportunist and 'nomological' in outlook, the preferred opportunity being one that delivers an immediate return.

The term nomological refers to an opportunist outlook on the world, which recognises certain decision-making procedures that can impose constraints, but are intended to maximise the possibility of considering alternative courses of action. Lessam and Neubauer categorise pragmatism as the philosophy of the 'west'. Pragmatism as a philosophical doctrine holds that know-how is derived from experience. As such, it fosters an inductive mode of thought.

Aspect or Feature	Attribute
Kindred philosophies	Empiricism, utilitarianism
Unit focus	Entrepreneur, enterprise
Business outlook	Competitive, transactional
Psychological characteristics	Action oriented
Path of evolution	Self-help to self-development to learning company

Source ***: adapted from Lessam and Neubauer (1994, p. 36).***

Pragmatism

Pragmatism is primarily a US philosophy promoted by William James, Charles Pierce and John Dewey. It has its place in the United Kingdom in the modern works of Hayek and Popper. Pragmatism in Britain has been led by Bertrand Russell and A. J. Ayer in the twentieth century.

Lessam and Neubauer note that pragmatism has a tradition in Holland and Scandinavia. They do not note that it also has a tradition in Germany where it has been promoted by Hans Vaihinger. As is noted in the discussion of Germany later in this topic, pragmatism is not strong in this country. But it is not alien. It has no notable tradition elsewhere in Europe (Burns 1961).

The pragmatist utilitarian tradition of thought in the UK was dominant in the first half of the nineteenth century. However, in considering the 20th century, Lessam and Neubauer's claim that it is the dominant UK philosophy and characteristic of the west of Europe is contestable, and contrary to that of authoritative interpretations of European thought (Burns 1961; Outhwaite & Bottomore 1993). These commentators recognise the importance of other schools of thought in the UK, the idealist in particular.

Let us now look at the philosophies that dominate in different parts of Europe.

- The UK
- France
- Central and Eastern Europe
- Southern Europe

The UK

Idealist ontological thought in Britain is represented by philosophers like Bradley, Collingwood and Oakeshott. The term 'ontological' refers to an outlook on the world that is reflective on the past with a view to conserving that which

Your notes

is considered to be of intrinsic value to those whose identity depends upon its survival. In the realm of British politics, this was the characteristic mode of conservative party thinking prior to the Thatcher era. During the Thatcher era, there was a resurgence of pragmatic thinking in the political domain, but idealism was not eradicated from the British conservative party and neither was it abandoned in the wider context of British society generally.

Programmatic teleological thought of the wholistic utopian type also has strong UK roots in the work of William Morris, the Webbs, Laski, Tawny and Durbin. The term 'teleological' refers to an outlook on the world in which existing resources are to be marshalled towards the pursuit of an overriding objective. It is acknowledged that sacrifices may have to be made in the short term to achieve the long-term goal. In the post-war period, this was a dominant mode of thought in the UK political arena.

The philosophical underpinnings of UK thought are therefore more diverse than the account supplied by Lessam and Neubauer implies. This fact helps to explain that, in the context of UK corporate cultures, at least three different ways of thinking about strategic requirements can be identified. These are the ontological idealist, nomological pragmatic and teleological wholist, which will be described later in this topic (Carlisle & Manning 1994). In the UK, these three traditional forms of reasoning have traditionally co-existed and continue to do so.

France

Lessam and Neubauer argue that rationalism is the philosophy that predominantly underpins thought in France. They categorise rationalism as the philosophy of the 'north'. Rationalism sees reason as the source of knowledge. It is a philosophy that fosters a deductive mode of thinking, seeing certain knowledge as derivable from irrefutable a priori concepts.

Aspect or Feature	Attribute
Kindred philosophies	Positivism, scientism
Unit focus	Management, organisation
Business outlook	Coordinated hierarchy
Psychological characteristics	Thinking, analysis oriented
Path of evolution	Functional to structural bureaucracy

Source: Lessam and Neubauer (1994, p. 38).

As in the case of the UK, there are other philosophical traditions in France. Rationalism stemming traditionally from Descartes (cogito ergo sum), despite the challenge from existentialists like Sartre and Camus, remains dominant today, although the importance of the co-existence of other traditions is not to be underestimated in accounting for the fact of European diversity.

France has its own native strands of idealist ontological thought, led by Bergson, although this philosophy has never achieved dominance in the French context. It also has a wholist tradition, which has been strong in the past, although it is now in decline. This is evidenced in the writings of Saint-Simon. The communist political outlook that has historically predominated in certain regions of France is a reflection of French wholist thinking.

In many European countries, it is notable that seemingly incompatible and antithetical modes of thought, beliefs and values have co-existed, albeit with varying degrees of dominance at various points of time in the histories of the countries concerned. In France, for example, the opposing doctrines of Roman Catholicism and Communism have both been influential forces shaping French society.

Lessam and Neubauer cite rationalism as the dominant mode of reasoning in France. Despite attacks on the French rationalist tradition by native schol-

ars like Paul Ricoeur, its dominance fundamentally remains intact. What is not stressed in their account is that, in France, as in the UK, the co-existence of seemingly opposing modes of reasoning has been fostered.

Central and Eastern Europe

Wholism is the philosophy that Lessam and Neubauer associate with Central and Eastern Europe in general and Germany in particular. It is a teleological goal-directed programmatic mode of thought that favours attempts at social engineering of the kind attempted by the Nazi party in the era of the Third Reich.

Aspect or Feature	Attribute
Kindred philosophies	Idealism, historicism
Unit focus	Industrial association
Business outlook	Cooperative and systemic
Psychological characteristics	Intuitive, reflective
Path of evolution	Differentiation to integration to closed cartel to open system

Source: Lessam and Neubauer (1994, p. 39).

Lessam and Neubauer suggest that it fosters an outlook that has similarities to that represented by the Japanese drive towards perfectionism. Germany also has a tradition of pragmatism, as was noted earlier. It may never have been a dominant or strong tradition, but nonetheless it does exist.

Idealist ontological thought, on the other hand, has a strong tradition in Germany, which is represented by Hegel, Herder and Heidegger. Before the Second World War, this was the tradition of thought that underpinned the thinking of German corporate enterprise as illustrated by such well-known examples as the chemical giant I. G. Farben (Hayes 1987). The Nazi movement combined ontological idealism, focused around the concept of volk, with teleological reasoning, directed towards technology and social engineering.

In modern Germany, idealism is a tradition evidenced mainly in the minority ranks of some political dissidents who have adopted extreme nationalist doctrines. As in the Nazi era, nationalism has been linked to teleological modes of reasoning by some of the more extremist groups, usually referred to as Neo-Nazi.

Today, the German ontological idealist tradition does not pose a serious challenge to the established mode of thought, which is, as Lessam and Neubauer point out, wholism. This is the tradition that has been dominant and influential in banking and business administration since the war. However, the fact that ontological idealism and teleological wholism both have strong German roots and could even effect a marriage at one point in the course of German history is evidence for the fact that in Germany, as in many other countries of Europe, diversity of thought is an established part of the culture.

Southern Europe

Europe's cultural heritage is also tied to the arts as well as to science. Lessam and Neubauer note that humanistic elements are especially strong in the catholic southern European countries, Italy being an exemplar. Feeling, as opposed to thought, is argued to predominate.

Aspect or Feature	Attribute
Kindred philosophies	Aestheticism, classicism
Unit focus	Family Group, social community

Business outlook	Communal, networked
Psychological characteristics	Feeling, concretely oriented
Path of evolution	Patriarchal to social architect to family business to socio-economic networks

Source ***: Lessam and Neubauer (1994, p. 44).***

These areas of Europe are more communal and their inhabitants value family relationships more highly than in northern Europe where the Protestant religion prevails. In Italy, family firms are common and their management is paternal.

Italy also has a native tradition of wholist thought. It is represented by the teleological wholist communal anarchism of Gramsci. Gramsci's thought was directed towards worker participation ideals in opposition to the elitist and paternalist traditions of catholic Italy. This native Italian form of wholist thought re-emerged as a force in Italian industrial life during the 1950s when communism became a formidable power in industrial relations. This was especially so in Bologna and Milan.

The impact on business

The philosophies of Europe that you have been reading about foster different dominant modes of thought and place different priorities on values. They have implications for preferred models of business activity, organisational structures, types of manager, management styles, strategic orientations and working relationships.

However, the four major European countries all have strong native traditions in more than one of the four philosophies, even though at particular times in their histories certain ones have been dominant. They have a tradition of co-existing philosophies of thought. To neglect this fact is to miss something of the importance of diversity of thought in these countries. The four philosophies may encourage the development of particular types of business culture, but not one of the major European competitors can be considered to have developed from a unitary tradition.

Lessam and Neubauer summarise the main differences implied by the different philosophies of Europe. See Figure 16.12 for an illustration of their summary.

Philosophy	Management type of Style	Productive process	Orientation
Pragmatism	Experiential	Competition	Transactional
Rationalism	Professional	Coordination	Normative
Wholism	Developmental	Cooperation	Integrative
Humanism	Convivial	Co-creation	Transforming

Source ***: Lessam and Neubauer (1994, p. 44).***

These philosophical differences and their implications are argued to lead to different types of business culture. See Figure 16.13 for an illustration of these implications.

Due to the fact that co-existence of philosophical traditions has been fostered in Europe, at the level of individual corporate enterprise, more than one type of culture is liable to be evidenced in any given country, even though a particular type of business culture may predominate in that country as a whole. Particular cultures, however, may still support tendencies towards the development of certain enthusiasms, abilities, competences, capabilities and strategic outlooks, in those companies and in those industries that are primarily influ-

Your notes

enced by their dominant modes of thought.

Pragmatism Commercial	Rationalism Bureaucratic	Wholism Industrial	Humanitarianism Familial
Foundation Transactional	Administrative order	Work systems	Service relations
results Enthusiasm for results	Enthusiasm for objectives	Enthusiasm for technology	Enthusiasm for working together and for people
Action planning	Cognitive orientation	Work discipline	Group orientation
Entrepreneurial flair	Strategic planning	Quality emphasis	Shared values
Commercial bias	Organisational bias	Technical association	Social affiliation
Improvisation	Coordination	Technical superiority	Personnel
Salesmanship	Management control	Production process	Human systems
Short-term outlook	Long-term outlook	Long-term outlook	Management as art

Source ***: adapted from Lessam and Neubauer (1994).***

Lessam and Neubauer point out that pragmatically oriented cultures are results oriented. Action planning, entrepreneurial flair and a commercial bias are encouraged. The ability to improvise is valued, sales skills are liable to be strong and the strategic orientation is likely to be short-term profit oriented.

Rationalistic cultures are more objectives oriented. There is a cognitive and strategic planning orientation coupled with a concern for the processes of organisation and management control. Rationalism fosters a more long-term outlook than pragmatism.

Wholism encourages a belief in the virtues of work discipline. The emphasis of wholist industrial cultures is upon technology, quality, technical association and technical superiority. The most valued and stressed part of the system is the production process and the strategic orientation is long term.

In humanistic cultures, management is seen to be more of an art than a science. Humanism fosters an enthusiasm for people and working in groups. Shared values are important and people relate to each other in a more social, convivial and less formal way than in pragmatic, rationalist and wholist industrial cultures. Human resource systems and personnel management are emphasised.

Different countries support different dominant economic rationalities, even though these rationalities may not be uniformly held by the companies operating in them. This is something that is documented in the literature (Powell & DiMaggio 1991; Whiteley 1991). Different ways of thinking about the requirements for business and the prioritisation of values in business cultures lead to different emphases both in strategic and organisational terms. In the modern world of multinational corporations, industries comprise companies with different national origins, yet firms within particular industries often pursue very similar strategic industry recipes (Spender 1989). Industry traditions can have as much influence upon the thinking of managers in them as their national cultures of origin.

In Figures 16.8 to 16.11, which you examined earlier in this section, it was shown that different philosophies and values imply different paths of organisational evolution. Figure 16.13 is suggestive of the propensity for organisations

whose managers are primarily influenced by different traditions of thought to develop different competences and capabilities. If managerial modes of reasoning are supported by the dominant traditions of thought in the countries in which their corporations are operating, the business culture of that country may also support their strategic intents and chosen organisation development paths better than countries in which the dominant economic rationalities are different.

For example, the emphasis upon technology in Germany may favour the development of technological competences. Companies such as BMW and Audi, for example, originate in this part of Europe and have developed a reputation for technologically sophisticated products. If this technological competence is one that can sustain competitive advantage, then BMW and Audi could conceivably be considered to have benefited from the fact that they are German companies.

Industry recipes

Porter (1990) argued that companies originating in some countries compete more effectively in particular industries than those originating in others. As earlier discussions of Porter's work reveal, he attributes this largely to economic factors, such as resource endowments, domestic demand conditions and the strength of related and supporting industries.

Pennings and Gresov (1986) suggest that congruences between national, industrial and organisational cultures, as well as organisational structures, will influence company performance. This suggests that when successful industry recipes are attuned to the dominant economic rationalities of particular countries, and the modes of reasoning of the managers of firms in those industries lead them to pursue successful 'recipe' strategies, the countries concerned can offer cultural advantages to corporations in those industries as well as the economic ones cited by Porter (1990).

The obverse side of this coin is that accepted industry recipes are not infallible. Many well-known industry leaders that have followed industry strategic recipes have in recent years been dislodged by 'upstart challengers' (Hamel & Prahalad 1994). These firms, termed 'industry revolutionaries' by Hamel (1996), employ creative new and different strategies that often serve to radically change an industry's competitive norms and standards. The industry strategic recipe follower, whose manager's modes of thinking are attuned to the dominant economic rationalities of their countries, may well be placed at a cultural disadvantage if different strategies are needed.

Competition Models, Managerial Mindsets and Strategies

The suggestion that countries may provide corporations in certain industries with cultural advantages or disadvantages is in no way antithetical to the notion that "the firm matters, not the industry" (Rumelt 1991). Dominant national philosophies and economic rationalities may support some types of strategy and directions of organisational evolution better than others, but organisational cultures are not uniform. Not all managers in an industry will have the same mindset, even though managers and their corporations may share the same national origins.

In preceding topics, different models of competition and their strategy requirements have been described, each of which may be associated predominantly with one or other of the two broad approaches to the process of strategy formulation. See Figure 16.14 for an illustration.

Your notes

Quick summary

Competition models, managerial mindsets and strategies

- Dominant national philosophies and economic rationalities may support some types of strategy and directions of organisational evolution better than others, but organisational cultures are not uniform.
- Spender affirms that managers base their attitudes towards competition on some kind of mental model.

	Competition as Positioning	Competition as a Battle of Strength	Competition as an Innovative Contest
Example	Positioning approach	Portfolio approach	Re-invent industries and regenerate core strategies
Advocates	Porter, Ansoff, Mintzberg	Rugman Booth & McGraw, BCG	Hamel & Prahalad, Baden-Fuller & Stopford
Central themes Determinant of the nature of competition	Industry structure	Market share and corporate resources	Competitive approaches of firms in industry
Definition of a good strategy	Enables firm to achieve/sustain a leading profit-making position in industry	Enables firm to maintain existing dominant market position	Enables firm to develop and exploit unique qualities
Basis for competition	Generic strategy	Size, scale economies, organisational learning	Capabilities and competences
Predominant perspective	Outside-in	Outside-in	Inside-out
Perceived requirements for strategic change	Secure better profit-making opportunities	Protect market position by ensuring new inputs and resources required to counter environmental threat	Achieve the stretch and leverage required to achieve a strategic intent

Spender (1989) affirms that managers base their attitudes towards competition on some kind of mental model. However, which of the three models described above best portrays the orientations of particular managers depends upon their mindsets as determined by their beliefs and values. Different national and industry rationalities can be expected to influence managers' interpretations of their competitive environments and the strategy requirements of their companies.

However, despite the dominance of particular economic rationalities in particular countries, variations are likely to be found. Similarly, though firms in an industry may have a tendency to follow particular 'industry recipes', not all firms in an industry will do so. Uniformity cannot be presumed, but uniformity is not a necessary condition of a global economy.

Three forms of reasoning have been identified in the Western context of the UK garment manufacturing industry, which are formative of managerial competitive mindsets (Carlisle & Manning 1994). These forms are the nomological, ontological and teleological forms, which were briefly described earlier in this topic. From the description given by Carlisle and Manning, they can be related to each of the three models of competition and its strategy requirements which were described.

Forms of ideological reasoning determining mindsets

	Nomological	Ontological	Teleological
Compatible competition strategy model	Positioning model	Battle of strength model	Innovative contest model
Determinants of successful competition	Opportunities that exist, but are not created, in the external environment of the firm	Ability of firms to protect existing market advantages	Ability to reach a predetermined goal
Orientation towards competitive requirements	Opportunist	Defensive and pre-emptive to avert potential threats	Goal oriented
Central themes ***Perceived relationship between firm and its competitive environment***	Opportunities exist that firm can take advantage of, e.g. profitable industry sectors and positions	Existing strengths of firm provide foundation for future competitive success, e.g. market share and corporate resources	Achievement of goal (strategic intent) is essential to future success. Means must be found to reach it, e.g. strategic innovation
Definition of a good strategy	Enables firm to exploit opportunities to achieve or maintain a better industry position	Enables firm to maintain dominant market position	Enables firm to marshal resources necessary to achieve pre-determined goal
Basis for competition	Contingent upon opportunities and resources	Accumulated skills, knowledge and resources	Commitment of organisational members to goal (ability to mobilise them towards it)
Predominant perspective	Outside-in	Outside-in	Inside-out
Perceived requirements for strategic change	Secure advantages of opportunities	Protect and build on existing position; counter any threats to it	Adopt any suitable means to achieve the goal

Source ***: Carlisle and Manning (1994).***

- The first form of reasoning, the nomological, is opportunist.
- The second, the ontological, protects and builds upon what already exists.
- The third, the teleological, is oriented towards a future goal.

Different traditions of philosophical thought tend to be associated with the ontological, nomological and teleological respectively. However, the three forms of reasoning are germane to different attitudes towards the requirements for change that can occur in any cultural context.

Summary

Your notes

Although the majority of strategic management theory and practice originates in the US, it is increasingly realised that cultural differences restrict its usefulness in many countries of the world. Fundamentally, a strategy that works well in one culture is often difficult to employ efficiently and effectively in a different cultural context. This is due to different attitudes, beliefs and values, which foster different managerial mindsets and contrasting ways of doing business.

Established managerial mindsets can, be a major obstacle to organisational change, as can the established mindsets of the workforce. This may not be a problem in times of environmental stability, but given that the international business environment is, for many companies, turbulent and unpredictable, this has become an issue.

Task ...

Task 16.1

To check your understanding of the material in this topic, try to answer the following questions. If you have any difficulties, you may wish to go back and revise the relevant part of the topic.

1. Hofstede (1980) offered a categorisation of countries based on four dimensions of difference. What are these differences?
2. What are the implications of the 'power-distance relationship' for strategic change in an organisation?
3. What are the main characteristics of masculine society, as defined by Hofstede?
4. Mintzberg et al. (1998) advance five linkages between corporate culture and strategy. What are they?
5. In the spectrum of management approaches developed by Lessam and Neubauer (1994), which European approach is closest to that of Japan?
6. What are the four main business cultures of Europe?
7. What are the main features of 'pragmatism', the dominant mode of thinking in the UK?
8. What do you understand by 'wholism' as a philosophy underlining management thinking?
9. Spender (1989) affirms that managers base their attitudes towards competition on some kind of mental model. What factor(s) determine which competitive model best portrays the orientations of particular managers?
10. What are the three forms of reasoning, in the Western context, that are formative of managerial competitive mindsets?

Resources

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Topic 17

International Strategy in the Service Sectors

Aims

The purpose of this topic is to:

- show the importance of the service sector in the economies of the developed world in particular;
- illustrate how different service provision is to product provision, at least traditionally;
- show how in recent years moves to achieve scale economies in services have reduced these differences;
- illustrate this by considering the internationalisation of professional services.

Objectives

By the end of this topic you should be able to:

- perceive the generally under-rated importance of the service sector;
- understand how service strategies are developed;
- see how the theories of scale and scope economies affect the modern service sector;
- perceive how as a result service and product provisions are coming to become economically more alike;
- understand the growing internationalisation of professional service firms.

Introduction

Service industries are those whose output is not a physical good or product but an intangible 'experience'. This underpins an essential difference in the significance of internationalisation or globalisation in services as opposed to manufacturing. International service delivery is about controlling the quality of the offering at the point of sale to the customer. The expectation of the customer is for consistency and predictability of service levels in any location worldwide.

Whilst service MNCs may follow any of the strategies or structures discussed in the preceding topics, service industries and service firms have distinct characteristics that may add risk and delivery problems to the design and implementation of international service strategies. This topic will present current research into service standardisation and approaches to managing 'intangibles' across borders. It will cover potential sources of economies of scale and scope in services, and internal management processes for the effective implementation of international strategies in service firms.

Growth in International Services

Historically, the literature on global strategy (Porter 1986; Ghoshal 1987; Prahalad & Doz 1987; Bartlett & Ghoshal 1989; Ohmae 1989; Yip 1991 &1992) has taken its evidence overwhelmingly from manufacturing industry, although services now account for some two-thirds of GDP in developed economies and are significant in terms of output, jobs and trade balances (Riddle 1986; Enderwick 1989).

Agreement on freeing trade in telecommunications was finally reached by the WTO in 1997 and a new round of talks in services trade was due to begin in 2000. Such deregulation allowing freer trade in services will help to clarify comparative advantage in services. It is already commonplace for systems and software engineers in developing countries to write computer programmes for corporate customers in developed economies to process airline tickets or insurance claims. Any activity that can be conducted through a screen and a telephone can now be carried out anywhere in the world and linked to other offices or corporate centres anywhere in the world. This should both drive down prices to customers and create employment.

A prolonged process of concentration and cross-border restructuring has been occurring for the last 20 years in most service industries. Mergers and acquisitions have been commonplace. In services it is often the customer who internationalises first, with the service company following to meet the needs of important clients. In the advertising industry worldwide, firms such as Omnicom, WPP or Interpublic needed to build international networks of agencies to service MNC clients, particularly those requiring the delivery of global campaigns. Similarly, from the end of the 1980s to the end of the 1990s, the 'Big 8' accounting and consulting firms became the 'Big 5', raising worries about lack of client choice for MNC accountancy services. Other professional services such as law are now following the same path of international merger and consolidation.

Service growth has partly come as a consequence of organisational trends towards delayering, outsourcing and downsizing. Specialist service suppliers are replacing service provision previously carried out in-house.

Firms like EDS, the US technology and facilities management company, have grown rapidly, nationally and internationally, as an external supplier of information technology (IT) design and management for client companies. Large service firms can standardise and replicate facilities, methodologies and procedures across locations. Specialisation and standardisation are leading to high quality provision at lower cost to the client company or customer, whether

Quick summary

Growth in international services

- Agreement on freeing trade in telecommunications was reached in 1997, Such deregulation allowing freer trade in services will help to clarify comparative advantage in services.
- A prolonged process of concentration and cross-border restructuring has been occurring for the last 20 years in most service industries. Mergers and acquisitions have been commonplace. In services it is often the customer who internationalises first, with the service company following to meet the needs of important clients.

in such different service businesses as car repair (e.g. exhaust, brake and tyre centres) or management consultancy. Building international brands for services has become an important guarantee of quality and consistency around the world.

Managing 'Intangibles' Across Borders

Service industries have some important characteristics that distinguish them from manufacturing industries. Amongst the most widely recognised are those of intangibility of the service offering and the simultaneous production and consumption of the service as a shared experience between the customer and the supplier of the service (Sasser et al. 1978). Successful international service delivery is about being responsible for this quality of customer experience, often known as 'the moment of truth' (Normann 1984; Carlzon 1987; Lovelock 1996) or 'the service encounter' (Bowen, Chase & Cummings 1990).

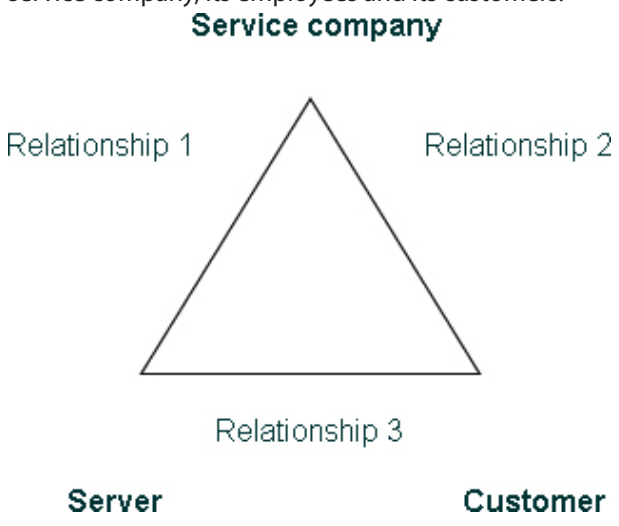
For service industries, control of the offering at the transaction point with the customer or client is critical. When the service network is extended globally, the management of outcomes for the customer faces quality control problems in accurately reproducing the service concept in different cultural, political and economic environments and ensuring consistency of quality in the daily operational detail of face-to-face service delivery. In an influential article, Carman & Langeard (1980) argued that international expansion is the most risky growth strategy for service firms since the quality control problems are exacerbated when firms attempt to operate across national boundaries.

Most large service firms have met these requirements for consistency through standardisation of their offering (Campbell & Verbeke 1994). All the international hotel chains (Hilton, Sheraton, Inter-continental) undertake to make the traveller's experience of Tokyo, Cape Town, Manila or Sydney, as similar as possible. However, issues like staff training are critical in international service firms since it is these front-line staff that are responsible for the quality of the customer's experience.

Erramilli (1990) distinguishes between hard and soft services. Many modern service businesses contain a shifting mixture of hard and soft elements.

- The hard elements are increasingly amenable to management by means identical to a manufacturing business.
- The soft (i.e. the service encounter) elements retain the distinctive needs of service management and service delivery.

Thus the role of management in services is particularly demanding, especially for complex services with a high intangibility content. What Heskett (1986) called "the service triangle" describes the iterative relationship between the service company, its employees and its customers.



Quick summary

Managing 'intangibles' across borders

- Service industries have some important characteristics that distinguish them from manufacturing industries. Amongst the most widely recognised are those of intangibility of the service offering and the simultaneous production and consumption of the service as a shared experience between the customer and the supplier of the service.
- Erramilli distinguishes between hard and soft services:
  - The hard elements are increasingly amenable to management by means identical to a manufacturing business.
  - The soft (i.e. the service encounter) elements retain the distinctive needs of service management and service delivery.

Source: Heskett (1986).

Your notes

Often the strongest relationship in a service business is between the employee (the 'server') and the customer. It is balance in the triangle that enables the company to carry out the effective management of intangibles across borders.

The management task for service MNCs is to develop a mix of hard and soft resources and the internal competences to combine these into consistency of cross-border 'service encounters'. If we think back to Novotel in Topic 15, in terms of the hotel industry, 'hardware' such as beds or televisions are relatively more straightforward to coordinate and deliver across borders than 'software', such as the style and atmosphere of a hotel or how staff conduct themselves in their dealings with guests (and each other). The firm infrastructure and procurement management policy and processes which support the selection and supply of beds or televisions to hotels around the world involve many levels of task and resource. However, the shared values and tacit understandings underpinning the delivery of service encounter 'software' is far more problematic in terms of management processes.

We will consider how the issues that you have been reading about above have been addressed in a rather different international service business: contract cleaning. Read the case study about ISS, a Danish company, to find out more.

Case study: Cleaning as knowledge management – ISS of Denmark

In an industry characterized by perceptions of low status, low-skilled workers and high staff turnover, ISS invests heavily and continuously in training its staff and attempting to retain their loyalty. Although a commonplace in most other industries, it may appear unusual to emphasize knowledge, skills and staff expertise in relation to office cleaners. Yet this is a service business and customer satisfaction depends ultimately on how front-line staff (in this case, cleaners) carry out their jobs. Commercial cleaning requires high levels of efficiency in timeliness, use of cleaning supplies, avoiding accidents and dealing with idiosyncratic customers. In many hospitals and factories, conditions are often complex and hazardous.

In the commercial cleaning business there are now several international service providers such as Rentokil (UK), ServiceMaster (USA) and ISS (Denmark). These large service MNCs outbid local providers since they benefit from scale and investment in back-office systems to enable them to efficiently coordinate their purchasing, marketing and logistics to win national and international contracts with hospitals, offices, factories and government departments. However to retain these contracts, service delivery by staff is what counts.

ISS itself operates throughout Europe and Asia, although it had to sell its USA business in 1997 because of an accounting scandal. It has a universal emphasis on training and an impressive staff retention record. ISS Denmark, for example, operates a six-month training programme for all employees covering things like safety and which chemicals to use on which stains. After a year with ISS employees may become team leaders. For this they need better overall knowledge of the business. So they are given prior training on the economics and finance of the business, so that they can understand where the profit in each contract is to come from and how to interpret each client contract. Team leaders have tight performance targets, measured on both profitability and customer retention. So they also receive training on how to deal with customers and how to coach less experienced members of their team.

ISS attempts to provide its employees with technical skills but also to motivate them as front-line staff and to keep the benefit of their expensive training inside the company. To do this the company has had to think creatively about it organizes the work. ISS Denmark has grouped its cleaners into two or three-person 'hit squads' for its small office division. They work together travelling

from site to site. This is in many ways less efficient and more costly than sending separate individuals to separate sites, but ISS believes that this system generates both higher motivation and makes possible more contact between ISS's supervisors and the client's site managers. To increase such customer contact, when crucial customer feedback may be obtained, ISS is rescheduling many of its accounts to provide overlap time between cleaning staff and office staff. As part of its focus on motivation, ISS also pays above the competitor average. So far it feels that it has not lost business as a result of its higher costs. Well-trained employees and good back-office systems have enabled it to bid for, and win, complex contracts, such as the hotel cleaning contract at Disneyland, Paris. Partly, ISS is helped by timing, since this industry has just emerged from a period of rapid concentration internationally, so that ISS faces only two or three major competitors in its market. Nevertheless profitability and productivity are major concerns, especially ISS's higher training and wage costs. It recently sold its ISS University which had co-ordinated training across regions. Instead, training is being decentralized in an attempt to tailor knowledge to local conditions.

Source: adapted by author from press articles and The Economist, 25/4/98.

When you have read the case study, let us compare Novotel, which you read about in Topic 15, with ISS in how they each attempted to manage their service intangibles.

Novotel first attempted to manage their cross-border 'service encounter' issues by what Levitt (1986) called the "industrialization of service", in other words imposing rigid control processes (the 95 Bolts) on staff in order to ensure predictability of outcomes. After rethinking the business in 1992, they saw their competitive advantage as residing in their concept of 'hospitality', a classic intangible. They returned to their entrepreneurial roots and replaced the hierarchical structure with an enabling culture of front-line discretion, supported by high levels of training.

Whereas ISS could have defined itself as a business-to-business service and designed the timing of much of its operations to avoid any 'service encounter' contact, instead the company went out of its way to build it in. They wanted to utilise the service encounter both to motivate staff and to provide direct contact and feedback opportunities with customers/end users (even though these 'customers' did not themselves pay directly for the service).

Each company also invested greatly in training both as a way of enhancing skill levels of staff but also as a way of ensuring a coherent and consistent worldwide knowledge base in the firm

Scale and Scope in Services

Industry concentration rather than fragmentation

Much of the historic pattern of competition in services occurred within domestic market boundaries as a result of the small-scale, fragmented structure of service industries, and their culture-specific patterns of demand and consumption. Under these conditions clearly scale and volume effects were limited. However, as has already been argued, in most service sectors restructuring has led to industry concentration replacing industry fragmentation. In addition, some homogenisation of demand in services (as already discussed in Topic 3) is also observable.

'Back-office' and 'front-office' activities

The important difference between back-office and front-office activities in services is extremely significant for the internationalisation of services. 'Front-office' describes those activities that come into contact with the customer; 'back-office' are the operational activities which can be decoupled from the

Quick summary

Scale and scope in services

- Much of the historic pattern of competition in services occurred within domestic market boundaries as a result of the small-scale, fragmented structure of service industries, and their culture-specific patterns of demand and consumption..
- The separation of back-office and front-office activities, combined with the standardisation of many back-office processing functions, has created the opportunity for breaking out of the requirement for simultaneous consumption and production of a service

customer. The significance of this distinction in international strategy terms for service MNCs is that the larger the proportion of 'back-office' value chain activities in the service that can be decoupled from the location of the customer, the greater the potential for optimising OLI advantages (Dunning 1989); reconfiguring the organisation's value chain (as discussed in relation to Porter's Configuration/Coordination matrix in Topic 10); and securing scale and scope advantages in the same way as manufacturing MNCs. If most activities of a service organisation cannot be decoupled from the customer in this way, then strategic flexibility remains low and the costs and service delivery problems for an international strategy remain high.

The separation of back-office and front-office activities, combined with the standardisation of many back-office processing functions, has created the opportunity for breaking out of the requirement for simultaneous consumption and production of a service.

The developments you have just been reading about, which are largely due to technological advances in IT, have had a huge impact on potential sources of economies of scale and scope in services. They allow for the reconfiguration of service value chains which can be desegregated (just as for manufacturers) and parts of the activity may be located geographically for optimum scale, scope or cost advantage.

For example a company like VISA International has a geographically dispersed value chain whereby all its worldwide back-office data transactions (e.g. card clearances) are handled by just two global transaction centres in Japan and the USA. These types of international configurations for services are technology-dependent rather than 'service encounter' dependent.

Under changed technical and structural conditions it becomes necessary to reconsider the definition of what constitutes a service and also to consider how firms actually design and deliver their services.

Your notes

	Balance of Resources	
	Back office	Front office
Standardisation	retail banking	contract cleaning
Customisation	courier services	professional service firms

Source: adapted from Segal-Horn (1993).

Figure 17.3 reflects some of the differences in core assets and service delivery between hard and soft services. It also reflects some of the rethinking of services that has occurred.

For example, the location of retail banking in the top-left box, reflects the capital-intensive, volume-driven, transaction-processing part of retail banking operations. These activities are usually now centralised and regionalised. At the same time, the retail banks have been redesigning branch outlets to be more customer-friendly, in order to cross-sell other higher-margin financial services. Software houses may sometimes appear in the top-left box also if they are selling standardised rather than bespoke software packages.

However, the examples in Figure 17.3 are inevitably oversimplified (e.g. it ignores the search by PSFs for methodologies to increase productivity and

margins via back-office standardisation, an approach for which Arthur Andersen is well known). It is inevitable that continuous shifts such as those between standardisation and customisation, should result in firms continually seeking optimisation of such features at the highest level of scale and cost position available to them. It is also to be expected that these positions of optimum efficiencies will be continually shifting.

Ghoshal's framework

We can now usefully return to the Ghoshal (1987) framework introduced in Topic 10. Service firms seek to benefit from the same sources of potential advantage as manufacturing firms in their international expansion. The issue is whether such benefits from international expansion are as attainable for service firms as for manufacturing firms. Ghoshal (1987) summarised three potential objectives of international expansion to benefit from:

- National differences (for example, to obtain beneficial factor costs, or offset country-specific government policies).
- Scale economies (for example, to spread cost-reduction and experience effects across national boundaries, to expand or exploit scale in purchasing, distribution, capital costs, etc.).
- Scope economies (for example, shared investments, knowledge and learning across products and markets).

A combination of structural, market, regulatory and technological changes has provided a shift in the balance of activities within service firms. Greater technological capability has led to the redesign of many services to enhance the back-office proportion of activities in the service value chain. This has lowered considerably the levels of perceived risk, and enhanced the potential benefits, attached to international expansion of service firms.

In seeking a model to capture these developments in international services and also to look at their relative potential in different service industries, in the next section of this topic, we have adapted Chandler's model (1977, 1986, 1990) of manufacturing industry growth to explain the growth of service MNCs. We explore and develop this framework to show the potential of economies of scale and economies of scope within a variety of service industries.

Scale and scope variables are particularly useful since they drive cost for a service firm and one of the big issues in successful international expansion is that it must involve some efficiency advantages to justify the costs of integration of cross-border operations, compared to provision of the service by a domestic firm. These factors appear to be having some impact on the creation of international oligopolies in services.

The Application of Chandler's 'Logic' to Services

Chandler's work (1977, 1986, 1990) addresses the circumstances under which a firm will continue to grow to maintain a position of dominance. The economic basis of Chandler's model is:

> the cost advantages that scale and scope provide in technologically advanced, capital-intensive industries. (1990, p. 32)

It was a model of the managerial enterprise built on manufacturing industry data (e.g. oil, pharmaceuticals, agricultural machinery, and steel). Chandler (1986) showed that in sectors where few large firms appeared, it was because neither technological nor organisational innovation substantially increased minimum efficient scale. Therefore, in those industries, large plants did not offer significant cost advantages over smaller ones and:

> opportunities for cost-reduction through more efficient co-ordination of high-volume throughput by managerial teams remained limited. (1986, p. 417)

Quick summary

The application of Chandler's 'logic' to services

- Chandler's work addresses the circumstances under which a firm will continue to grow to maintain a position of dominance. The economic basis of Chandler's model is that the cost advantages that scale and scope provide in technologically advanced, capital-intensive industries.
- Chandler (1986) showed that in sectors where few large firms appeared, it was because neither technological nor organisational innovation substantially increased minimum efficient scale.

Hierarchies (Chandler's "visible hand", 1977) emerged and spread:

> only in those industries or sectors whose technology and markets permitted administrative co-ordination to be more profitable than market co-ordination. (p. 11)

The structure of service industries lay outside Chandler's study. Historically, despite considerable variance across sectors, service industries had been neither so technologically advanced nor so capital-intensive as manufacturing. They had exhibited minimum efficient scale at low levels, with significant diseconomies of scale reached at modest levels of growth.

The special characteristics of service businesses had dominated thinking about the design and delivery of services. Received wisdom has been that services are 'different'. Thus the growth paths of service firms have indicated a different 'logic' to manufacturing firms. For Chandler's model of growth now to be applicable to service industries, would indicate similarity between manufacturing and service firms and that the special characteristics of services have diminished in significance.

Economies of scale and scope in service industries

More capital-intensive asset structures and high fixed costs in services, largely IT-related have been influential in creating extra-national economies of scale which have encouraged the high levels of merger and acquisition activity in many service sectors already mentioned (e.g. hotel chains, accountants and management consultancy firms, airlines, software, information services, telecommunications, financial services, etc.). Service industries are no longer fragmented, but increasingly concentrated. In many sectors they resemble oligopolies (as in international contract cleaning), although a 'tail' of small local firms coexist as local providers in most markets.

We will now assess the significance of greater potential for economies of scale and economies of scope on the growth strategies of service firms. Some of the sources of scale economies and scope economies now commonplace in service MNCs are listed in Table 17.1.

Economies of scale	Economies of scope
■ Geographic networks ■ Physical buildings & equipment ■ Purchasing/supply ■ Marketing ■ Logistics and distribution ■ Technology/IT/IS ■ Operational support	■ IT?IS shared information networks ■ Shared knowledge and know-how ■ Product or process innovation ■ Shared R&D ■ Shared channels for multiple offerings ■ Shared investments and costs ■ Reproduction formula for service system ■ Branding ■ Training ■ Goodwill & corporate identity ■ Culture ■ Privileged access to parent services

Source: Segal-Horn (1993).

Your notes

Your notes

Any asset which yields scale economies, can also be the basis for scope economies if it provides input into two or more processes i.e. when the cost of producing two outputs jointly is less than the cost of producing each output separately (Teece 1980, 1982). An obvious example of the interaction between scale and scope is the central role now played by computer reservation systems (CRS) in the activities of airlines, hotel chains, car rental firms, cinemas, etc. These not only support the geographic spread of the business and the rapid processing of volumes of transactions, but also provide customer databases for cross-marketing of services and the capability to design and deliver completely new services.

IT-based scale and scope benefits

IT-based scale and scope benefits in different service businesses take many different forms:

- American Express can use its information systems to set and monitor service standards for fast response times for card enquiries, or to provide additional services such as 'free' travel arrangement or theatre bookings for cardholders.
- Benetton has become renowned for replacing inventory with information in the management of supplies to its worldwide outlets and in using real-time information from point-of-sale systems to tailor seasonal production to demand.
- British Airways (BA) has developed sophisticated software to maximise yield from higher-revenue seats on all flights, a major contribution to profitability in a service business with high fixed costs.
- Advertising MNCs such as Interpublic or WPP derive economies of scale from bulk purchasing of media time and space, as well as the internal transfer of market and design data in the management of global campaigns for clients.

Knowledge as a scope economy

Knowledge is a powerful scope economy in services (Nayyar 1990; Vandermerwe 1993) since many services are based on the capability to acquire, process and analyse information. Additionally, it has a shelf life, during which time it may be repeatedly used at little or no cost (e.g. an advertisement, a software programme). Many services comprise a firm-specific pool of both explicit and tacit knowledge (Grant 1991; Nonaka & Takeuchi 1995). Service firms (e.g. management consultancies and other PSF's, fast food chains, hotel chains) are increasingly attempting to codify this knowledge as the basis of standardisation of their products, to achieve cost-reduction and increased productivity, as well as reliability of international service standards.

Some of the strongest brands in services are based on perceived accumulated know-how, for example, McKinsey, Reuters, and McDonald's. Information-intensive resources are absorbing heavier investment in fixed costs which in itself exerts pressure to lower unit costs by spreading output over larger markets (for scale economies) and a wider variety of products (for scope economies).

The role of internalisation

Individual and organisational knowledge represent a generalisable capability or core competence (Prahalad & Hamel 1990). This implies that where diversification is based on scope economies it makes sense for service firms to manage their international expansion by means of internalisation (i.e. the internal control and coordination of assets and activities) rather than by market transactions.

Internalisation (part of OLI, which we discussed in Topic 13: Dunning 1985) means that firms retain control of their internal capabilities (rather than, say, outsourcing) giving greater control over their use. Internalisation is especially important in the growth of service firms in regard not just to efficiency, but

to the management of the 'moments of truth' in which the quality of service firms is experienced by their customers.

The Changed International Potential of Services

Chandler's logic – Phase 1

Chandler explains the growth of firms to a position of dominance in their sector, through the early pursuit of cost advantages derived from volume. Scale and scope are fundamentally volume- and cost-driven. Chandler shows that companies which create and sustain dominant positions in their industries do so by making pre-emptive investments in scale and scope which enable the firm to strongly influence the evolving structure of the industry, and the bases of competition within the industry.

Phase 1 of Chandler's logic consists of four sets of core investments:

1. In volume, to achieve cost advantages of scale.
2. In scope, to achieve consistent capacity utilisation.
3. In national, and then international, marketing and distribution networks.
4. In a management hierarchy to coordinate and allocate current and future resource utilisation.

Firms that moved first to make these coordinated sets of large investments could dominate their industries and influence its path of development, both in the short-term and longer-term. This is because challengers would have to match the first-mover advantages in comparable costs, build distribution and reputation to a point where the dominant incumbent could be effectively challenged, recruit teams of experienced managers and match specialised experience curve effects.

Let us now look at the case study of American Express to illustrate phase 1 of Chandler's logic.

Case Study: Chandler's International Growth Path – Phase 1: American Express

The financial services company American Express is a company in which scale and scope operate in a massive way. Over time it has successively made the investments in marketing, distribution, volume, product and process outlined by Chandler. In so doing it created a world-scale service industry, which it has dominated for more than a century after its first international expansion moves.

The development of American Express, involved a series of "phase 1"-style investments. The company was founded in New York, USA, in 1850 by Wells & Fargo, progressing rapidly from the express carriage of cash and parcels, to bonded carrier of freight and finance. It handled European imports to all US Customs interior ports-of-clearance. Investment in its distribution network proceeded beyond national US coverage to the beginnings of its European network in freight forwarding. From an initial office in Liverpool, UK, in 1881, it expanded to 300 European agency offices in 1890. Beyond scale expansion of the network, these also provided considerable expansion in scope, through the increased range of services offered, utilising additional capacity in the same network of outlets. The company was already benefiting from a virtuous cycle of scale, volume and scope effects which enabled it to advertise in brochures in Europe at this time, that American Express could

> pay money on Telegraphic Order, at a moment's notice, between points thousands of miles apart and sell small Drafts or Money Orders which … can be cashed at 15,000 places. (Amex Company

Quick summary

The changed international potential of services

- Chandler explains the growth of firms to a position of dominance in their sector, through the early pursuit of cost advantages derived from volume. Scale and scope are fundamentally volume- and cost-driven.
- Chandler shows that companies which create and sustain dominant positions in their industries do so by making pre-emptive investments in scale and scope which enable the firm to strongly influence the evolving structure of the industry, and the bases of competition within the industry.
- Firms that moved first to make these coordinated sets of large investments could dominate their industries and influence its path of development, both in the short-term and longer-term.

documents)

It began extending its management hierarchy in Europe by beginning its own directly owned chain of offices in Europe in 1895. The freight express business encompassed many developing financial service activities e.g. paying foreign money order remittances from emigrants, or commercial credit transactions begun in Rotterdam in 1907. There were major new product development initiatives:

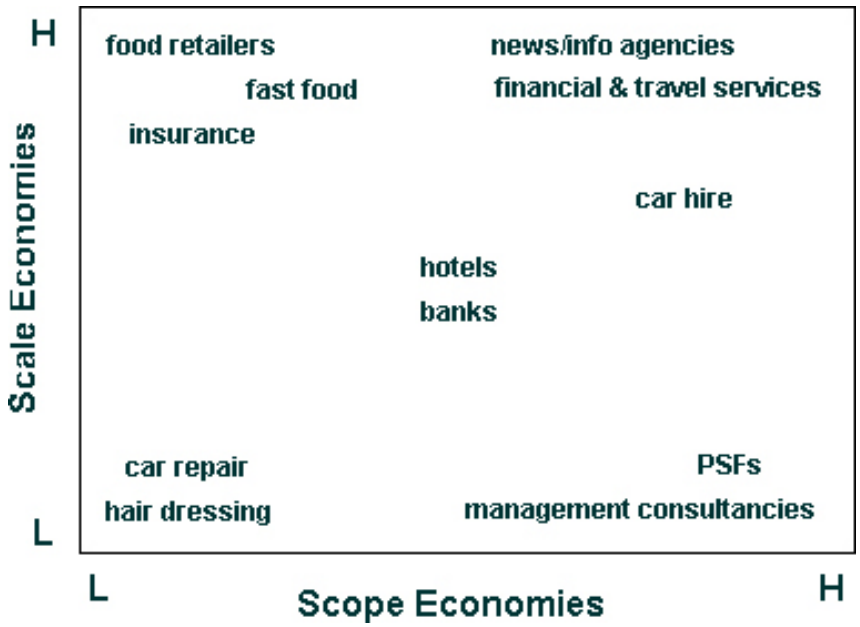
- Amex Express Money Order (1882)
- Amex Travellers Cheque (1891)
- Amex Charge Card (1958)

These provide illustrations of Chandler's proposition that incumbent first-mover advantages determine the future structure of an industry. The sale of travellers' cheques unleashed demand to provide additional services to tourists, such as itineraries and tickets. A European, and eventually worldwide, travel network was established, uniquely combined with the Amex portfolio of financial products and services to create a new set of asset structures for a specialised segment of the financial services industry. By the 1960's 38,000 outlets worldwide sold American Express 'travel-related financial services' (TRS), which is still the source of 70% of the American Express Company's revenues in the 1990's.

Source: compiled by author.

The Potential for Scale and Scope Economies in Different Types of Service Businesses

Moving from a specific illustration of one service company, as we saw above, some more general observations may be made concerning scale and scope in services. We can begin by examining Figure 17.5, which illustrates the traditional view of scale and scope economies in service businesses.



Source: Segal-Horn (1993).

The grid in Figure 17.5 gives a customary representation of the spread of availability of scale and scope economies in different types of service businesses.

- The top right corner of the grid is illustrated by financial services companies such as American Express; by the major international airlines; by travel firms such as Club Med; by information service firms such as Reu-

Quick summary

The financial mechanics

- Share capital is predominantly managed by the fund management companies
- By the end of 1998 it was estimated that $2000 billion (1997 $1600 billion) was spent by international business on mergers and acquisitions.
- Whilst cross border deals have expanded significantly in recent years they account for only approximately 20% of the total international spend on mergers and acquisitions.
- The costs of the deal very much depend on the market value of the business
- The challenge facing a company that pays a large premium for the acquirer is how to absorb the acquired firm into the consolidated accounts without substantial disturbance to the ROCE.

ters or Dun & Bradstreet.

- The top left corner is illustrated by food retailers where high scale effects have arisen from electronic-point-of-sale equipment (EPOS) and concentration of retailer buying power, combined with limited scope opportunities, although some large food multiples also trade in clothing, homewares and financial services such as in-house credit cards.
- Bottom right of the grid is illustrated by management consultancies or other professional service firms (PSFs) such as accountants, surveyors, civil engineers, head-hunters. PSFs may be high on potential scope economies from, e.g. shared client and project databases or shared teams of expertise across national or regional offices, but with low potential economies of scale, since these services are frequently customised, often within different national regulatory frameworks.
- Bottom left are typically small-scale service businesses, highly location specific.

Scale and scope advantage in service businesses

Although Figure 17.5 represents the traditional view of these varying types of service businesses, what is interesting from our point of view is the drift towards top right on the grid for many firms in these different sectors.

The creation via mergers of very large international accounting and consultancy firms, which is mirrored in other PSF sectors, is part of the search for greater efficiencies in capacity utilisation of scarce resources (expensive professional staff) and for productivity gains from implementation of standardised methodologies. Equally, food (e.g. Aldi) and non-food (e.g. IKEA, Toys 'R' Us) retailers have begun to operate beyond domestic boundaries seeking scale benefit from volume purchasing and scope benefits from investments in information technology, logistics networks and branding.

Retailers are also moving heavily into related services such as financial services and banking, now sold by many supermarkets and providing huge economies of scope in use of customer databases and intensive use of expensive sites. Insurance companies in Europe (e.g. Allianz of Germany, Generali of Italy, Prudential of the UK) are building cross-border operations, as regulatory differences become less extreme and types of distribution channels develop and converge.

Finally, many erstwhile small service businesses are moving upward on the grid, for volume benefits in purchasing and operations arising from specialisation and standardisation (e.g. Kwik-Fit Euro specialising only in the repair of car exhausts or brakes and international hairdressing chains such as Toni & Guy with centralised training and purchasing). What this shows is the ever-greater potential and intensity of the use of scale and scope advantage in international service operations.

The impact of consumer behaviour

Clearly also, none of these shifts would be possible without at least some perceived shift on the demand side in consumer buying behaviour. Economies of scope in services can lower transaction costs for customers. Common examples include the effect of retailer buying power on quality and price in multiple retail chains, worldwide reservation systems of hotel chains and airlines, cheaper products in banking and insurance, and in all brokerage services such as travel agents or investment analysts. Indeed, Nayyar (1990) discusses the potential benefit to diversified service firms from leveraging customer relationships across service businesses. He argues that buyers of services will attempt to economise on information acquisition costs by transferring reputation effects to other services offered by a firm, thus enabling the service firm to obtain quasi-rents from firm-specific buyer–seller relationships.

This contributes to our understanding of the growing importance of the branding of services and reinforces, for services, two of the main propositions

Your notes

regarding the competitive advantages of MNCs:

1. first, the ability of MNCs to create and sustain a successful brand image and its concomitant goodwill;
2. second, the MNC's ability to monitor quality and reduce buyer transaction costs by offering services from multiple locations (Caves 1982).

The industrialisation of service

Phase 2 of Chandler's model shifts from national to international growth and competition. Fundamental shifts have occurred in the character of service businesses: international chains now exist in virtually all types of service businesses, even highly 'local', regulated and culture-specific services such as education or medical services (e.g. AMI health care group, EF language schools, international campuses trading on well-known university brand names, even the funeral industry). Underlying these trends is what Levitt (1986) called "the industrialization of service".

Services can be industrialised in a variety of ways.

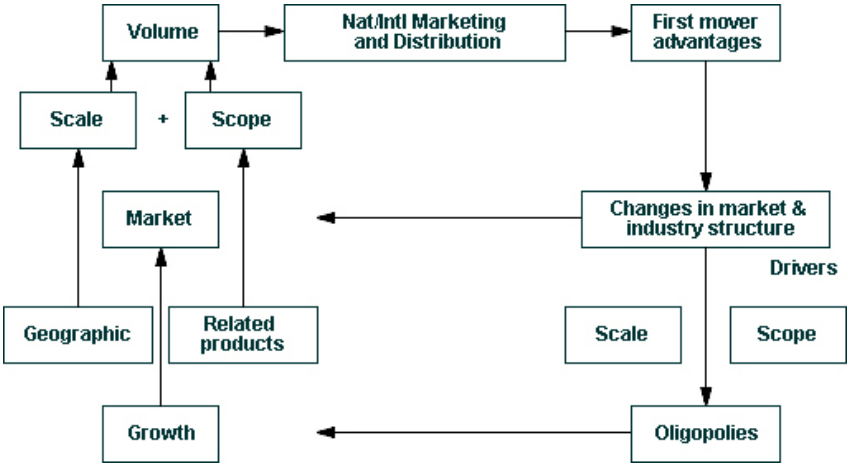
1. first, by automation, substituting machines for labour, e.g. automatic car-wash, automatic toll collection, ATM cash machines;
2. second, by systems planning, substituting organisation or methodologies for labour, e.g. self-service shops, fast food restaurants, packaged holidays, unit trust investment schemes, mass-market insurance packages;
3. third, by a combination of the two (e.g. extending scope in food retailing via centralised warehousing and transportation/distribution networks for chilled, fresh or frozen foods in technically advanced temperature- and humidity-controlled trucks).

Such industrialisation of service is based on large-scale substitution of capital for labour in services, together with a redefinition of the technology-intensiveness and sophistication of service businesses. It also assumes a market size sufficient to sustain the push for volume. This is the point at which a firm is likely to shift to international operations since the domestic market provides insufficient volume to support minimum efficient scale. This may come earlier for service firms than for manufacturing firms since for many types of services the option of exporting is not available.

Building on these changes in the concentration and industrialisation of services, phase 2 of Chandler's model relating to growth via the international expansion of scale and scope, may now be discussed.

Chandler's Logic – Phase 2

Let us begin our examination of Phase 2 of Chandler's logic by examining a diagram illustrating his model of growth and competition, in Figure 17.6.



Source : Segal-Horn based on Chandler.

Your notes

Figure 17.6 provides a completed representation of Chandler's model. Arising from investments in scale, scope, distribution and management, large firms will have built dominant positions sufficient to influence the structure, key assets and capabilities relevant to competing in their industry. Thus economic advantages of scale and scope lead to national and international concentration, so that competition rapidly becomes oligopolistic.

Such oligopolistic competition is based more on innovation than price, although firmly rooted in continuously enhanced cost structures. Growth thus becomes a continuous search for improved quality, sourcing, distribution and marketing (especially branding and advertising), as well as new markets and lower costs. Some growth comes from acquisition, but the main emphasis for long-term growth is two-fold:

1. first, geographic expansion into international markets in the continuous drive for increments in scale and cost advantages;
2. second, related product markets in the pursuit of enhanced scope economies.

Together these form a dynamic spiral of volume, scale, scope and cost curves, reinforced by organisational capabilities developed to cope with fierce oligopolistic competition. Chandler emphasises repeatedly that the opportunity to create such first-mover investments is short-lived. The logic of sustainable international competition is to make long-term scale investments to create organisational capabilities, and then to continue to reinvest in these assets.

To demonstrate this industry concentration phase of the model, we will revisit the American Express case study that we examined earlier in the topic.

Rethinking Services

Chandler's model is of international growth and competition based on firm-specific assets. It is interesting to note that such resource-based theories of the firm have dominated competitive strategy in the 1990s (Grant 1991; Rumelt 1991; Amit & Schoemaker 1993), balancing the industry structure-driven emphasis of strategic thinking of the 1980s. Since such assets may erode over time and must be continually upgraded to sustain their advantage, it is important to review the implications of this approach to the changing nature of competition in services.

Enderwick (1989) provides insight into firm-specific advantages (FSA) and location-specific advantages (LSA) available to the service MNC. He builds on the work of Dunning (1985, 1989), and the eclectic paradigm of international production based on ownership, location and internalisation (OLI) advantages, which was introduced in Topic 13.

- Ownership incorporates competitive advantages.
- Location incorporates configuration advantages.
- Internalisation incorporates coordination advantages.

[You will recognise the similarity to Porter's (1986) conceptualisation in international strategy of configuration and coordination in the allocation of value chain activities by the firm.]

Enderwick includes under FSA, factors familiar from the earlier scale and scope debate in services:

- Privileged access to assets such as goodwill and brand name, particularly important in consumer buying processes for services.
- Scale economies obtainable from high fixed costs and low variable costs of operation.
- Other economies of common governance available from single hierarchical management of complementary assets.
- Scope economies which enable incumbent firms to offer innovatory or

Quick summary

Rethinking services

- Chandler's model is of international growth and competition based on firm-specific assets.
- The internalisation issue is of exceptional importance for service MNCs, since they will wish to retain internal control over anything affecting their management of the 'service encounter'

complementary services which reinforce their competitive position.

Under LSA factors, most significant is the differential between services which are location-specific because production and consumption are inseparable and therefore where wide international representation is mandatory (e.g. fast food chains), compared to those services which are tradable and therefore choice of international location would result from considerations of comparative advantage (e.g. software houses).

Lastly, the internalisation issue is of exceptional importance for service MNCs, since they will wish to retain internal control over anything affecting their management of the 'service encounter'.

The continual search for optimisation of OLI advantages in services, using the same models and criteria as for manufacturing firms, makes simple distinctions between product and service obsolete.

The Future for Services

Many services (e.g. credit cards, automated teller machines, airline seats, software, automatic carwash) have emerged relatively recently in human society. Therefore, in international terms, they have the advantage of no prior patterns of usage or acculturation, thereby making them more easily acceptable across national boundaries. However, alongside social, cultural and technological changes affecting demand for services, there are additional economic and political pressures on governments to create, or remove, regulatory barriers as the WTO has been attempting. Current difficulties affecting international trade in services still include issues such as intellectual copyright protection.

Restructuring and concentration in most service sectors in recent years has meant that many service industries (such as travel, fast food, some financial services, information services) now meet Kobrin's (1991, p. 18) definition of a global industry, defined in terms of "the significance of the competitive advantages of international operations" arising mainly from the structural characteristics of scale economies and technological intensity. Strong international segments exist for many types of services; we have already discussed many of these local adaptations around a global standard core such as Benetton's leisurewear, Pizza Hut's food or Sheraton's hotel rooms. Therefore both demand for, and efficient supply of, global services exists (Lovelock & Yip 1996).

However service industry growth has often been across traditional industry boundaries. Some examples are:

- Retail/financial services
- Retail/ leisure
- Leisure/travel
- Travel/hospitality
- Accounting/management consultancy
- Advertising/public relations

This leads to the notion of increasingly 'fuzzy' industry boundaries in services, with industries not viewed discretely but as fuzzy sets. The example of American Express used earlier in the topic is an example of service firm growth within a fuzzy industry set of leisure/travel/financial services. It also demonstrates how it is precisely because Amex operates across this fuzzy set that it is able to sustain such strong branding across its portfolio of related services. This may suggest that 'growth' for service firms may not involve a deepening of asset structure as in manufacturing companies, but a horizontal accretion of assets across different markets and different industries (i.e. scope).

Quick summary

The future for services

- Many services have emerged relatively recently in human society. Therefore, in international terms, they have the advantage of no prior patterns of usage or acculturation, thereby making them more easily acceptable across national boundaries.
- Restructuring and concentration in most service sectors in recent years has meant that many service industries now meet Kobrin's definition of a global industry, defined in terms of "the significance of the competitive advantages of international operations" arising mainly from the structural characteristics of scale economies and technological intensity.

Understanding growth at the level of the firm

Your notes

Nevertheless, the concepts of economies of scale and economies of scope explored in this topic operate at the level of the firm. The Chandler model of growth used here, is a resource-based explanation of successful international competition, driven by sustained investment in the development of firm-specific asset structures. Therefore, while the issue of change in service industry structure is central to any discussion of the growth of international competition in services, it may be that the most important factors determining successful international expansion in services should be understood at the level of the firm, as in the Novotel, Benetton and ISS examples already given earlier in the topic. This is particularly important with regard to the managerial and organisational capabilities of the firm.

The point has been made with regard to MNC activity in general (Dunning 1989), and service MNC activity in particular (Enderwick 1989), that the way in which firms organise their international activities may itself be a crucial competitive advantage. This is strongly reinforced in recent work by Rumelt (1991), concluding that the most important sources of long-term business rents "are not associated with industry, but with the unique endowments, positions and strategies of individual businesses" (p. 168). These points may go some way towards explaining both the successes and the failures in international expansion undertaken by individual service firms.

Services – then and now

The special characteristics of services have been diluted in significance. Many services contain 'hard' tangible components which are capital-intensive, amenable to separation from the point of service delivery and responsive to standardisation. In addition, core knowledge and information-based assets of service firms are codifiable and transferable across national boundaries, as is the consumer franchise from strongly branded services.

These issues can be simply summarised as follows.

- Issue 1 – Then and Now
  - » Then: Services were time dependent and could not be inventoried.
  - » Now: Because of technology, information is the one part of a solution that can be stored, retrieved and transported.
- Issue 2 – Then and Now
  - » Then: Services always had to have local presence with service providers physically on the scene.
  - » Now: Many services can come from far away via remote linkups.
- Issue 3 – Then and Now
  - » Then: Services were culturally bound and were difficult to transplant from one country to another.
  - » Now: Technology has created many new types of services that have no prior cultural associations.
- Issue 4 – Then and Now
  - » Then: Services were considered to be a domestic business.
  - » Now: Many services are global, customers neither know nor care where they originate.
- Issue 5 – Then and Now
  - » Then: Most services were accessible only at certain times in clearly defined places.

Now: It's possible to deliver a growing proportion of services anyplace and anytime.

Source: adapted from Vandermerwe (1993, p. 208).

As a result of this combination of factors, service industry dynamics are beginning to parallel those of manufacturing. Manufacturing businesses and service businesses appear to be following similar development paths, creat-

ing similar types of asset structures, and competing in similar ways. Even the most distinctive characteristic of services, the criticality of the interface with the customer, is increasingly a hygiene factor for all types of businesses. The emphasis on customer service in manufacturing, and the emphasis on efficient deployment of back-office assets in services, are each trying to capture the advantages the other has traditionally utilised. This once again illustrates the 'dynamics' of strategy-making.

Your notes

Summary

This topic demonstrated the importance of the services sector, especially in the developed nations. It then identified the key characteristics of service companies that differentiate them from manufacturing companies. It went on to show how the recent search by service companies for economies of scale and scope has gone a large way to reducing the differences that were earlier present between the service and manufacturing sectors. The topic then focused on international professional service firms and showed how in pursuit of global reach they have developed commodity features that reduce costs but also reduce the bespoke nature of the service that justified it high cost. Increasingly services have become 'packages' and their individual client-centred nature has been substantially reduced in the interests of volume.

Task ...

Task 17.1

To check your understanding of the material in this topic, try to answer the following questions. If you have any difficulties, you may wish to go back and revise the relevant part of the topic.

1. How do services traditionally differ from products?
2. What is meant by the moment of truth?
3. What is the service triangle?
4. How is strategy typically developed in service firms?
5. How do service firms achieve economies of scale?
6. How do service firms achieve economies of scope?
7. In what ways are service firms coming to resemble product firms?
8. How is the role of the Chief Executive of a service firm changing?.

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Topic 18

Managing Strategic Change

Aims

The purpose of this topic is to:

- explain the nature of strategic change;
- show how difficult it is to achieve;
- identify frequently found barriers to change;
- chart a staged approach to achieving change;
- show the importance of the cultural aspects of achieving change.

Objectives

By the end of this topic you should be able to:

- outline the challenge of strategic change for an organisation;
- distinguish between the types of strategic change that can occur;
- identify the causes of strategic change;
- explain how an ongoing process of organisational innovation and learning can better prepare a company for change;
- advance a number of models for managing change;
- develop a process for the effective implementation of strategic change.

Introduction

Your notes

The topics in this course have considered the concept of strategy and how it links the firm to the competitive environment in which it operates. Two broad approaches to the strategy process have been outlined. The first, the Market Positioning Approach illustrated by Porter, covered in Topic 3, stressed the need for the organisation to adapt to environmental change. The second, the Resource-Based View exemplified by Hamel and Prahalad and others, covered in Topic 4, stressed the need for the firm to be proactive in shaping its competitive environment based on its unique qualities or capabilities. Both approaches are applicable to the complexities of change in the internationalised firm.

Grundy defines strategic change as:

> The reshaping of the strategy, structure and culture of an organisation over time, by internal design, by external forces, or by simple drift. (Grundy 1994, pp. 19–20)

He goes on to argue that strategic change normally constitutes the proactive management of change in an organisation and the implementation of new strategies that involve substantial changes beyond the normal routines of the organisation. Its activities include the induction of new patterns of action, belief and attitudes among members of the organisation.

The real challenge of strategic change for an organisation is, according to Pettigrew:

> Anchoring new concepts of reality, new issues for attention, new ideas for debate and resolution, and mobilising concern, energy and enthusiasm often in an additive and evolutionary fashion to ensure these early illegitimate thoughts gain powerful support and eventually result in contextually appropriate action. (Pettigrew 1985, p. 439)

This topic will address these challenges and concerns.

In this course, we have already looked at a number of models of organisational structure that have been associated with strategic recipes for successful international competition. During the 1970s, organisational structures tended to be viewed as enabling mechanisms. Structures were seen to help the company meet the challenges of change with an appropriate response. They were considered to be the frameworks within which strategy could be implemented.

Consequently, structure was regarded as the critical change factor. This presumption of a straightforward strategy–structure relationship came to be questioned. More complex models emerged, such as the Peters and Waterman 7S framework and Porter's coordination and configuration model. These writers highlighted the need to consider other factors in the change process. They drew our attention to the fact that effective organisations depend upon the interaction of a range of variables of which strategy and structure are only two.

Topic 11 considered cooperative strategies in international business, possible motivations for pursuing them and the senses in which cooperation and competition are strategically compatible. New cooperative approaches to strategy have been accompanied by the emergence of new structural forms, such as the federated and networked organisations. They have also introduced new considerations in relation to requirements for change. Cooperative relationships in times of change cannot be managed in the same way as hierarchical ones. They require consensus rather than fiat.

Organisations are not static, and competitive environments are no longer stable. Whether realised strategies are planned or emergent, organisations are dynamic entities operating in a rapidly changing world. Change has become an inescapable fact of corporate life and managing change is a central strategic issue.

Types of Change

If an organisation is studied over an extended period of time, it may be seen to have experienced a variety of types of change in its history. It may also be seen to have experienced particular types of pressure for change at various points in its development. Greiner (1972) suggests that phases of development can be identified and that, during each phase, typical sorts of pressure for change occur. The challenges will lead to alternating periods of evolutionary and revolutionary change. As Figure 18.1 illustrates, drawing upon some of the concepts that were introduced earlier, changes can be planned or emergent, radical or transformational, or incremental.

	Radical	Incremental
Planned	e.g. process re-engineering, OD	e.g. planned incrementalism
Emergent	e.g. crisis management response	e.g. incrementalism

Earlier topics have discussed Alfred Chandler's (1962) observation that some kinds of organisational structure are better suited to the achievement of particular kinds of strategy than others. During the 1960s and 1970s, many managers came to regard organisation structures as strategy-enabling mechanisms and, as a result, structural alterations and modifications were a common response to the pressures for change. During the late 1970s and early 1980s, when a greater awareness of other interacting components of organisations developed, organisational practices, processes, procedures, systems and routines came to be regarded as equally important. These provide the organisation with capabilities that may lead to competitive advantages.

Quick summary

Types of change

- If an organisation is studied over an extended period of time, it may be seen to have experienced a variety of types of change in its history.
- Earlier topics have discussed Alfred Chandler's observation that some kinds of organisational structure are better suited to the achievement of particular kinds of strategy than others.

Triggers for Change

Greiner has suggested some of the factors that may trigger organisational change as a company ages and grows. Those triggers for change can emanate from the outside in and from the inside out. One way of considering them is in terms of the concept of environmental fit.

Kirkbridge (1993) presents a model that was developed in 1985 describing four possible scenarios (Allaire & Firsirotu 1985). Each one relates to possible degrees of fit between the organisation and its present and likely future environment. In some circumstances, there will be strategic continuity and in others, strategic discontinuity. It is important to note that longitudinal studies of organisations through time reveal that continuity and change are both important strategic issues (Pettigrew 1985).

You can see the model in Figure 18.2, and then examine each scenario in more detail, in the table below.

Case 1: Harmony and continuity

In case 1, there is harmony between the company and its present environment. The future environment can be anticipated to present it with an evolutionary extension of its present circumstances. This enables the company to prepare for organisational change in an incremental fashion. In this scenario, there is continuity. Strategic developments in the company are evolutionary and do not represent any radical change of direction involving a break from the past.

Case 2: Pre-emptive adjustment or temporary misfit

In case 2, there is a misfit between the organisation and its present environment. Present strategies are resulting in a poor competitive performance. The anticipated future environment, however, is one that will be radically differ-

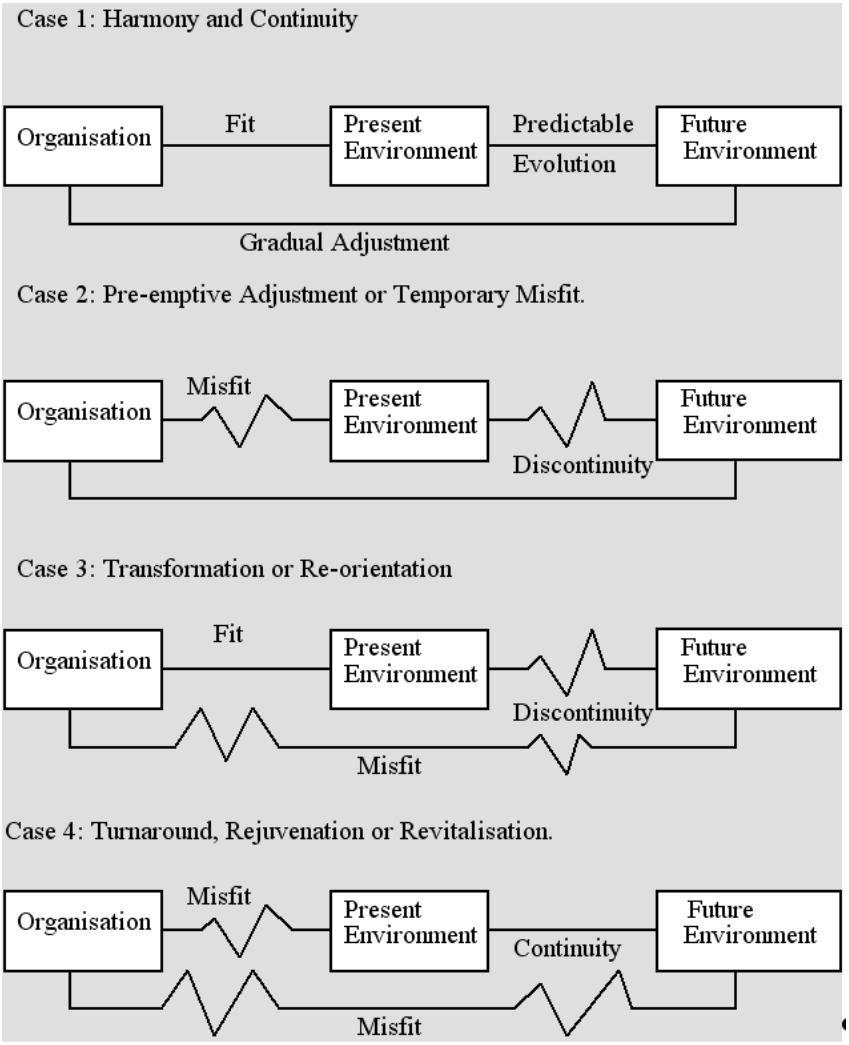
Quick summary

Triggers for change

- Greiner has suggested some of the factors that may trigger organisational change as a company ages and grows. Those triggers for change can emanate from the outside in and from the inside out. One way of considering them is in terms of the concept of environmental fit.
- Changes are required in each of these scenarios, but they are changes of a different kind. In the first scenario, no threats are posed to the future competitive performance of the company. Changes can be planned and implemented incrementally.

ent to the environment faced in the present. This discontinuity between the present and the anticipated future is likely to lead to circumstances in which the present strategy will become appropriate. The present strategy drives the company towards a future oriented strategic vision. The scenario is therefore one in which there is only a temporary misfit. Continued pursuit of existing strategies will achieve a pre-emptive adjustment to future changed circumstances in which the company will reap the benefits of its perseverance.

Your notes



Case 3: Transformation or reorientation

Case 3 describes a situation in which the company is competing successfully in its present environment and pursuing strategies that are suited to it. It is, however, anticipated that there will be a radical discontinuous change in the future competitive environment, which will require a radical change of strategic direction. This company has kept its options open, but at the same time has run the risk of being unprepared. It now needs to respond to avoid a future decline.

Case 4: Turnaround, rejuvenation or revitalisation

Case 4 represents the worst of all possible worlds. The company strategy is ill-suited to its present circumstances and the future environment is not anticipated to change. The company is facing falling profits and a declining market share in such an environment is in urgent need of rejuvenation. The company facing imminent bankruptcy is in need of a turnaround. This may require new managerial blood in the boardroom.

Summary

Changes are required in each of these scenarios, but they are changes of a

different kind. In the first scenario, no threats are posed to the future competitive performance of the company. Changes can be planned and implemented incrementally. They may even be allowed to emerge as long as they are in keeping with the overall existing strategic direction of the enterprise. The second scenario is one in which the requirements for change have already been anticipated, but the company has acted too soon. The problem here is one of maintaining momentum. The third scenario requires a reactive change in order to avert a threat. Depending upon the organisational culture and extent to which organisational members are cognisant of the impending threat, the changes may be difficult to effect with existing resources. The last scenario is a crisis management situation requiring an immediate response.

Internal triggers

As organisations grow and develop, they face pressures for change both internally and externally. It is important to note that not all change in organisations is environmentally driven. Some triggers are internal, but external and internal triggers for change are often linked.

Organisational politics and power relationships are an internal force that can push in the direction of organisational change (Pfeffer 1982). Changes in key personnel, particularly the chief executive officer, can trigger widespread change (Kotter & Hesketh 1992). Such a change often brings a new perspective, a new way of thinking, a different managerial mindset. Changes at the top are likely to be associated with changes in strategic direction and culture change. New top teams frequently have a different way of looking at the business and will therefore evaluate its circumstances and requirements differently. Senior managerial strategic orientations have a profound influence upon the strategic direction of the firm. Their mindsets are an important factor in perceptions of its requirements for change.

Barriers to Change

One way of exploring the barriers to change is to examine the extent to which the current organisation supports or constrains movement towards the aims set out in the mission statement. There may be a requirement for new specialisations and different groupings of activities to support a new strategy. Then the more intangible aspects of culture can be addressed by focusing on the values and management styles that are supportive of the mission.

Thus, a picture can be developed of the way the organisation might need to look if it is going to achieve the mission successfully. This vision of a future organisation can then be used to compare and contrast the present situation. To do this, a 'force field' approach can be useful.

In Figure x, the future organisation is represented by the dotted wavy line, the current situation is the solid wavy line. There are forces acting in the organisation that are already moving the firm in the right direction, for example it is already engaged in extensive training in quality assurance and shop floor attitudes seem to be in favour of some changes.

However, set against these pushing forces are resisting forces, or barriers to change. If a major barrier is the cynical attitude of a key top team member towards any new initiatives, then this must be raised and confronted. If an autocratic director or senior executive is seen to be stifling initiatives, then this must be brought out into the open and discussed. Not all barriers will be of this sensitive nature, but they may still be difficult to identify.

Questions need to be asked that may expose some of the taken-for-granted routines that are actually impediments to change.

Once the major pushing and resisting forces have been identified they can be rated according to their perceived strength or importance. This can be repre-

Quick summary

Barriers to change

- One way of exploring the barriers to change is to examine the extent to which the current organisation supports or constrains movement towards the aims set out in the mission statement.
- Once the major pushing and resisting forces have been identified they can be rated according to their perceived strength or importance.

sented on the chart by the length of the arrow.

You can now follow through the process of breaking down the barriers to change.

- Generating actions to reduce the barriers
- Prioritising the actions
- Timetable for action
- Control and reward systems
- Eliminating and reducing aspects of the business

Generating actions to reduce the barriers

To follow on from the discussion above, the pace of movement towards the required organisation can be increased by strengthening the pushing forces (for example, extending the quality programme to include all staff), adding new pushing forces (for example, setting up a new product development task force to explore ways of reducing the time to market) or reducing the resisting forces (for example, firing the intransigent director). In this way, tangible actions can be identified, again by getting managers to think creatively, which taken together will accelerate progress towards the aims of the mission statement.

If either or both the force-field technique and the 'mission-actions-required capabilities' approach described here are used it is likely that a large number of actions will be generated. The management group has a limited capacity to do new things, to drive new initiatives. This scarce resource must therefore be deployed to best advantage.

Prioritising the actions

The actions derived from the processes described above must be prioritised. This can be done in a systematic way by identifying which actions impinge on the achievement of more than one capability, and then by rating how well this is currently performed. Alternatively, the managers could agree on a subset of actions to be tackled first – this selection should be guided by the following principles:

- Select actions that can be accomplished fairly easily; early success is vital. If there is demonstrable success in tackling an action, this can encourage others to try new ways of doing things, and the momentum of change can be built up.
- Select an action that has powerful symbolic qualities. Do something that clearly signals to people that things are changing, and that the organisation is breaking away from the past.

Each prioritised action must be owned by an individual, preferably a volunteer. Collective action rarely works: a particular person must feel accountable for delivering the action. This is necessary in order to encourage busy managers to find the time to work on the things that need changing.

Without this accountability, the day-to-day demands of the job will drive out the good intentions of the managers. Managers must be accountable, but this does not necessarily mean they are personally responsible for effecting the actions: instigators of the action may convene small teams from within their departments or from across the organisation to implement the required actions.

Timetable for action

There must be an agreed timetable of deadlines for the achievement of each action, and managers must be held to account for progress towards the required results. There is some merit in periodically reviewing the strategy implementation process. This review should seek to confirm the broad strategic direction set out in the mission statement and managers should share their experiences of trying to implement the required changes. They may identify some common

Your notes

barriers to change that may require new actions to be mounted. Sharing the experiences of implementation successes can help others to formulate ideas, and should boost morale.

Your notes

Control and reward systems

Lastly, it is important that the control and reward systems reflect the intentions of the mission statement. There is little point in having a mission statement that says 'we aim to delight out customers' if there is no genuine attempt to measure the firm's performance against this objective. If the control systems still emphasise other variables such as capacity utilisation, overhead recovery and gross margin, then staff will direct their efforts towards these measures, not towards achieving 'delighted customers'.

To take another example, if the mission statement says 'we aim to have an organisation that our staff can be proud of', then this must be brought about in some way. First, managers need to know what would make the staff proud to work there, then they should set about changing things so that the staff become proud of their organisation, as well as finding ways, through staff surveys and so on, of measuring how well they are meeting this important aim.

Similarly, rewards must be in tune with the intentions set out in the mission statement. Staff must be recognised and rewarded for behaviour that is clearly in line with the statement:

- If an employee stays on late to solve a customer's problem, this must be recognised.
- If a group of people use their initiative to come up with a way of achieving major savings in material costs, they should be appropriately rewarded.
- If it is important to shift the organisation away from a conservative, toe-the-line, keep-your-nose-clean culture to one where people are free to experiment, take risks and assume responsibility, it is vital that individuals displaying these qualities are encouraged and promoted.

Eliminating and reducing aspects of the business

We have deliberately concentrated our attention thus far on the most difficult aspects of managing strategic change. These are changes that require members of an organisation to behave in different ways, learn new things, evolve new attitudes. However, it must be recognised that there is another category of strategic change that is essentially about eliminating or reducing aspects of the business: for example, closing an inefficient plant, sacking a layer of management, halving the range of products, withdrawing from unprofitable client relationships, eliminating a shift or closing the research department.

These changes may well be painful for the individuals directly affected, and they are of a quite different nature from changes that are concerned with building new capabilities. There is no doubt that dramatic changes can be effected rapidly by eliminating people or activities from the organisation, and that such changes can have a powerful influence on the attitudes and behaviour of those that remain. But when compared with the problems of building capabilities, these draconian changes are fairly straightforward to implement.

However, of course, if 'cutting' is easy to implement, it cannot be a source of competitive advantage, because it can be imitated as Bowman and Faulkner (1997) emphasise. Moreover, because of the relatively straightforward nature of cutting strategies, they can be regarded as dominant strategies. If building is vague and ambiguous, the clearer cutting strategy will prevail.

Requirements for Change

A simple model of change, attributed to Gleicher (Beckhard 1992), helps us understand some of the issues involved in bringing about strategic change. If we take as a starting point that there is usually a degree of inertia in an organisation, what prompts significant change?

Gleicher's model can be set out follows:

$$\text{Dissatisfaction with Status Quo} \times \text{Vision} \times \text{First Steps} > \text{Costs}$$

The model is multiplicative. This means that no change will occur if any of the items to the left of the inequality (>) are zero.

- Before change happens there has to a sufficient critical mass of senior people to be dissatisfied with the way things are at present, to want to do something about it.
- Secondly, they need to have some vision of where to take the organisation.
- Third, they need to have some understandable first steps to implement, to start the process of change.
- And the total of all of these multiplied together must exceed the perceived costs of changing.

So, there is little point in having a great strategy, and even to have set out in some detail an implementation program, if no-one at the top is sufficiently dissatisfied with the way things are at present. In this case nothing will happen.

Although this 'deck clearing' can have immense symbolic power, and it can bring about some short-term profit recoveries, it must be followed by a sustained 'building' strategy, concerned with the development of competences that can deliver advantage.

Typologies

Various writers have developed typologies of strategic orientations. Miles, Snow, Meyer and Coleman (1978) offer a categorisation of four types of company, which derive from their different orientations towards the requirements for strategic change.

Defenders

A typical strategy for a defender company is to penetrate a market niche with an appropriate product and defend it. The entrepreneurial problem of the company is how to seal off its portion of the market to create a stable domain in the foreseeable future. Its concern is to maintain its position. Its engineering problem is how to produce the goods and services in its domain as efficiently as possible and its administrative problem is how to achieve and maintain control of the organisation to ensure efficiency. Future changes in the competitive environment can only be seen as a threat by such a company. It is oriented towards defending its established position against invaders.

Prospectors

Prospectors are defined as being almost the opposite of defenders. The entrepreneurial problem is seen in terms of how to locate and develop new product and market opportunities. They employ broad environmental scanning techniques and are frequently the creators of change in their industries. The prospector's technology is future oriented. Their engineering problem is seen in terms of avoiding a commitment to a single type of technological process that would tie the company down to its present products and markets. This type of company is looking to move into the future rather than secure its present position. Its administrative problem is seen in terms of facilitating new organisational operations rather than controlling existing ones. The prospector company sees the future in terms of new products and markets. It

Quick summary

Requirements for change

- Once the major pushing and resisting forces have been identified they can be rated according to their perceived strength or importance
- Usually the level of dissatisfaction is cranked up from zero by a crisis. This provokes a reaction, which often involves 'cutting' activities, products, people, factories and so on. .

avoids actions that commit it merely to survival in present circumstances. The focus is upon the means of getting to these new market opportunities, which are envisaged in terms of product and market potential. The authors see the defenders and prospectors as being 'at opposite ends of a continuum of adjustment strategies'. Their third type, the 'analyser', is seen as being in the middle between these two extremes, as you will see in the next section of this table.

Analysers

Analysers try to minimise risk at the same time as they maximise their opportunities for profits. The entrepreneurial problem is seen in terms of locating and exploiting new product and market opportunities in a manner that is consistent with its current core businesses. Its engineering problem is how to achieve an equilibrium between the conflicting demands for technological flexibility and organisational stability. The company's administrative problem is to accommodate the requirements of both stable and dynamic areas of operation. The analyser is a company that is oriented towards keeping options open. To this kind of company, the future is seen to be open ended. It is believed to present new opportunities of which the company can take advantage, provided that it has the skills to recognise them and the flexibility to pursue them. The defender, prospector and analyser orientations are, according to Miles et al., all viable competitive strategies. The fourth is not, as you will see in the next paragraph.

Reactors

Reactors respond to environmental change, often inappropriately. The description offered suggests a continuing round of too little too late. Three reasons for lapsing into the reactor mode are suggested.

- The first is that top management has not clearly articulated the organisation's strategy.
- The second is that the management has not fully shaped the organisational structure and processes to fit a chosen strategy.
- The third is that the management has a tendency to maintain the organisation's current strategy–structure relationship despite the fact that overwhelming changes make it inappropriate.

In previous topics, different models of competition were discussed along with the managerial mindsets with which they are compatible. The positioning approach requires that managers be alert to market opportunities that could improve the profit position of the firm in the industry. As the positioning approach assumes that some industries and industry segments are more profitable than others, sustaining competition will require re-positioning in the market. As some generic strategies are more profitable than others, a change of strategy may also be required. This approach was argued to be compatible with a nomological way of thinking about the requirements for change, and can now be seen to be compatible with the analyser type of firm, which you read about above. The implication is that this kind of firm expects change to be periodic. Once the required changes have been effected, and new strategies implemented, these will be pursued until there is another potential opportunity for the company to improve its profit position.

Firms that engage in a competitive battle also expect to experience change as an intermittent affair. Organisational change is required in response to anticipated future threats to their position. But as long as the existing strengths of these firms can be sustained, and incrementally improved, they will remain competitive. This model of competition was argued to be compatible with the ontological mode of reasoning and can also be seen to be compatible with the defender company described by Miles et al. They are liable to be driven to increasing specialisation. This is typical of the niche market supplier.

The innovative contest model

Both of the views of competition that you read about above are consistent

Your notes

with the conventional precept in the literature that successful strategy is more concerned with stability than change. Change does occur, usually incrementally, but it is not viewed as an everyday event.

The innovative contest view is different. It suggests that successful strategies are visionary and more concerned with change than stability. This view implies that change is more than an intermittent episode in the general pattern of strategic development. It is more of a process of permanent revolution than evolution. A view of competition as an innovative contest between firms implies a continuous process of innovation as the organisation progresses in the direction of its strategic vision. Such aggressive companies expect change to be ongoing. In Topic 16, this model of the competitive process was argued to be compatible with the teleological mode of reasoning and would be appropriate to the prospector type of firm. In the next section, this innovative contest model will receive more detailed consideration.

It may be the case that, under certain circumstances, a defender is at risk of lapsing into an unviable strategic orientation. The risk is that a challenger may emerge with a more innovative strategy or technology that makes the defender's strengths obsolete. During the late 1980s and early 1990s, a number of well-known market leaders were challenged in such a way and a number have subsequently lost their dominant positions. Both Marks and Spencer and IBM were thought in earlier time to be impregnable in their dominant positions in their respective markets. However the rise of more fashionable clothing companies more in the with the culture of youth has pushed Marks and Spencer into seeming very tired and old-fashioned. Similarly the growth of the personal computer and other allied electronic devices and software have made IBM seem a company of the past ceding market leadership to Microsoft and others. When this happens, a crisis is precipitated and the defensive firm is forced to adopt a programme of radical change. Miller (1992) offers an account of the fall of a defender, in which existing competences are valued at the expense of newer more appropriate ones. The company pursues them too far and as a result suffers decline. He describes this scenario as "the Icarus paradox".

It is clear that different contrasting managerial mindsets, and the different models of the competitive process with which they are associated, lead to different perceptions of the requirements for change and preferred courses of action. However, it is also clear that, in the modern competitive environment of international business, strategic orientations that once were viable and have served a company well in the past may not suffice any longer. As Robert Howard remarks:

> global competition is multiplying rivals and complicating business strategy. New information technologies are re-inventing products, fragmenting markets and re-organising work. (1993, p. xiv)

The company that is engaged in repositioning can, in some industries, be confronted with such a rapid pace of change, that entering new product or market segments, and leaving old ones, can no longer be expected to be the kind of periodic event that it once was. Without the ability to innovate technologically and/or strategically, it could soon find itself outpaced by its rivals. The company engaged in a competitive battle can, as has already been noted, find that its strengths have been rendered obsolete by new innovative challengers. The threat here is to survival itself.

Once again, the implication is that an ability to innovate is a requirement for competition in the modern age. During the 1990s, emphasis upon organisational innovation emerged as a direct response to the intensification of competitive pressures in the international business environment. The innovative contest model of competition is one that has increasingly been argued to be applicable to the modern corporate world.

Innovation and Learning

Peter Drucker (1992) is one of the writers who has argued that, in the information age, a key managerial task is to "put knowledge to work". The implication is that managers need to foster a continuous process of organisational innovation. Stalk, Evans and Shulman (1992) have observed that organisational innovation is at the heart of the business strategies of many of today's most successful enterprises. Many of these companies are focusing upon building capabilities rather than competences. Organisational capabilities are concerned with business processes. The innovative contest shifts the focus from competing on competences to competing on capabilities. The stress is less upon the scope of the business – its products and markets – and more upon how it competes in whatever markets it is in.

Strategic innovation is reflected in practices, procedures, processes, systems and routines. These are the capabilities that determine how the firm competes. It may be recalled that the way in which Hamel and Prahalad (1990) defined a core competence was in terms of the special technologies and skills that provided the underpinning of organisational product lines and marketing specialisms. Competences are concerned with products and markets. Stalk, Evans and Shulman suggested four principles of capability-based competition (1992, p. 26):

1. The building blocks of corporate strategy have less to do with products and markets than business processes.
2. Competitive success depends on transforming a company's key processes into strategic capabilities that consistently give the customer superior value.
3. Companies create these capabilities by making strategic investments in a support infrastructure that links established business units and transcends traditional functions.
4. Because capabilities are necessarily cross functional, the champion of a capability-based strategy is the CEO.

Vertical integration is a strategy that has not been as popular in recent years. However, it has been favoured by some capability-based companies. This is because they want to ensure control of key business processes. It is suggested above that the positioning approach may no longer be applicable to the fastest moving industries because of the speed at which markets and products develop. The rationale given by Stalk et al. for competing on capabilities is that when a corporation needs to move in and out of markets and product lines quickly, performance depends more upon the behaviour of the firm than the behaviour of the industry.

Achieving continuous innovation

As we discussed in Topic 7, a corporation that is aiming to achieve continuous innovation, needs to develop its learning capabilities. Organisational learning must therefore be factored into any framework for sustainable competitive advantage.

We can therefore highlight three factors that can help the firm to sustain its competitive advantage in the context of an innovative contest:

1. Organisational learning: the ability of the firm to update, upgrade and acquire new knowledge.
2. Strategic innovation: the ability of the firm to translate the knowledge of individuals and groups within it into practices, procedures, routines and systems. If the knowledge of groups of people can be combined in this way, then the knowledge can become truly organisational and adhere to the organisation in such a way as to make it difficult to replicate.

Quick summary

Innovation and learning

- Peter Drucker (1992) is one of the writers who has argued that, in the information age, a key managerial task is to "put knowledge to work". The implication is that managers need to foster a continuous process of organisational innovation.
- Strategic innovation is reflected in practices, procedures, processes, systems and routines.

Your notes

3. An organisational culture that can encourage organisational members to give commitment and support to the strategic visions with which organisational learning and strategic innovation are associated.

Organisational learning and innovation should be continuous and the implication is that, if these capabilities are to confer a sustainable competitive advantage, they will dictate continuous change. This change may be incremental change or radical change in the senses that were outlined earlier in this topic. However, in rapidly changing environments, incremental changes will be rapid and this rapidity of change in itself is a factor that can unsettle individuals and lead them to perceive the changes as radical. Managing the human side of change is one of the most challenging aspects of strategic management.

There are, of course, no easy answers to the question of how to create a winner in the innovative contest between firms. The above list is not necessarily a comprehensive list of requirements and neither can the discussions in this topic be taken to be a prescriptive solution. They may, however, help to shed more light upon the sorts of changes that may be required of some organisations if they are to continue to compete successfully in the rapidly changing world of international competition, which is now characteristic of most industries. Similarly, the traditional models of change, to be considered next, each have particular strengths and weaknesses, but they help to highlight the kinds of difficulties and issues with which organisations facing requirements for change must contend.

Traditional Models for Managing Change

The vast majority of models for managing change are models of planned and intended change. The assumption that underpins planned change models is that the corporation can effect a change to a desired future state, articulated in the form of a strategic vision, by adopting a suitably planned strategy for change.

Tichy (1983) points out that models of some kind underpin the changes that managers decide to make whether or not those models are explicit or implicit. He highlights the fact that managers often make organisational changes on the basis of implicit models and draws attention to the importance of the managerial mindset. He argues that implicit models of change can cause problems because they cannot be examined for their weaknesses, omissions and blind spots. These can lead to different conclusions about the requirements for managerial action. Tichy recommends that models of change should be explicit and the assumptions that underpin them understood. He advances three common models of change: the technical, the organic and the political. We shall examine each of these in this section, as well as a cultural model of change.

Quick summary

Traditional models for managing change

- The vast majority of models for managing change are models of planned and intended change. The assumption that underpins planned change models is that the corporation can effect a change to a desired future state, articulated in the form of a strategic vision, by adopting a suitably planned strategy for change.
- Tichy points out that models of some kind underpin the changes that managers decide to make whether or not those models are explicit or implicit.

Technical models

Technical models are based upon principles of organisation design. Tichy (1983) outlines the mechanistic organisation, as described by Burns and Stalker (1961), and explicates the assumptions that underpin a mechanistic technical model of change. Such a model prescribes that:

1. Organisations should be differentiated into specialised functional tasks.
2. Subordinates should pursue narrowly defined tasks.
3. There should be a rigid chain of command and subordinates should report to only one boss.
4. Job descriptions should be detailed and exhaustive.
5. The overall picture of the organisation is only relevant to those at the top

of the hierarchy.

6. Interaction should follow vertical lines along the chain of command.
7. Behaviour should be governed by superiors.
8. The emphasis should be upon organisational members gaining specialised knowledge and know-how, which is specific to their specialised tasks, rather than generalised or comprehensive knowledge.

The implicit strategy of change, which is implied by principles of organisational structure and design, is technical. In the mechanistic model Tichy describes, the goal of change is to move the organisation towards a better fit with mechanistic design principles. The assumption is that the more closely a corporation resembles the mechanistic model the more efficient it will be. The recent rise of the New Economy has made such rules largely obsolete, and replaced by quite different ones as described in Topic 8.

As was noted in earlier topics, structural changes were common in the 1960s and 1970s. They are underpinned implicitly or explicitly by the assumption that technical considerations of structure will lead to greater efficiency.

Organic models

Organic models focus upon human aspects of the corporation. They have their roots in the human relations movement which began between the First and Second World Wars. Central to the development of the human relationist school of thought was a study by Elton Mayo that came to be known as 'The Hawthorne Experiments'. This was because it was conducted in the Hawthorn General Electric company in the USA. Its most influential findings were subsequently described by Roethlisberger and Dickson (1939). The human relations movement drew the attention of organisational theorists to the fact that social factors can affect the motivation and performance of people at work.

During the 1960s, the organic approach to organisational change became popular when writers like McGregor (1960), Likert (1967), Argyris (1962) and others developed the underlying principles of the human relationist school of thought into a more coherent body of literature. The writers of the 1960s offered explanations of organisational behaviour and prescriptions for the management of individuals, groups and people in organisations more generally.

Organic models assume that:

1. Individuals need opportunities for personal growth and self-development.
2. Workers' abilities are usually under-utilised.
3. Interactive groups are important to people.
4. People have feelings, which organisations tend to suppress. This adversely affects job satisfaction and performance. If their feelings are respected people perform better.
5. Groups are essentially neutral and, depending upon their nature, they can either be a help or a hindrance to the achievement of organisational goals.
6. If people work collaboratively in groups, individual needs will be satisfied more effectively at work. If individual needs are satisfied, people will collectively be better able to achieve organisational goals.
7. Organisation and job design can be tailored to meet the needs of individuals and groups and by implication this will improve organisational performance.
8. Organisations are systems. Changes in one part of the system, technical, social or managerial, will impact on other parts of the system.

9. Most personality clashes are the result of faulty organisational design.

Your notes

The organic model led to the proposition that win–lose strategies for dealing with organisational change are counter-productive. Participative strategies are proposed as a means of engendering trust, eliciting commitment and developing support for organisational goals. Openness is advocated as the means to resolve organisational conflicts and the development of a trusting organisational climate is recommended.

Organisation development and action research are two of the behavioural science approaches to organisational change, which are based upon the above proposals. They were especially popular during the 1980s, although they were criticised as manipulative. Organisation development consists of a range of behavioural interventionist techniques designed to change the organisational climate. Action research is essentially a participative problem-solving technique.

Political models

Organisations can be viewed as political systems. Pfeffer (1982) and Mintzberg (1983) are two writers who have considered organisations from the political standpoint. Political models of change lead to strategies that are based upon negotiation and bargaining. Powerful coalitions may be in a position to achieve the changes they require by means of coercion. Often changes will involve compromise as political adjustments are made between different coalition groups. Tichy (1983) points out that to effect change, within the context of a political model, the starting point is the identification of coalitions.

Mintzberg (1983) has proposed a typology of power configurations that may be found in organisations. This can provide a starting point for the type of exercise described by Tichy. Mintzberg has also considered the political games that can be played by the various coalitional groups and their possible functions. It was more common for writers, prior to 1983, to consider organisational politics as dysfunctional. Mintzberg offered a different perspective.

Political models have also been used descriptively. They have sometimes been applied to the emergent strategy process. The political perspective has not been confined to intra-organisational issues. Henderson (1979) for example, offers a view of how the politics between rival organisations may influence the competitive conflict between them.

The political dimension is present in almost all large companies, and many smaller ones, and strongly influences the ease or otherwise with which change can be brought about.

Cultural models

Tichy (1983) notes that there is a degree of interdependence between the technical, economic and social aspects of an organisation. For this reason, changes in one area are liable to influence the others. It has also been noted earlier in this topic that people are a key resource in the organisational context. It is people that learn, but people do not always take readily to change. The organisational behaviour literature can offer numerous accounts of resistance to change and models for considering this phenomenon. The organisational environment, which both supports and is created by the actions of people, is complex and all embracing.

In 1979, Pettigrew introduced the concept of organisational culture into the management literature. Culture is a very broad concept that can encompass a range of historical factors. Management theorists in the 1980s proposed that cultural change could, over time, provide the key to competitive success. This idea was supported in a number of popular texts (Ouchi 1981; Pascale & Athos 1981; Deal & Kennedy 1982; Peters & Waterman 1982). Perspectives on organisation culture developed that suggested how it might be changed: for example,

through the management of meaning (Smircich & Morgan 1982), symbolism (Green 1988) and the use of rites and rituals (Trice 1985).

Strategy and culture are inextricably linked. Bate (1994) even goes so far as to argue that organisational strategies and organisational cultures are synonymous in the sense that organisational cultures are strategies for survival. In any event, whether or not strategies and organisational cultures are equated with one another, in Bate's sense, it can be said that strategic change often requires culture change if it is to be successful in achieving its intended objectives.

Bate (1994) outlines four strategies for cultural change, which we will explore here in detail.

The aggressive approach

In the traditional language of organisation development, the aggressive approach is power-coercive, conflict-centred, non-collaborative, win–lose and imposed. It is a strategy in which one side wins and one side loses. It is a strategy that attacks traditional organisational values and serves clear notice of an intention to impose a new cultural order. Cartwright and Cooper (1992) observed that this approach is sometimes used by parents on firms that they have taken over in an effort to integrate them as quickly as possible into the corporate culture. The assumption here is that, without a culture shock, cultures will not change.

The conciliative approach

To deploy organisation development descriptors, this is a group problem-solving, win–win, collaborative and integrative strategy. It is intended to be an approach in which everyone can win. The assumption is that culture change is a quiet exercise that can be achieved with people who are amenable to common sense. It is founded upon the type of organic model that was described by Tichy (1983).

The corrosive approach

This is a political, coalitional, unplanned, networking and essentially informal strategy. It is based upon a political model of change. Corrosives consider that change requires the skilful manipulation of informal power networks.

The indoctrinative approach

Indoctrinative strategies require re-education and training programmes to achieve a change that is viewed as a learning process. The learning is planned, rather than incidental, and it is usually designed to achieve attitudinal change. The assumption here is that if attitudes change culture will change.

Bate argues that none of the four approaches that you read about above is likely to be sufficient to achieve lasting cultural change. Each one is strong in some areas but weak in others. He therefore offers a linear model that draws on elements of all four. It is not proposed as necessarily the best way of tackling culture change.

Bate suggests that managers may prefer to build their own models in the light of the insights he offers in his book. What his account of strategies for cultural change highlight is that, in the context of strategic change, cultural change is also required. Some people will be intransigent and resist change, others will be more cooperative. In such situations, organisational politics may emerge as a significant influence. Some people may need help in the form of training to adjust to new ways of doing things. Others may be so set in their ways that they will not change. This latter group is likely to be offered voluntary severance or made redundant.

In the same way that Tichy (1983) explicated the assumptions behind technical, organic and political models of organisational change, so has Bate (1994) explicated the assumptions that underpin four commonly deployed strate-

Your notes

gic orientations towards the achievement of cultural change. As strategies for change, they embody particular assumptions about human beings and the nature of organisational cultures. These assumptions limit the light that they can shed on the process of cultural dynamics.

Implementing Strategic Change: The Eight-Stage Process

We have thus far considered a variety of different models for managing strategic change. Particular attention has been devoted to the dynamics of organisational culture and the centrality of cultural change to successful strategic change. We shall now shift the emphasis from more abstract concepts and approaches to change management and towards a step-by-step process for implementing strategic change in an organisation. The model we advance is Kotter's (1996) eight-stage process which provides a comprehensive and practical framework for successful change management. You can see Kotter's process illustrated in Figure 18.3.

1. Establishing a sense of urgency
   - » Examining the market and competitive realities
   - » Identifying and discussing crises, potential crises, or major opportunities
2. Creating the guiding coalition
   - » Putting together a group with enough power to lead the change
   - » Getting the group to work together like a team
3. Developing a vision and strategy
   - » Creating a vision to help direct the change effort
   - » Developing strategies for achieving that vision
4. Communicating the change vision
   - » Using every vehicle possible to constantly communicate the new vision and strategies
   - » Having the guiding coalition role model the behaviour expected of employees
5. Empowering broad-based action
   - » Getting rid of obstacles
   - » Changing systems or structures that undermine the change vision
   - » Encouraging the risk taking and non-traditional ideas, activities and actions
6. Generating short-term wins
   - » Planning for visible improvements in performance, or 'wins'
   - » Creating those wins
   - » Visibly recognising and rewarding people who made the wins possible
7. Consolidating gains and producing more change
   - » Using increased credibility to change all systems, structures and policies that do not fit together and do not fit the transformation vision
   - » Hiring, promoting and developing people who can implement the change vision
   - » Reinvigorating the process with new projects, themes and change agents
8. Anchoring new approaches in the culture
   - » Creating better performance through customer- and productivity-

Quick summary

Implementing strategic change

- We have thus far considered a variety of different models for managing strategic change. Particular attention has been devoted to the dynamics of organisational culture and the centrality of cultural change to successful strategic change..
- The model we advance is Kotter's (1996) eight-stage process which provides a comprehensive and practical framework for successful change management.

oriented behaviour, more and better leadership and more effective management
» Articulating the connections between new behaviours and organisational success
» Developing means to ensure leadership development and succession

The first four stages outlined in the change process model in Figure 18.3 are intended to loosen a rigid status quo. New ideas and practices are introduced in stages five to seven. The final stage is intended to imbed the changes in the corporate culture and make them endure.

Problems arise when executives attempt to disregard stages in this process, due to time or other pressures. Stages one to four and/or stage eight tend to be those most often omitted. However, if management neglects first, to remove internal opposition to change and, second, to consolidate the new norms and practices, strategic change is likely to be destabilised or ineffective. If useful change is to be successfully implemented and enduring, all stages must be complied with, in a sequential manner.

Kotter argues that successful change can only come about through a multi-step approach, as outlined in Figure 18.3. This creates power and motivation within the organisation capable of overcoming all existing sources of opposition and inertia (Kotter 1996, p. 20). Moreover, Kotter argues that the change process is never utilised effectively unless it is driven by high-quality leadership

Your notes

Summary

Organisational change may be driven from the outside in and the inside out. Often the two are linked. Common pressures for organisational change have been linked to the phases of company development, in which typical sorts of response can be identified. New ideas and practices cannot be successfully implemented if internal opposition and contradictions are not first neutralised or eliminated. Moreover, strategic change will not endure unless the new norms and practices are embedded in the organisational culture.

Task ...

Task 18.1

To check your understanding of the material in this topic, try to answer the following questions. If you have any difficulties, you may wish to go back and revise the relevant part of the topic.

1. How does Grundy (1994) define strategic change?
2. What are the four main types of change?
3. What are the four scenarios that may trigger organisational change?
4. List the four types of company that derive from their different orientations towards the requirements for strategic change.
5. Tichy (1983) advances three common models of change. Name all three models.
6. Organic models of strategic change have nine assumptions. Name at least five.
7. What are Bate's (1994) four strategies for cultural change?
8. Discuss the link between cultural and strategic change.
9. List Kotter's eight-stage process for implementing strategic change.

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