Dynamics of Organizing

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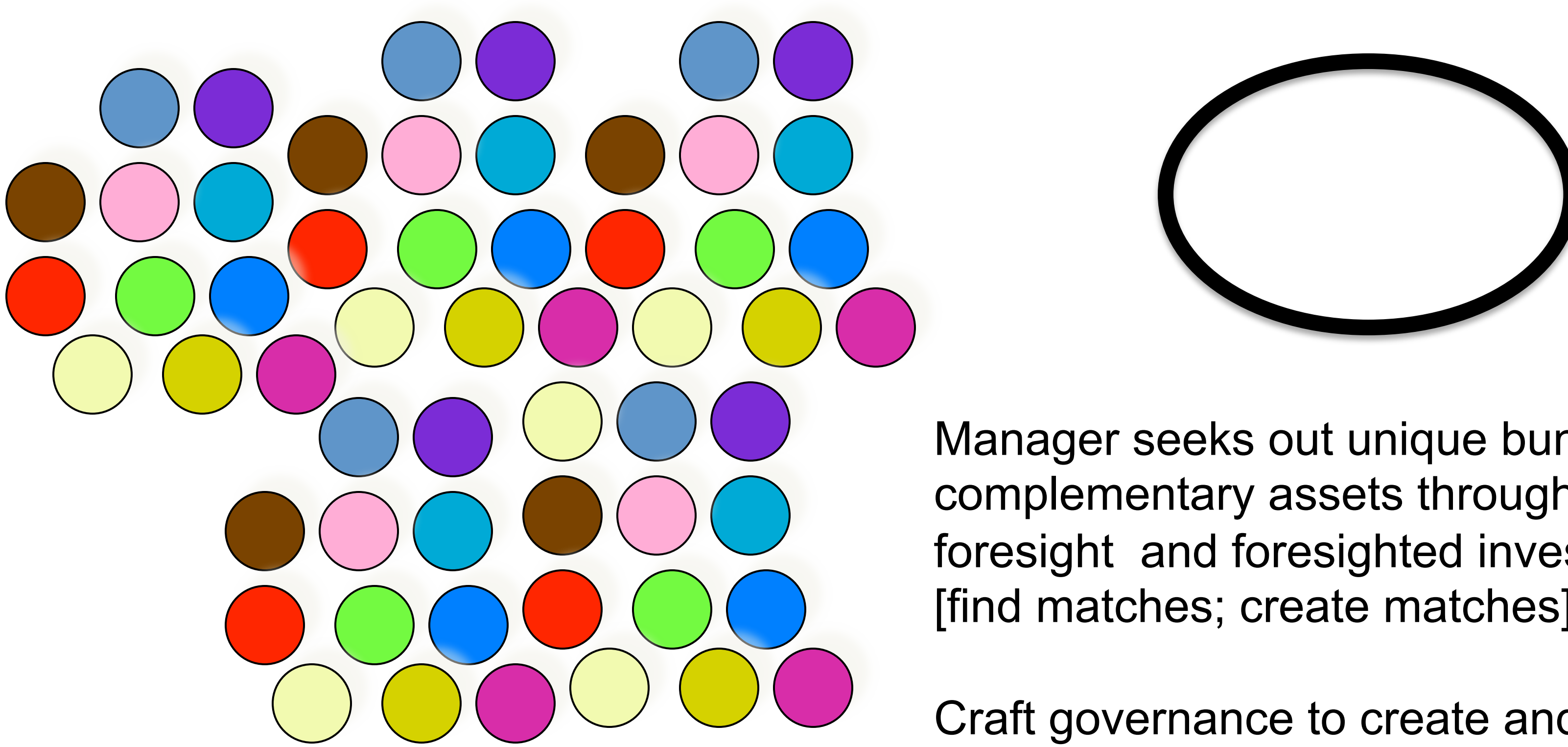
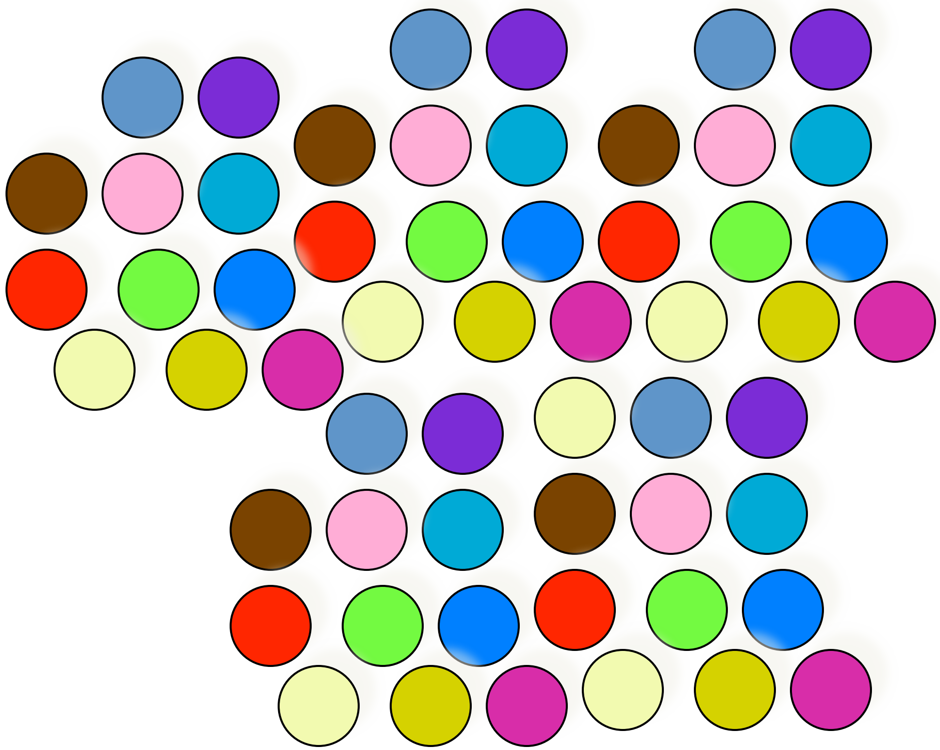
The manager's strategic task

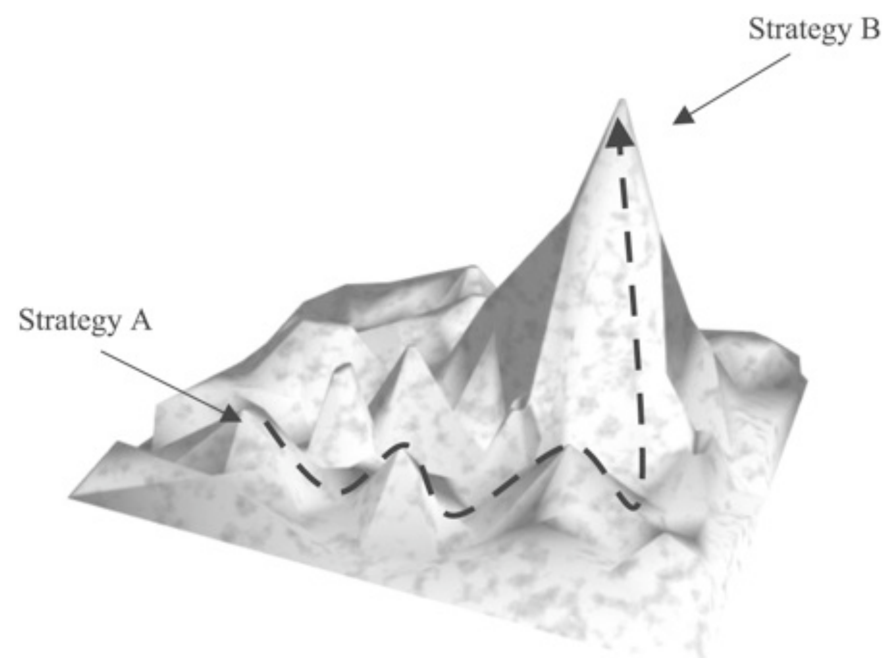


Manager seeks out unique bundles of complementary assets through foresight and foresighted investment. [find matches; create matches]

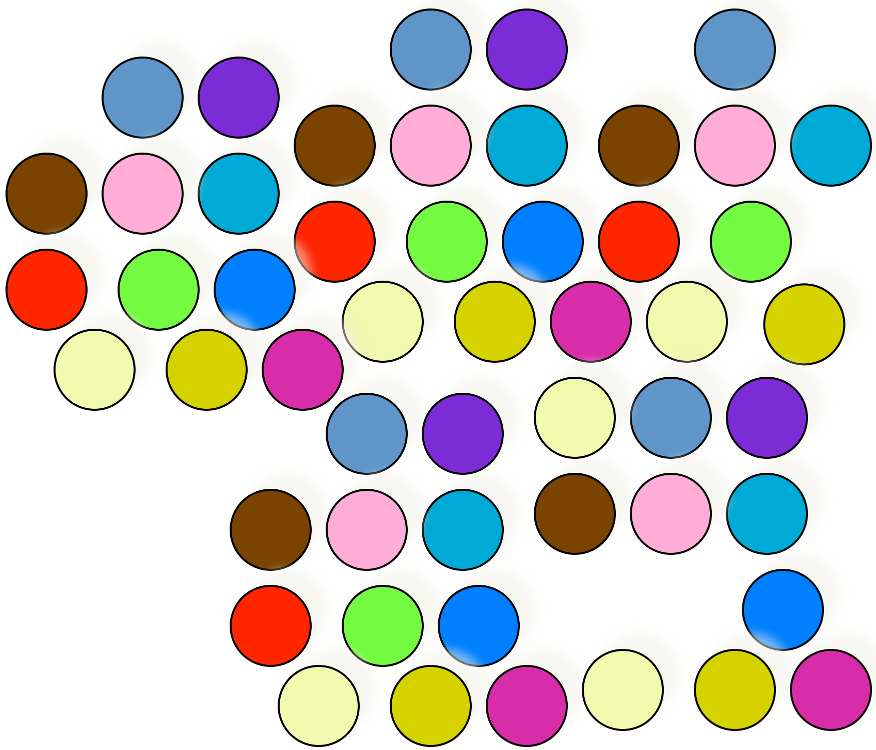
Craft governance to create and capture this value.

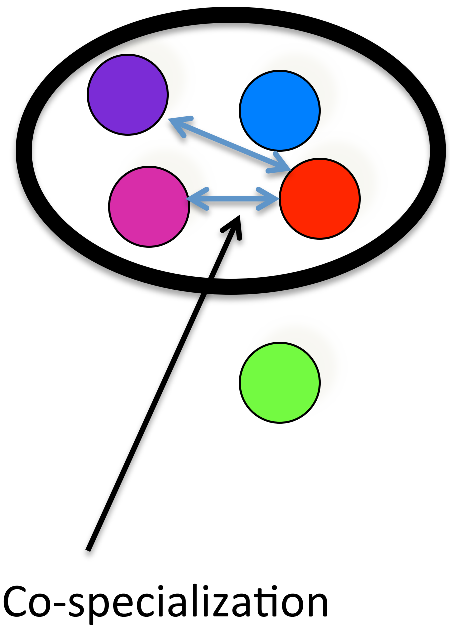
Design Decision 1: Composition



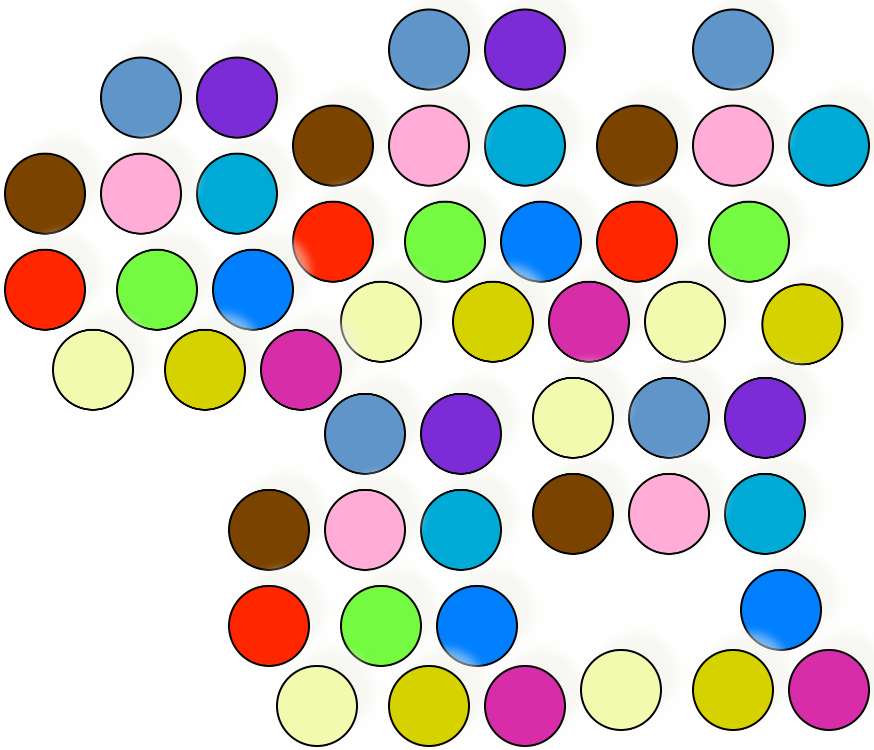


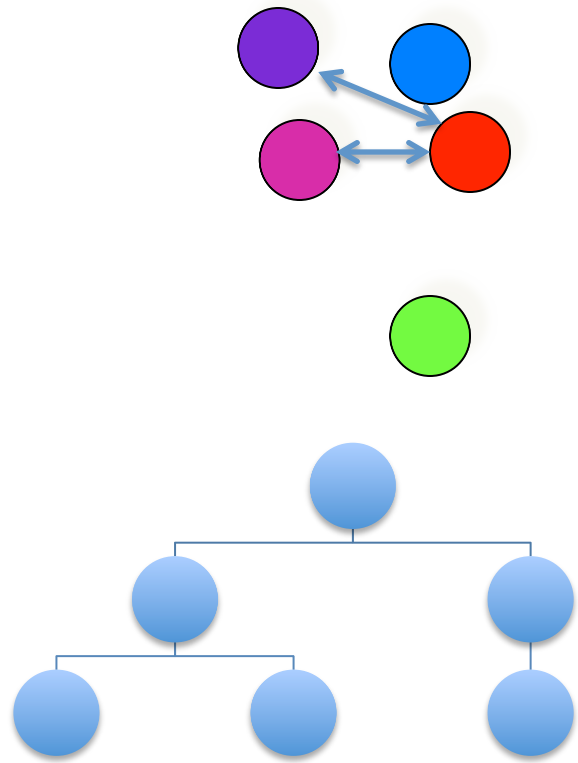
Design Decision 2: Boundaries





Design Decision 3: Structure





The concept of fit

- Boundaries and structure respond to exchange conditions, Williamson, 1975
- Structure follows strategy…Chandler, 1962; Rumelt, 1974; Williamson, 1975
- Contingency theories, Donaldson, 1987.

- Therefore, dynamics in organization occur in response to dynamics in strategy and environment

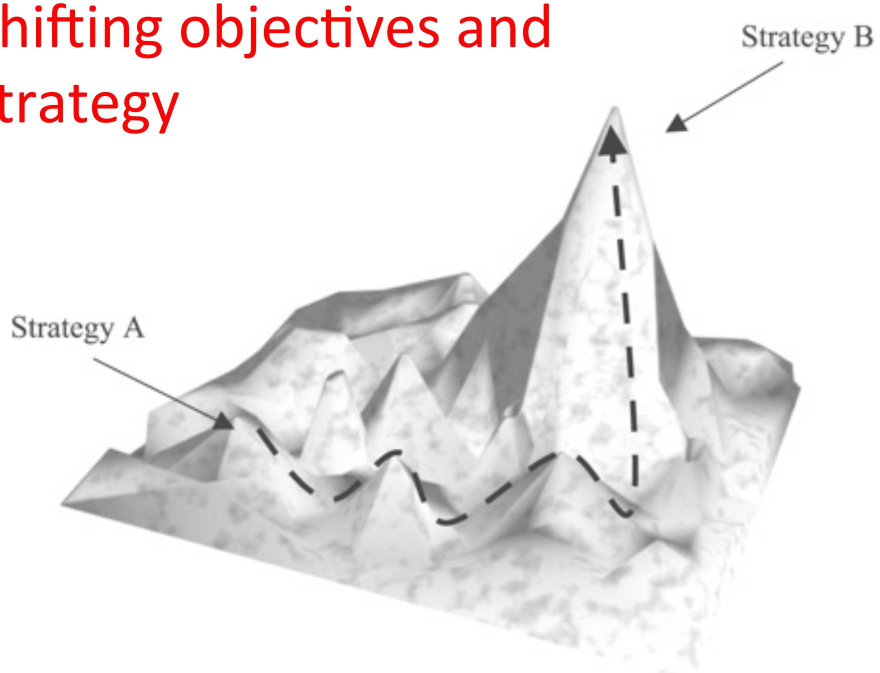
Influencing forces

Exogenous

- Shifting environment
- Shifting governance technology
- Shifting objectives and strategy

Endogenous

- Dynamic fit



Capabilities, Transaction Costs, and the Dynamics of Firm Boundaries

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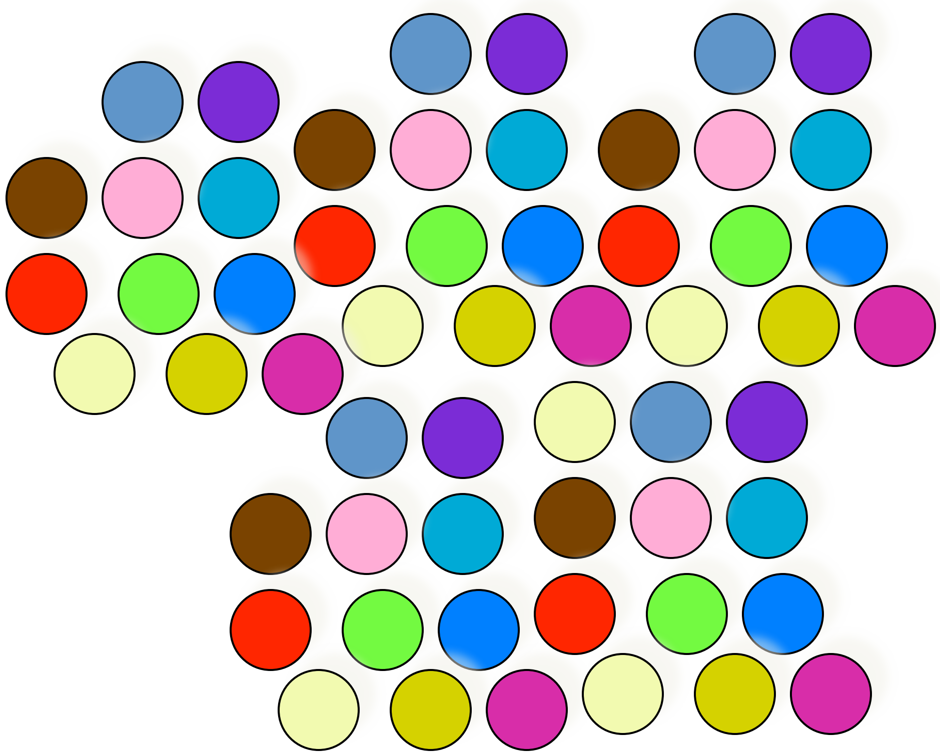
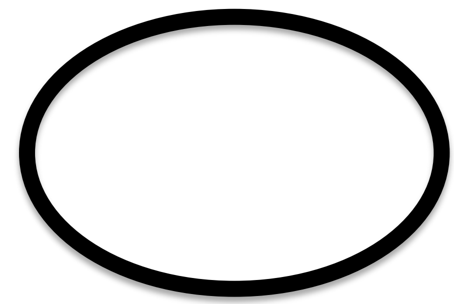
The manager's strategic task





Manager seeks bundles of complementary activities and assets that form unique rent-generating capabilities or positions of advantage.

How does manager build this bundle?
How does manager dynamically shape boundaries?

What theory guides boundary choice?

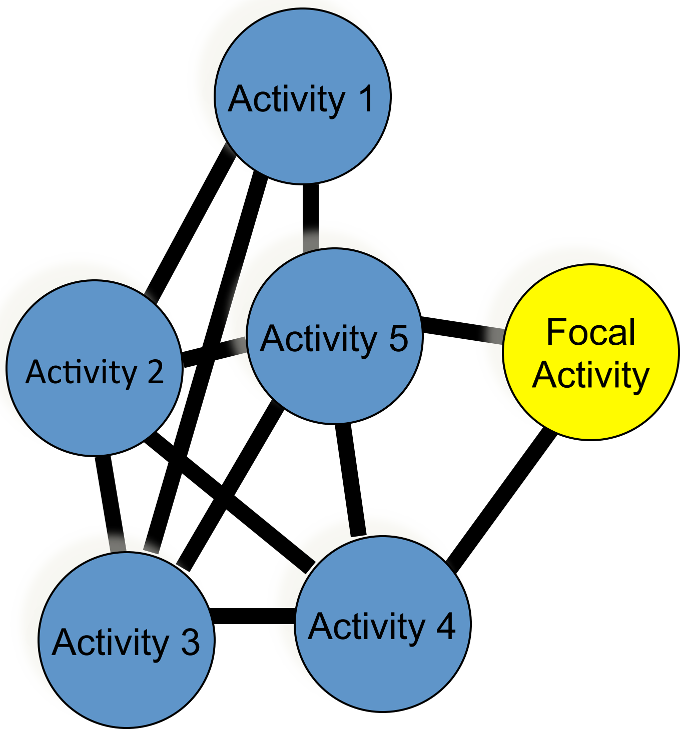
- Historical dominance of transaction cost economics (and related governance theories) as explanation for firm boundaries.
- However, capabilities-based logic argues that boundaries reflect comparative capability.

  (Langlois, 1992; Demsetz, 1988; Barney, 1999; Jacobides and Winter, 2005)
- Empirical work highlights role of capability, as well (Argyres, 1996; Poppo & Zenger; 1998; Jacobides & Hitt, 2005; Leiblein & Hoetker, 2005)
- TCE empirical results reinterpreted to support capability story (Carter & Hodgson, 2006; David & Han, 2004)
- What is the role of capability in boundary choice?

Capabilities Guidance

- Langlois (1992): "capabilities view of the firm suggests that the boundaries of the firm are determined (at least in part) by the relative strength of internal and external capabilities…"
- Jacobides and Winter (2005): to understand boundaries we must "look at the distribution of productive capabilities."
- Barney (1999): "capabilities possessed by a firm and by its potential partners…have a significant impact on boundary decisions."
- Demsetz (1988): emphasis on TC "dims our view of the full picture by implicitly assuming that all fimrs can produce goods or services equally well."

Key question



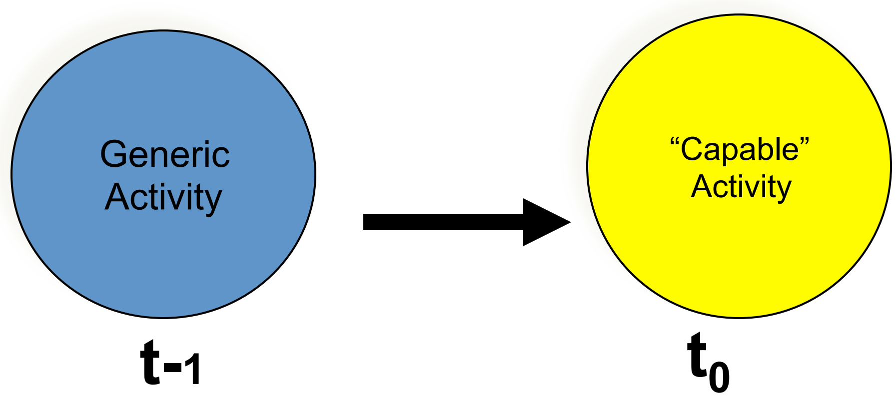
Activities, assets, resources, etc.

How does the "capability" of the focal asset influence boundary decision?

Common argument: if capable then integrated; if incapable then outsourced.

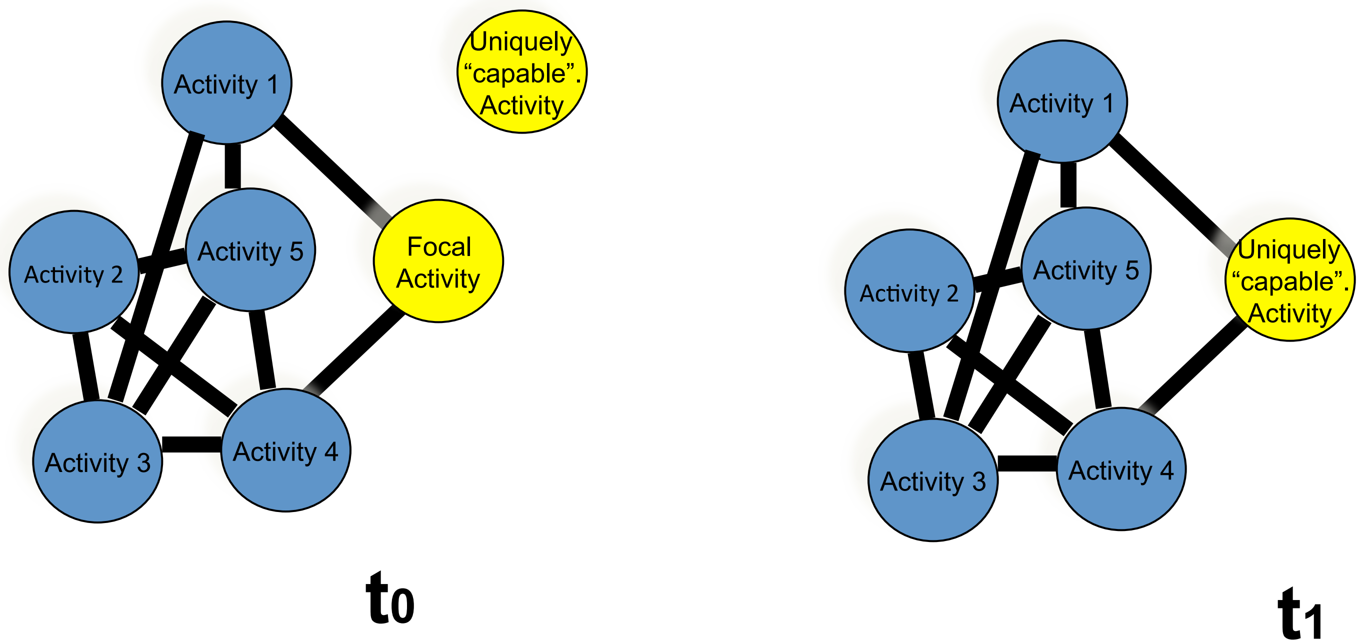
Problem 1: Fails to explain the origin

- Possession of capability today represents choice to internally develop (or acquire) capability in the past.
- Hence, comparative capability doesn't explain boundary choice. Rather, the boundary choice explains the development of comparative capability.



Problem 2: Fails to explain persistence

- If a firm lacks a particularly capable asset (possesses inferior capability), the firm can acquire it.
- If a firm possesses superior capability, why or when does it need to retain it? When is selling capability preferred?



Imagine a uniquely valuable goldmine…

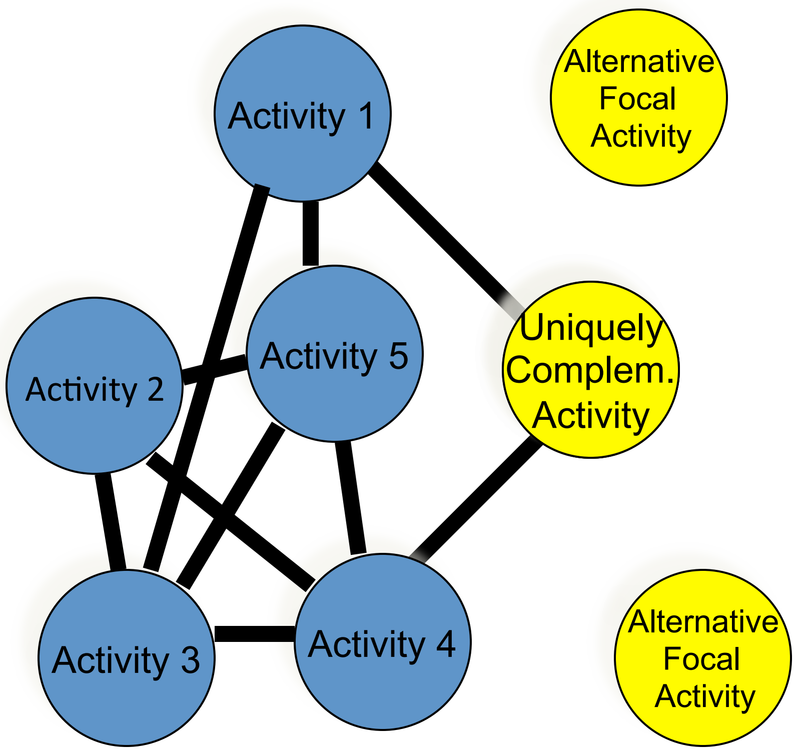
- Why should the ‘standalone’ capability or value of an asset or activity have any bearing on who should own it?

New Owner

?

Current Owner

Problem 3: Capability is bundle-specific



Capability of an asset is a strategy- or bundle- or entrepreneurial foresight-specific concept.

Capability of the focal asset is the value of the "bundle" with the focal activity relative to the value of the bundle with the next most capable asset..

TCE Limitations

- Problem 1: Assumes assets are homogeneous at outset, and transformed through investment.
  - However, assets are heterogeneous and hold up problems require no investment
- Problem 2: Boundary decisions exogenously shaped by exchange conditions. Prescription: integrate co-specialized exchange.
  - Many asset specific investments are not valuable.
  - Value creation is implicit, not explicit in theory.
- Problem 3: Bilateral vs. multi-lateral logic

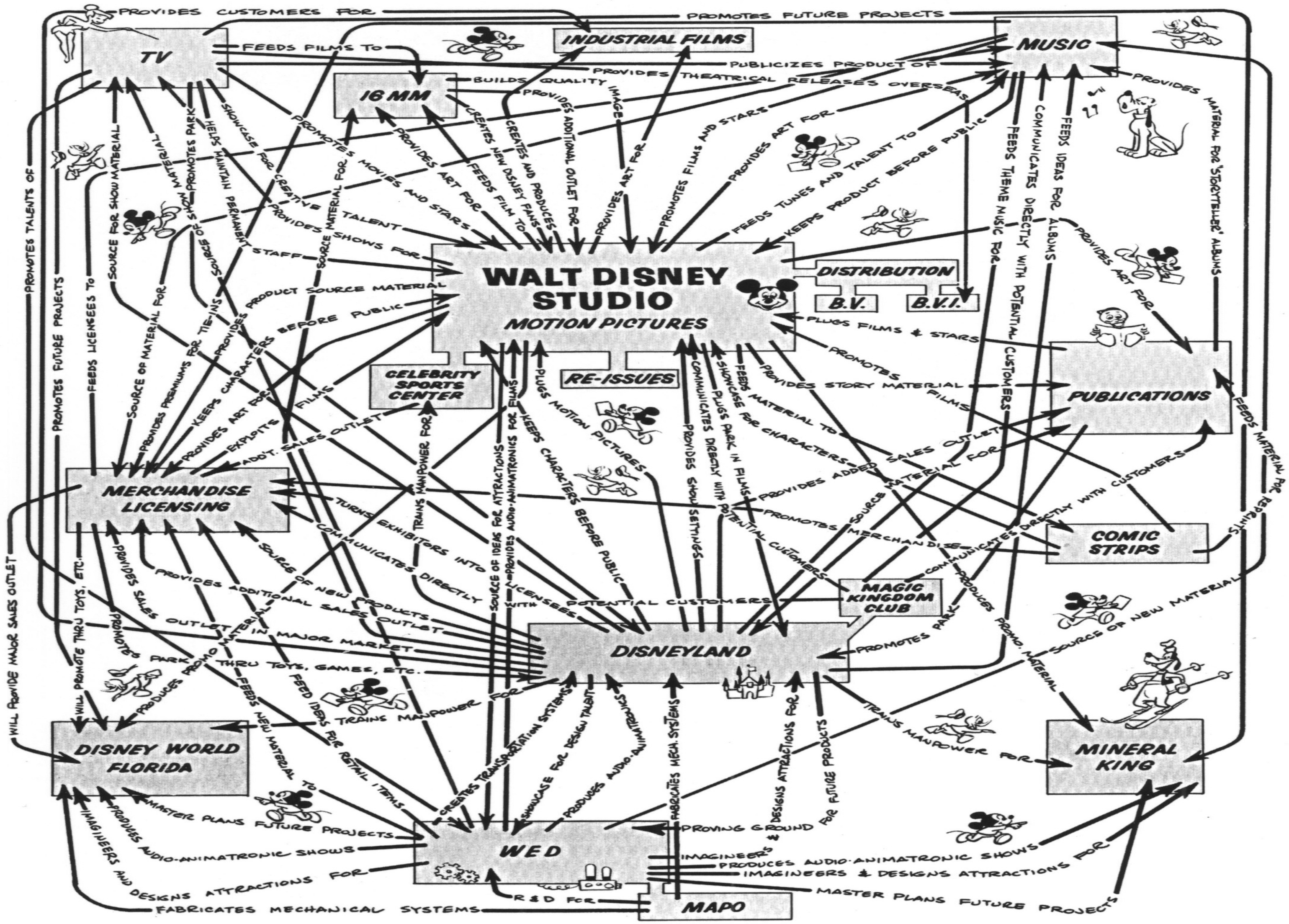
Williamson

- "Rather than ask the question, 'what is the best generic mode (market, hybrid, firm, or bureau) to organize X?,' which is the traditional transaction cost query, the question to put instead is, 'How should firm A —which has pre-existing strengths and weakness (core competencies and disabilities)—organize X.'"
- A correct, but rather limited view of integration possibility.

An Integrative Theory

- Foundational concepts
  - Need theory that explains the origin and persistence of boundary choice
  - Theory must explain role of boundary choice in creating capability
  - Need theory that integrates governance and capability logic, using common language

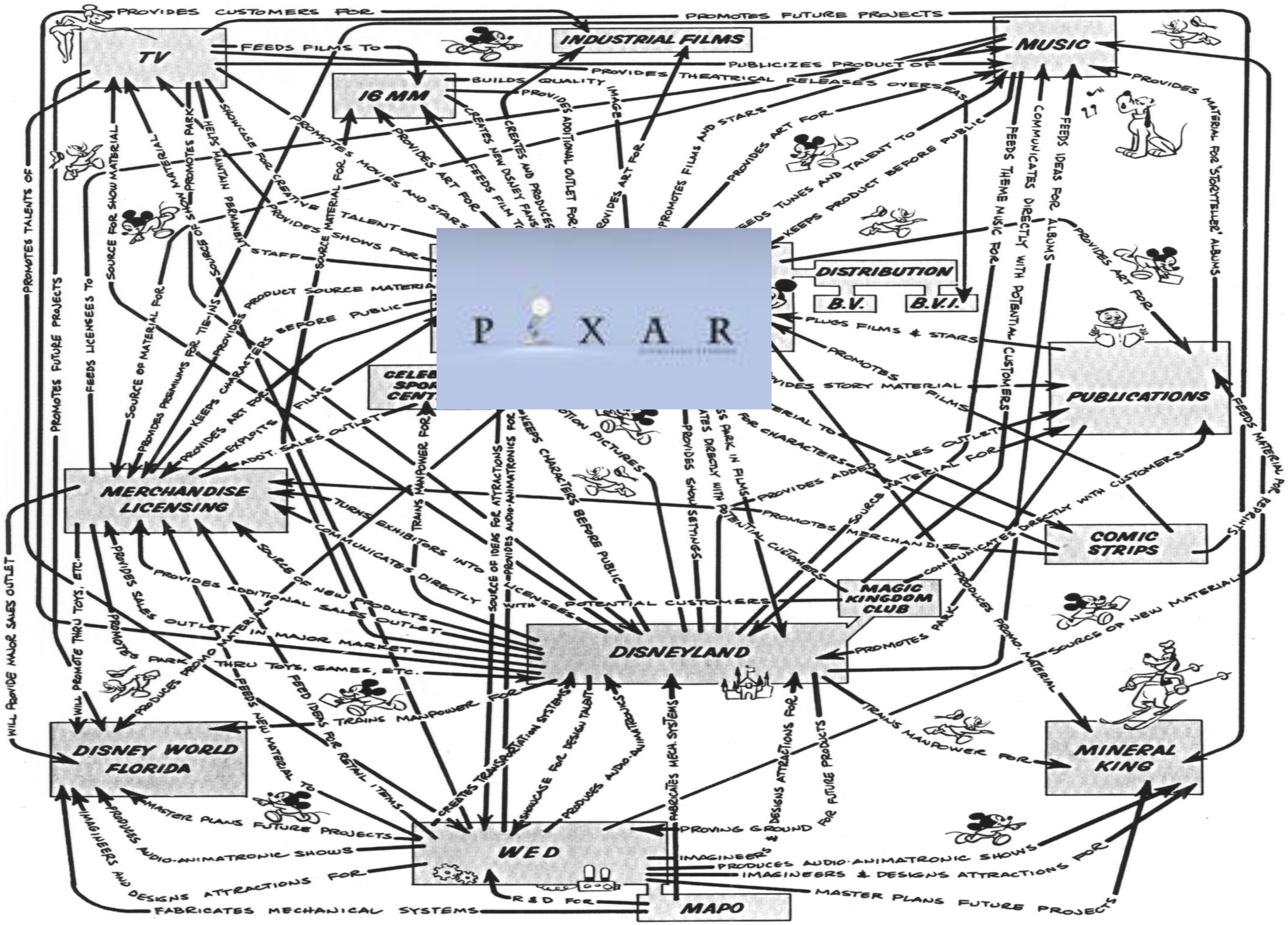
A Case Study to Explain: Disney



Disney Timeline

1. Disney owns and builds bundle of complements. (1950-1965)
2. Disney builds most capable animation activity.
3. After Walt Disney's death, Disney loses animation capability and the bundle loses enormous value (1974-1984).
4. New CEO Eisner rebuilds internal capability and expands complementary bundle; generates enormous value.
5. Disney loses comparative capability in animation to Pixar. (late 1996-2005)
6. Disney acquires comparative capability (Pixar) through costly acquisition.

Case Illustration: Disney



Disney Observations re: animation activity

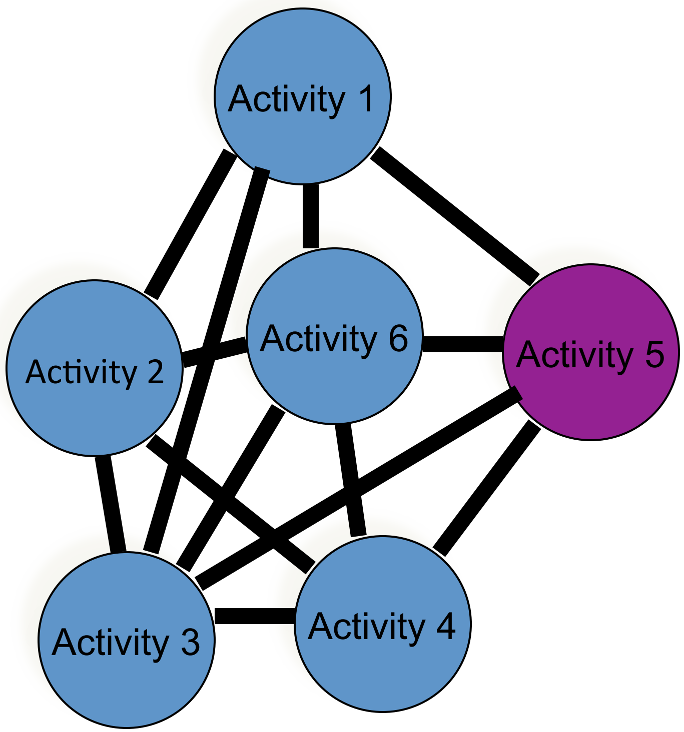
- Does simple comparison of capability explain boundary choices? NO
  - Disney lacked capability, but integrated to create and recreate it (1930-1960 and then 1984-1995).
  - Later, Disney again lacked capability, but integrated (purchased) capability it did not possess.
- If not comparative capability, what explains boundary?
- Why does Disney choose to acquire Pixar?
- Disney chooses to own those assets which are *uniquely complementary* to its bundle of other assets.

Capability and Boundary Choice

Focal asset is….

	Generic	Heterogeneous in capability
Complementary to bundle		
Non-complem.		

Complementarity and Capability



How do we govern each activity?

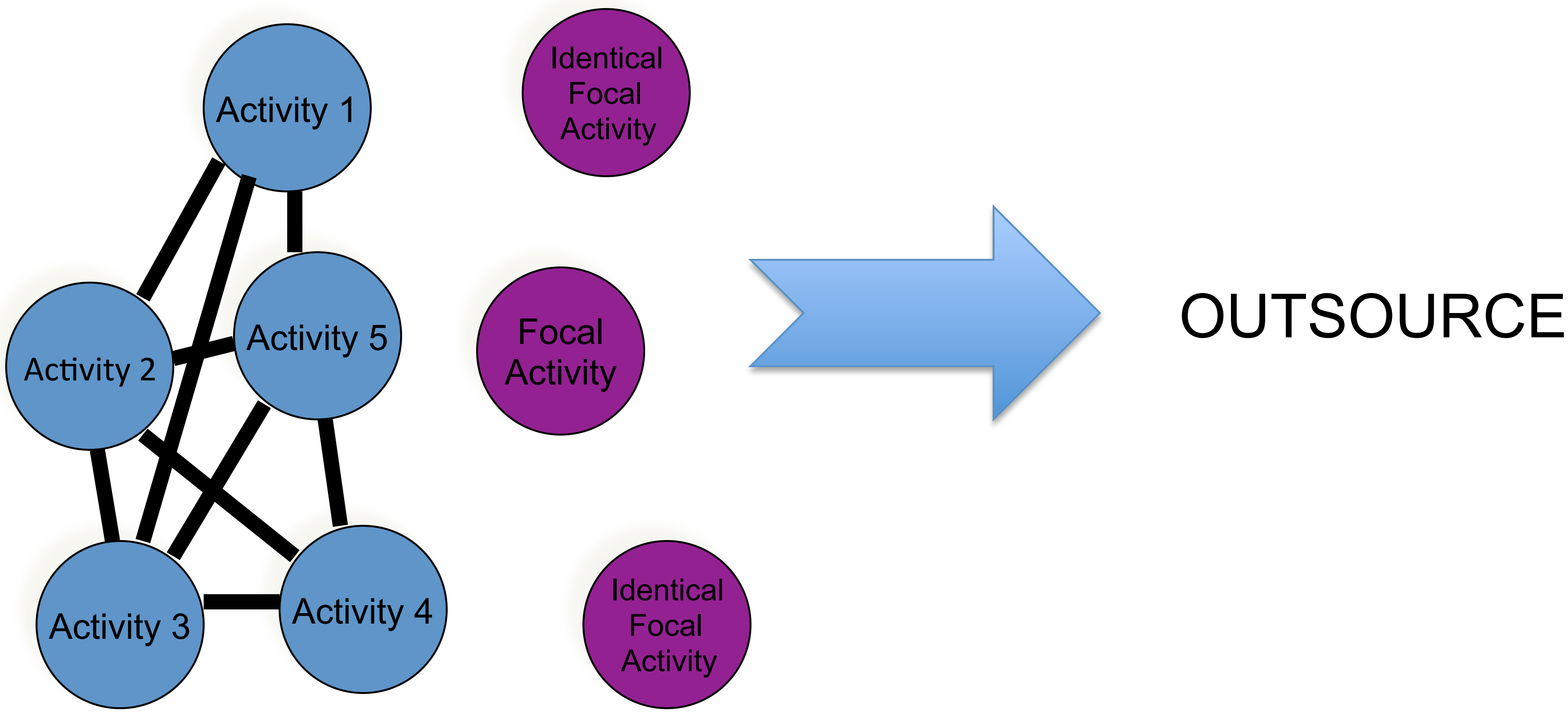
- Complementarity: "property that doing more of any subgroup of activities raises the marginal return of other activities" (Milgrom and Roberts, 1990)
- Comparative capability (heterogeneity) of an activity (for a particular firm) is the rent generated by the firm's activity bundle with the capable asset minus the rents created with the next most capable asset.

Capability and Boundary Choice

Focal asset is….

	Generic	Heterogeneous in capability
Complementary to bundle		
Non-complem.		

Non-complementary and generic



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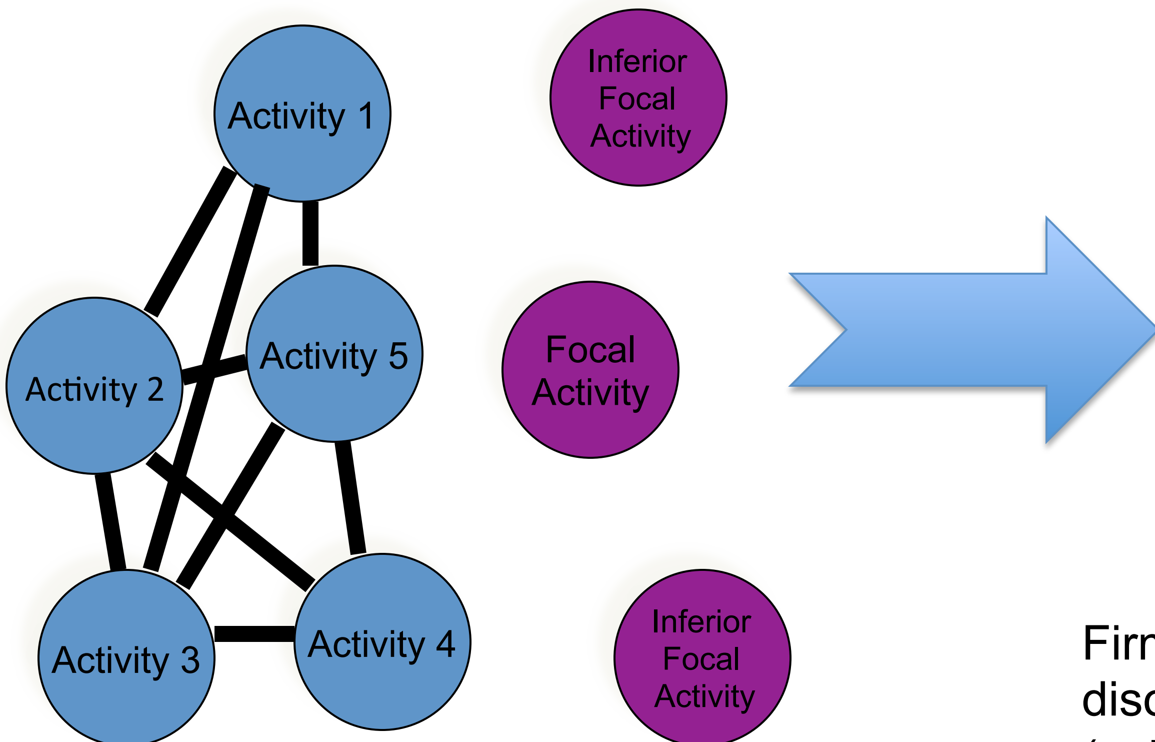
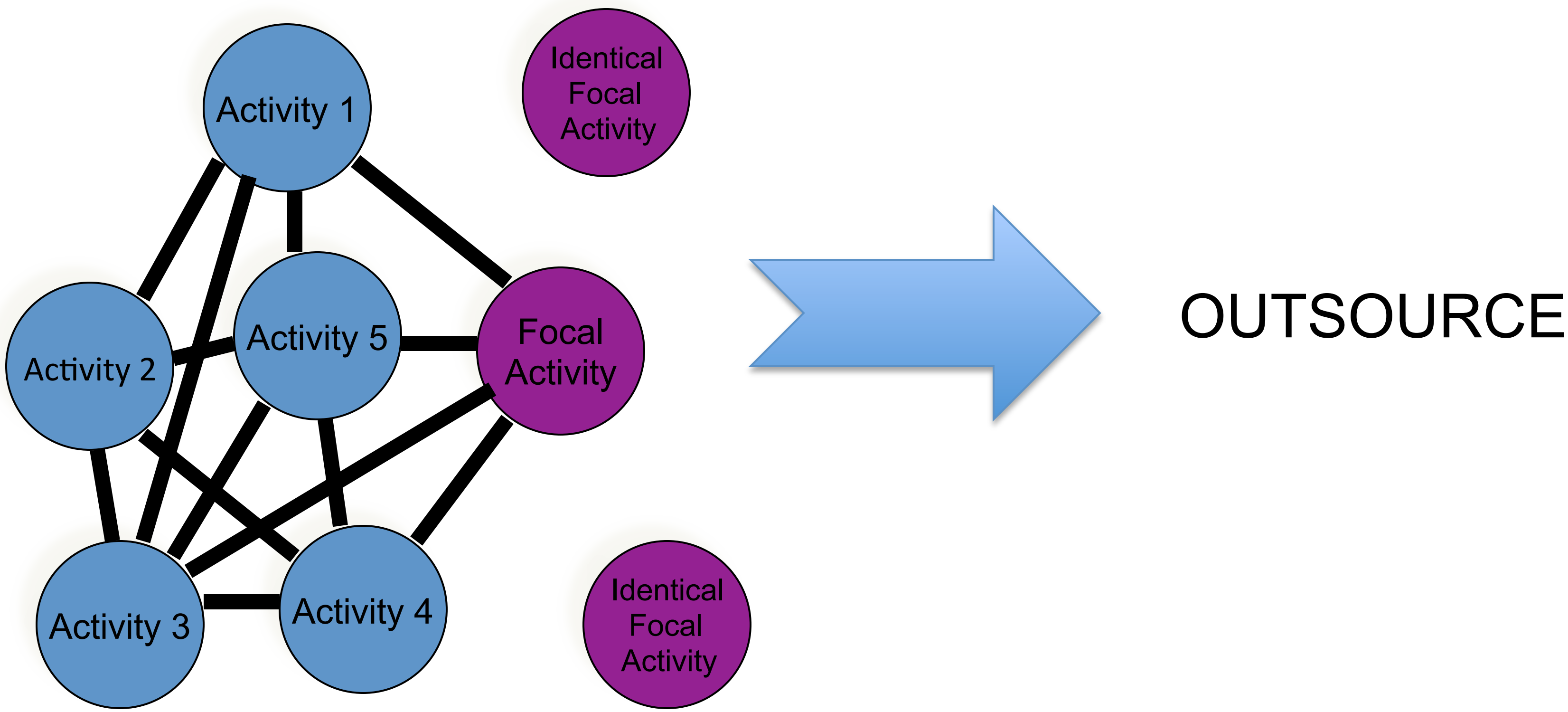
Non-complementary, but heterogeneous



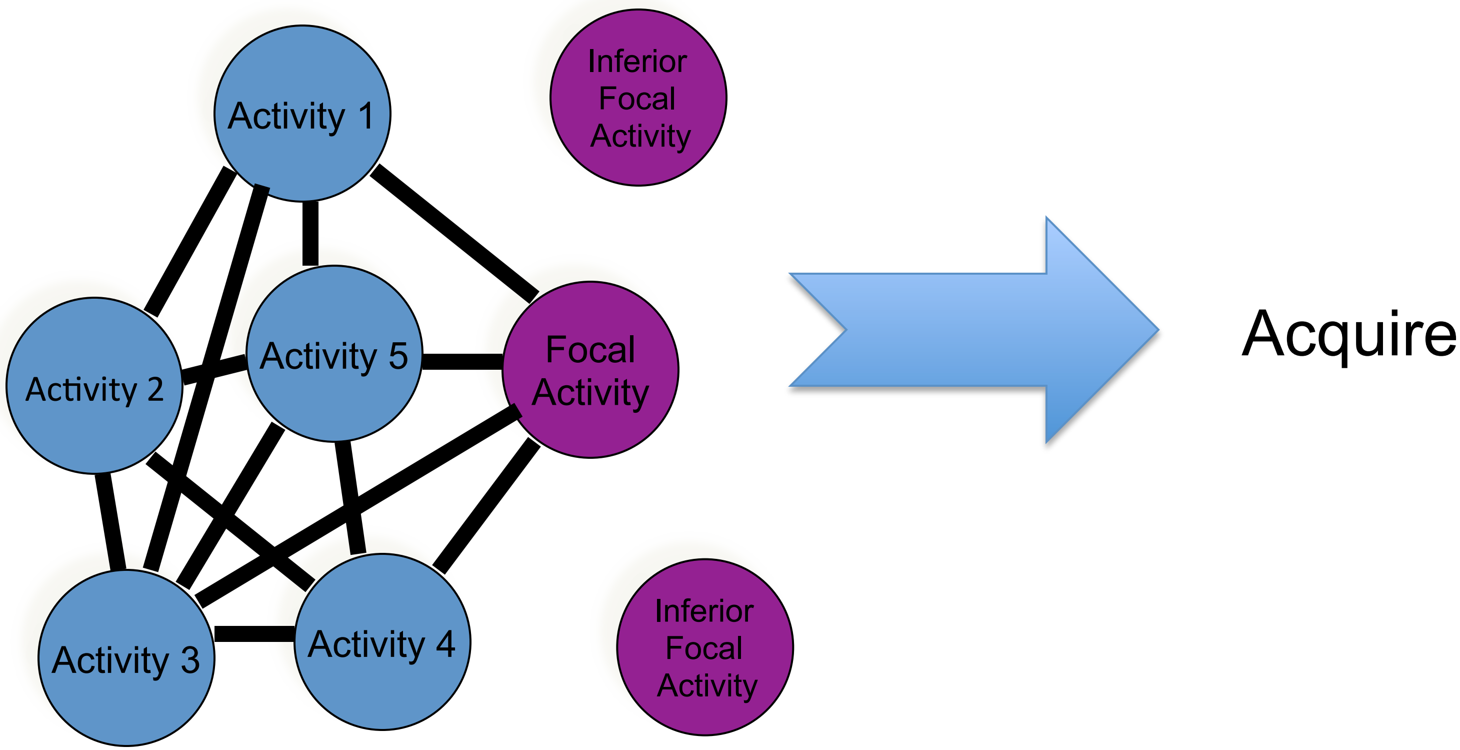
OUTSOURCE

Firm may choose to disown superior capability. (sell to owner with greater complementarity)

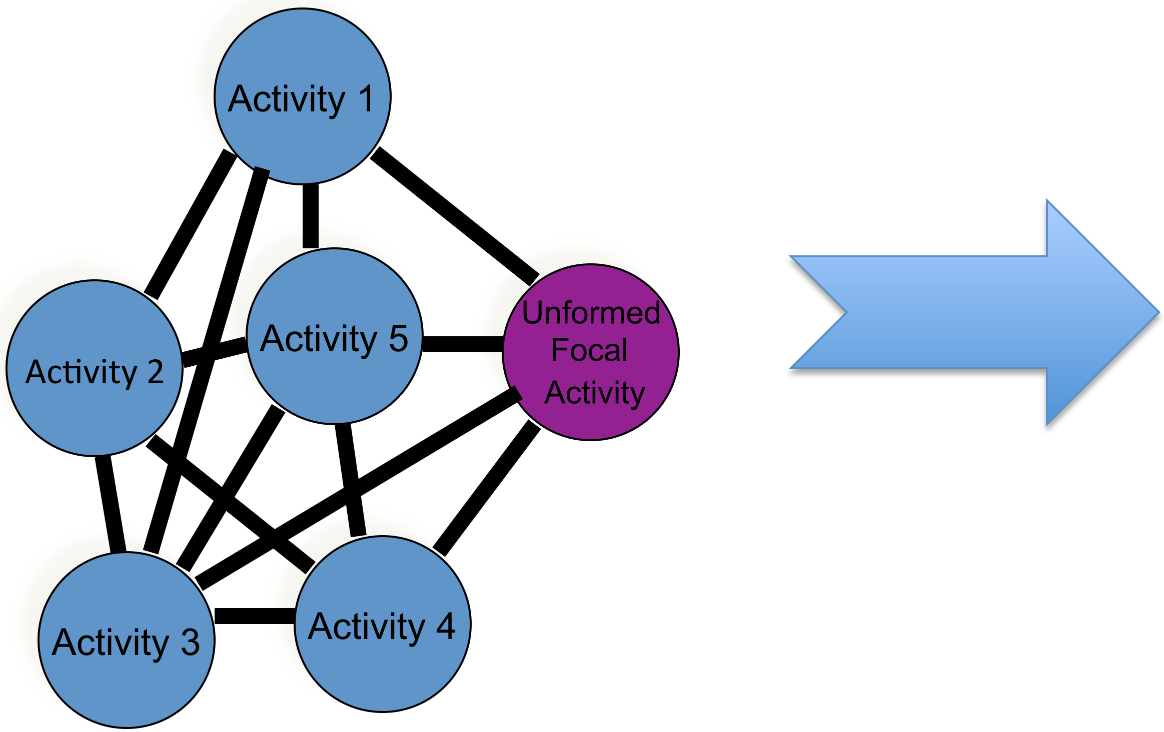
Complementary, but generic



Complementary and heterogeneous



Complementary, and heterogeneous



Build internally

Integrative Logic

Four types of assets….

	Generic	Heterogeneous (current or potential)
Complementary	Outsource	Integrate
Non-comp.	Outsource	Outsource

Consistency with Strategic Factor Market Logic

- Use foresight about the value of “strategies” (i.e. combinations of assets) to acquire assets at less than their future value.
- However, governance questions left unanswered: why must you buy these assets? Why not rent or contract for their services?
- Answer: Failure to acquire uniquely complementary assets generates substantial contracting problems.

Conclusions

- Firms should integrate to create or protect unique, bundle-specific capability.
- Firms have no clear reason to integrate non-complementary assets, however capable.
- Comparative capability alone (in the present) does not determine the boundary choice.

Future Opportunities

- Develop strategic theory of firm scope…
  - that recognizes a forward looking actor seeking value creation
  - heterogeneous assets
  - carefully treats role of capability
- Set aside the theoretical debates over language rather than substance

The Case for Dynamic Fit

Arises in presence of conflicting performance objectives

- Exploration and exploitation
- Quality and efficiency
- Basic and applied research
- Teaching and research
- Division performance and company-wide performance
- Individual effort and cooperation

Two Broad Solutions

Choose best discrete choice

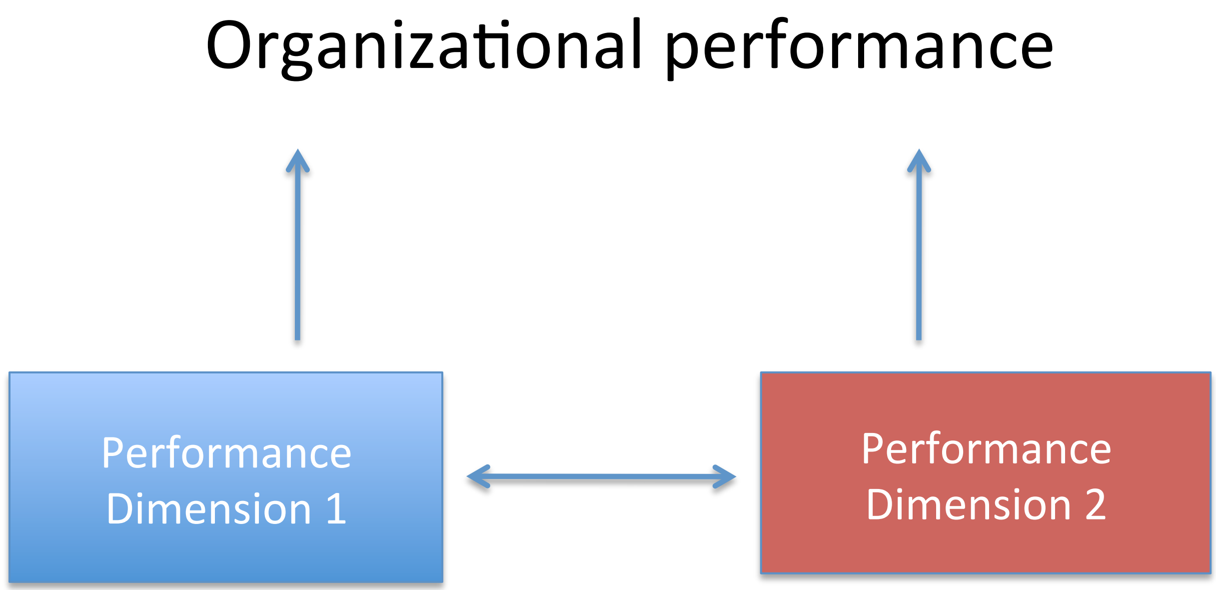
- Make vs. Buy
- High-powered vs. Low-powered incentives
- Centralize vs. Decentralize

Craft Hybrid form

- Relational governance/ networks
- Balanced scorecard
- Crafted incentives
- Matrix
- Ambidexterity

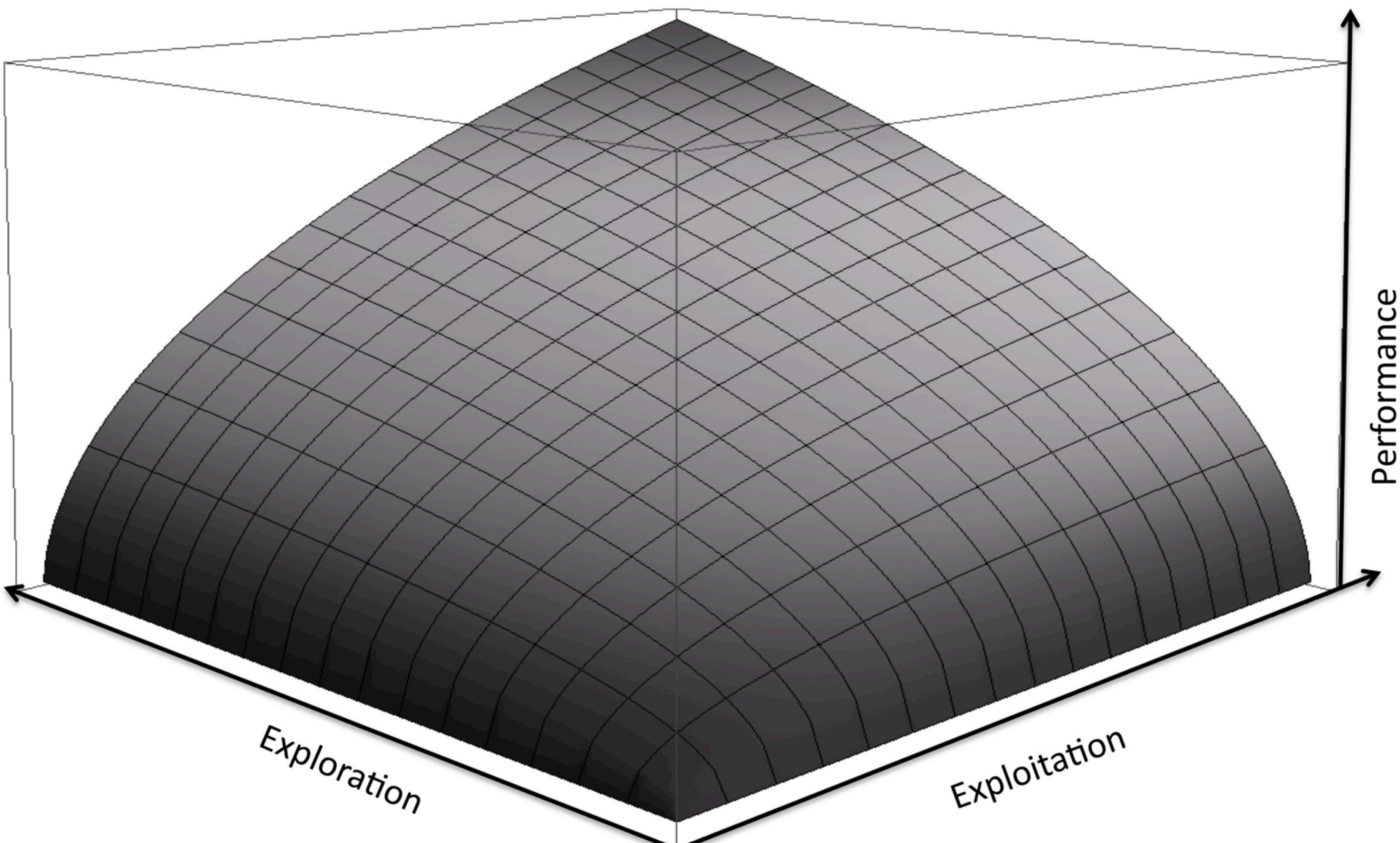
A Third Solution: Dynamic Fit

Assumption 1: performance complements

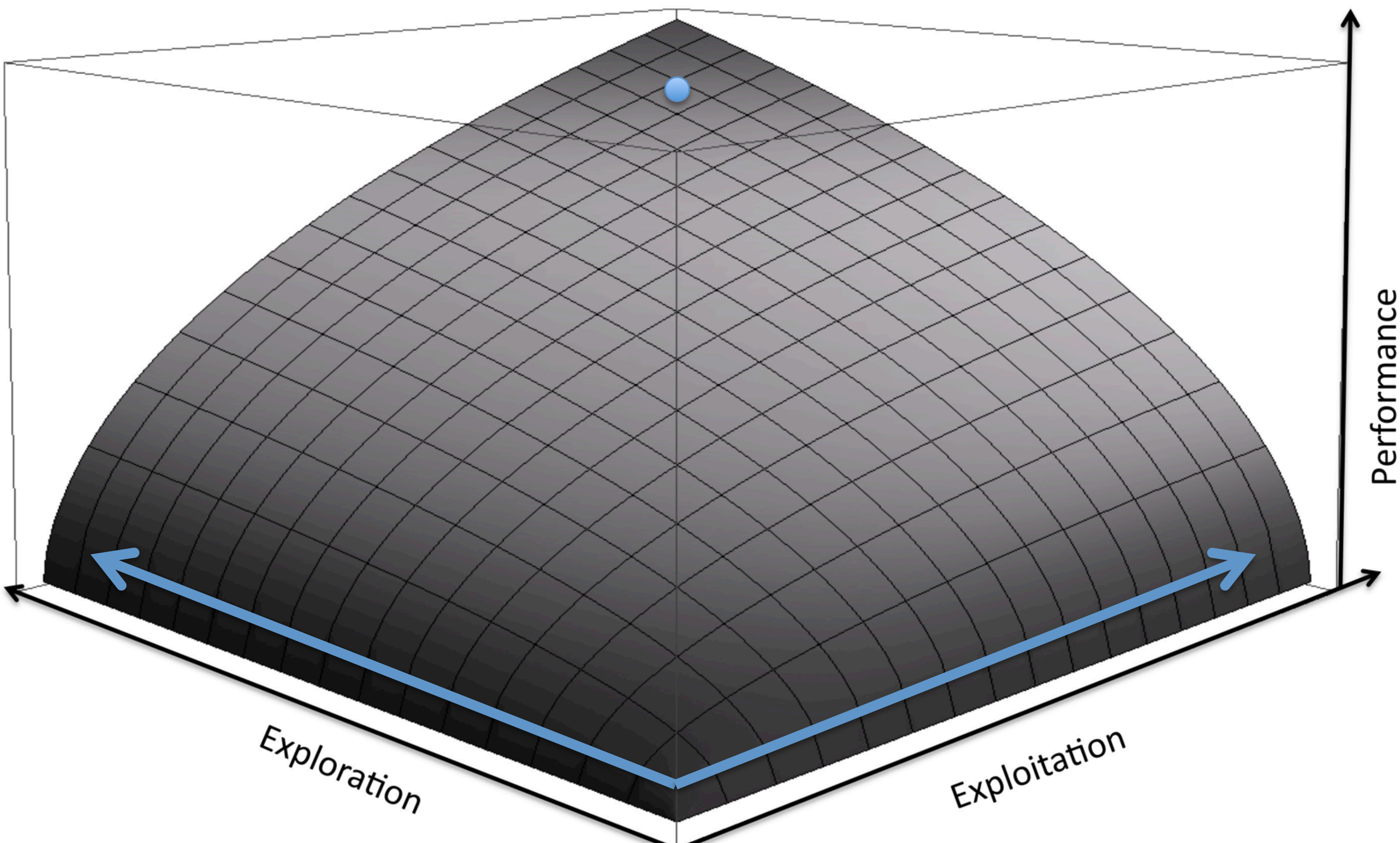


Complements in performance

Exploration and exploitation as complements in generating performance



Design Nirvana

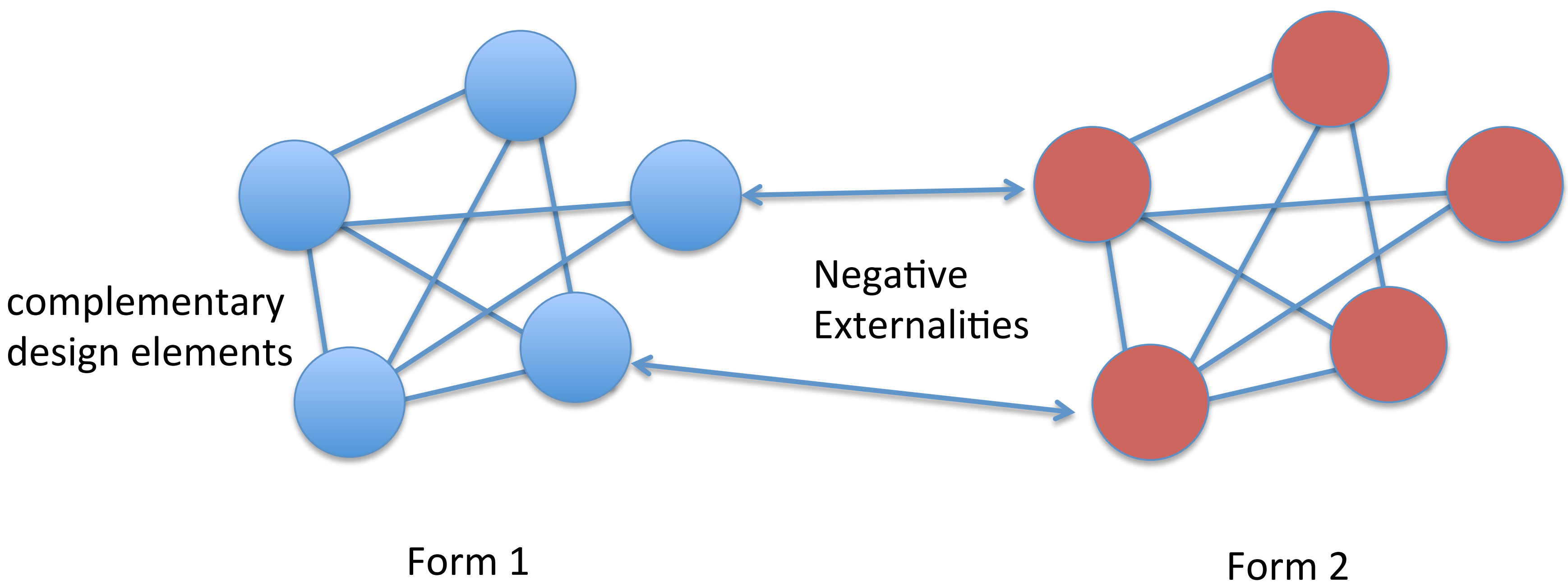


Assumption 2: Discrete Choices

- Organization theory: elements of bureaucracy (centralized hierarchy) "operate not in isolation, but as part of a system of elements that, in combination,…provide more effective and efficient administration" (Scott, 1981)
- Configuration Literature -- managers face menus of design choices.
  (Miller & Friesen, 1980; Meyer et al. 1993)
- Ecology Literature -- organizational populations composed of distinctive clusters of organizational traits (Baron, Burton, & Hannan, 1998)
- Organizational Economics – Complementaries in design;
- "each viable form of governance…is defined by a syndrome of attributes that bear a supporting relation to one another." (Williamson, 1991: 271)

- Punctuated Equilibrium Models-- "systems do not evolve through a gradual blending from one state to the next." (Gersick, 1991)

Assumption 2: Discrete Choices



Assumption 3: Inertia in response

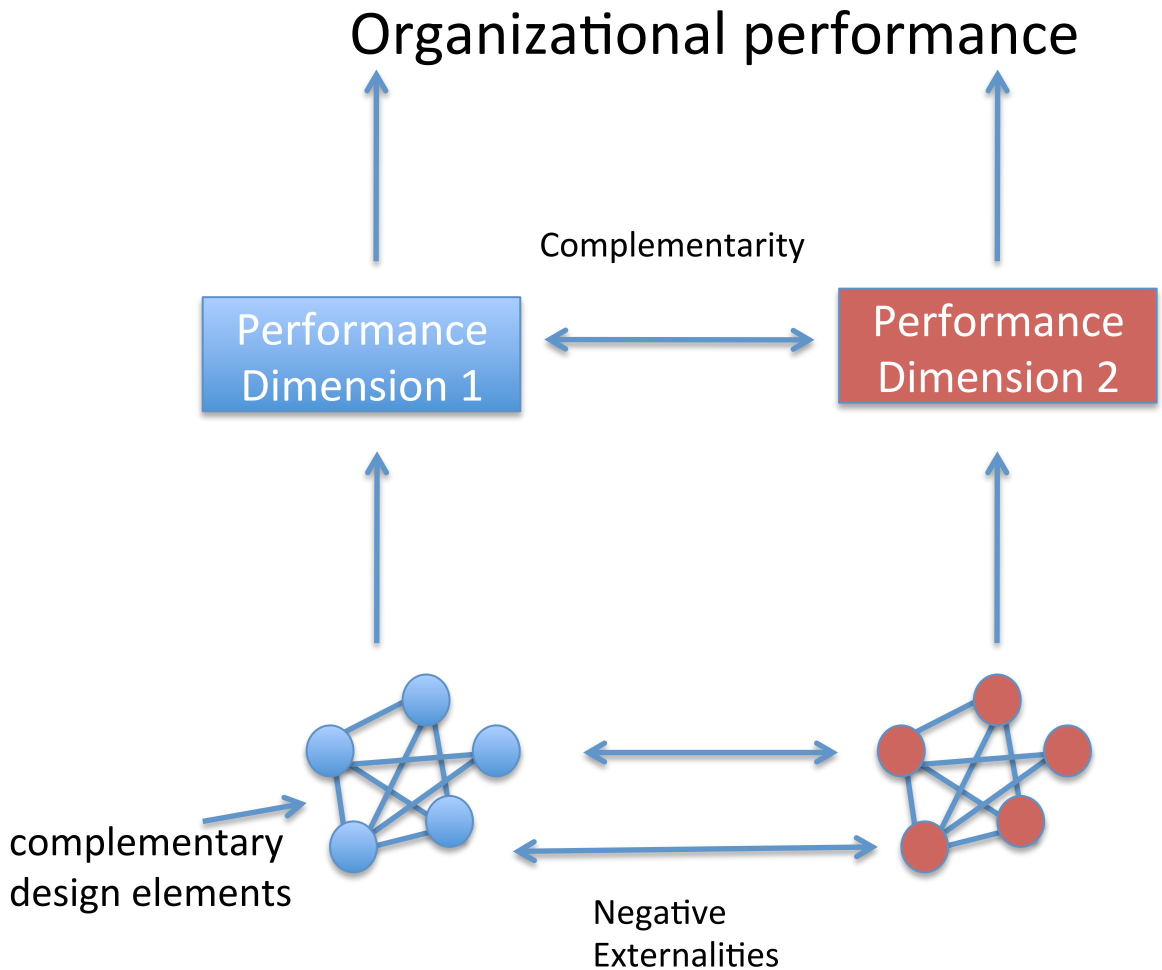
- *Trajectory:* The formal organization structure defines the trajectory of the informal organization.
  - "the formal largely orders the direction the informal takes" (Dalton, 1959)

- *Inertia:* webs of interdependent relationships, political coalitions, patterns of communication, established routines impede change in the informal organization.

  (Tushman & Romanelli, 1985; Hannan & Freeman, 1984; March & Simon, 1958; Nelson & Winter, 1982)

Informal organization has inertia

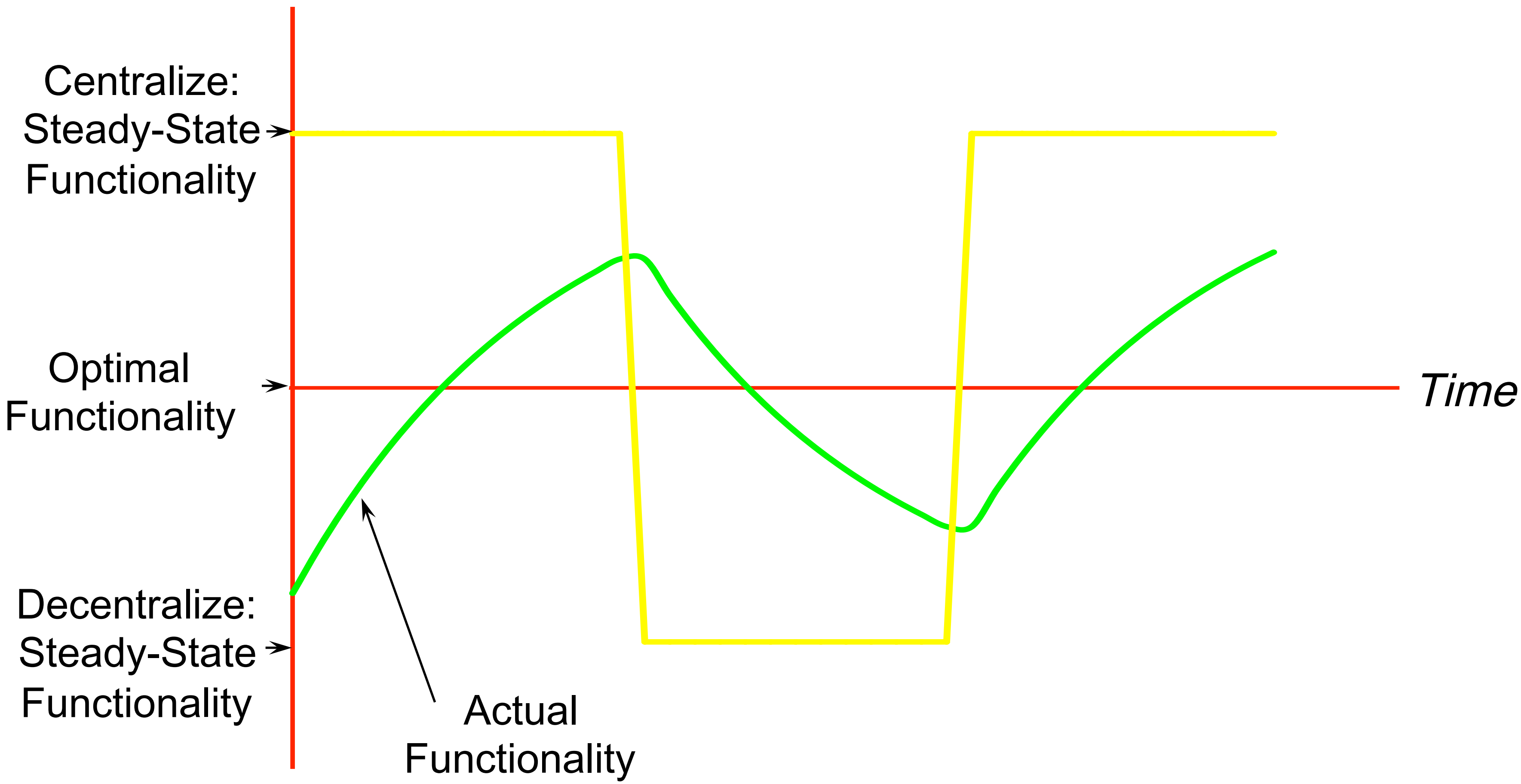
Design Dilemma



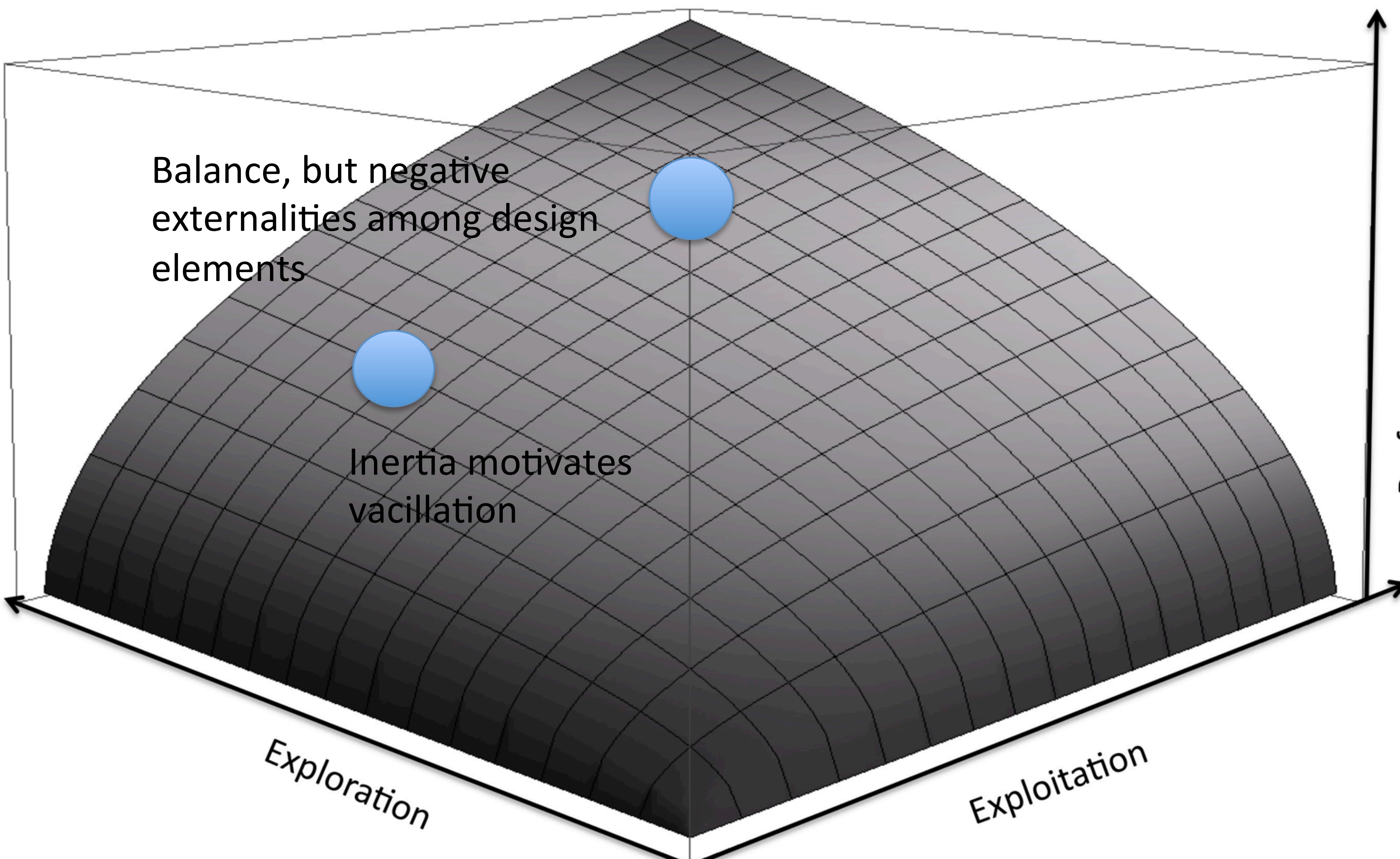
Motivates hybrid

Motivates modulation

Nickerson and Zenger (2002)



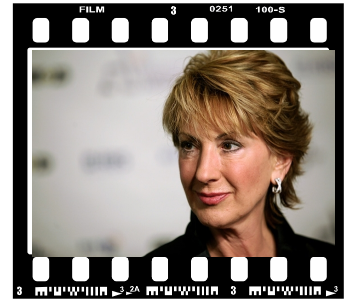
An empirical question



Hewlett-Packard Timeline

Centralization

Centralization



Centralization

?

1984-1990 | 1990-1995 | 1995-1998 | 1998-1999 | 2000-2005 | 2005-2010

Decentralization

Decentralization

Decentralization

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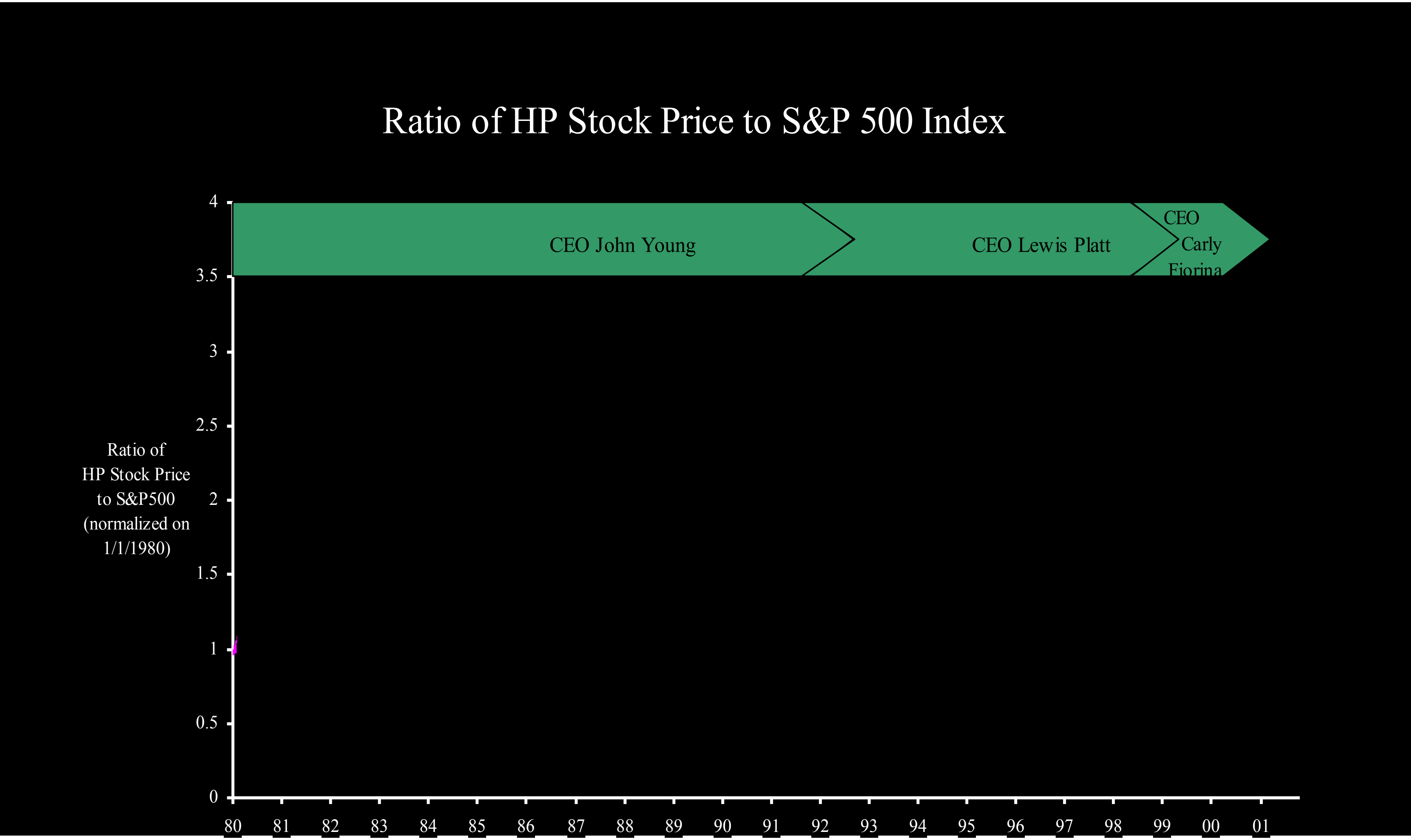
Hewlett-Packard Stock Index



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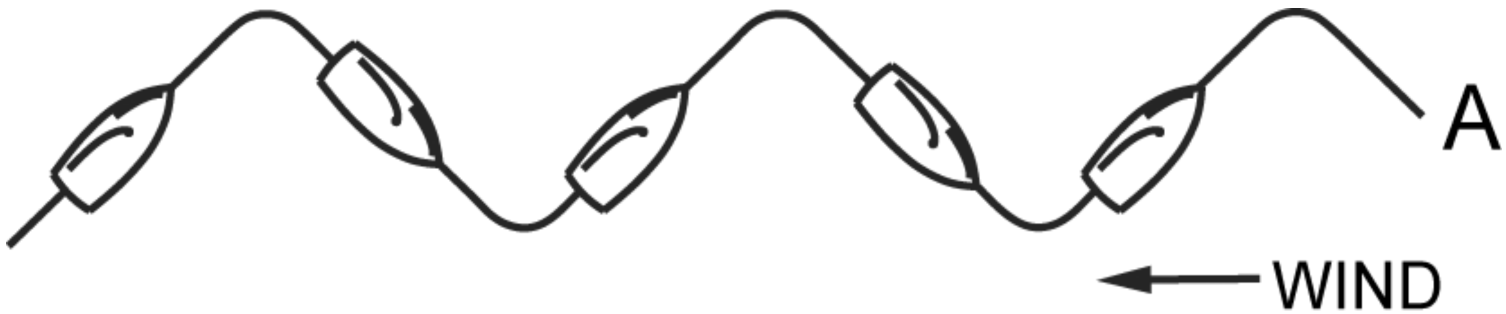
Hewlett Packard Conclusions

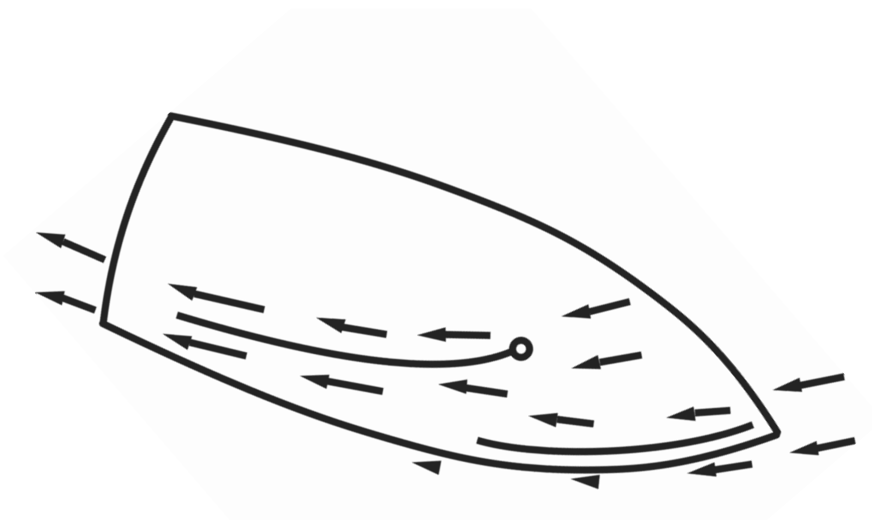
- HP analysts and CEOs constantly expressed the consistent belief that new structure would achieve "balance."
- But, what we observe is consistent vacillation.
- The firm long sought, but never achieved a stable and effective balanced design.
- Instead, firm organizationally responded to largely endogenously generated problems from prior organizational shift.

Ford Motor

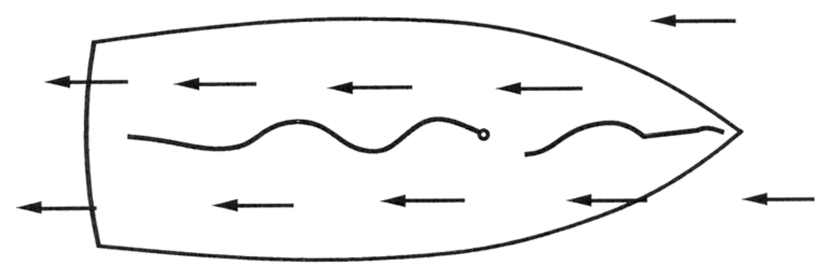
- Pre-1994: highly autonomous international operations
  - Latitude to design, market, and manufacture automobiles
  - Successful local products; high cost position internationally
- 1994 (Ford 2000): centralize design, manufacturing, and purchasing (key portions)
  - Dramatically lower costs in production, purchasing, and design
  - Poor international product designs; declining market share in international markets
- 2000: Decentralize
- 2005: Centralize; "Marketing, Sales and Service will be integrated into unified sales and unified marketing functions, combining the present Ford and Lincoln Mercury divisions."

Design as Sailing into the Wind





Close-hauled



Sailing into the Wind

- Pulling together a bundle of consistent choices that send the organization rapidly in a desired direction

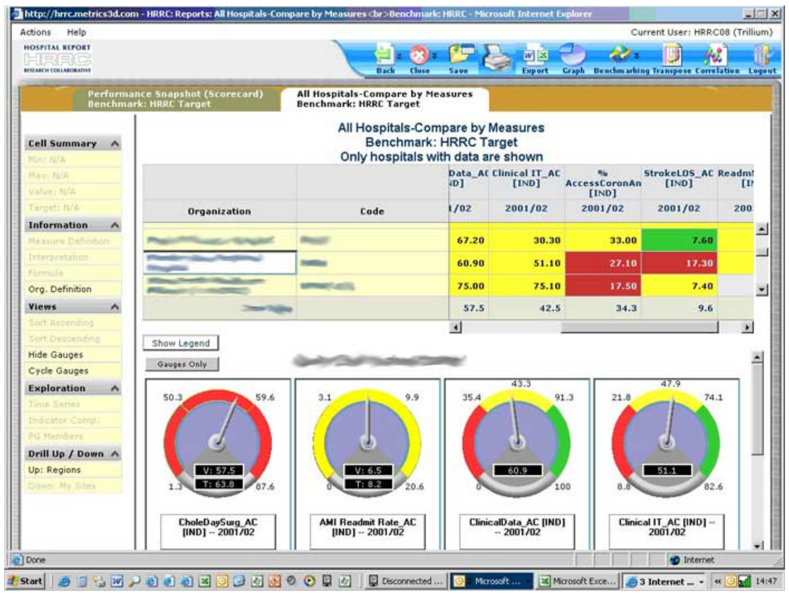
vs.

- Pulling together a bundle of inconsistent choices that confuse the organization, but could potentially lead the organization slowly in precisely the desired direction.

Conclusions

- Adopting a coherent set of organization choices generates momentum along performance dimensions.
- Efforts to craft balance (equal generation of both) may generate limited amounts of each.
- Modulation (dynamic fit) may be preferred in many settings.
- However, organization change is costly.
- Must optimize the pace of change

Balanced Scorecard: snake oil?



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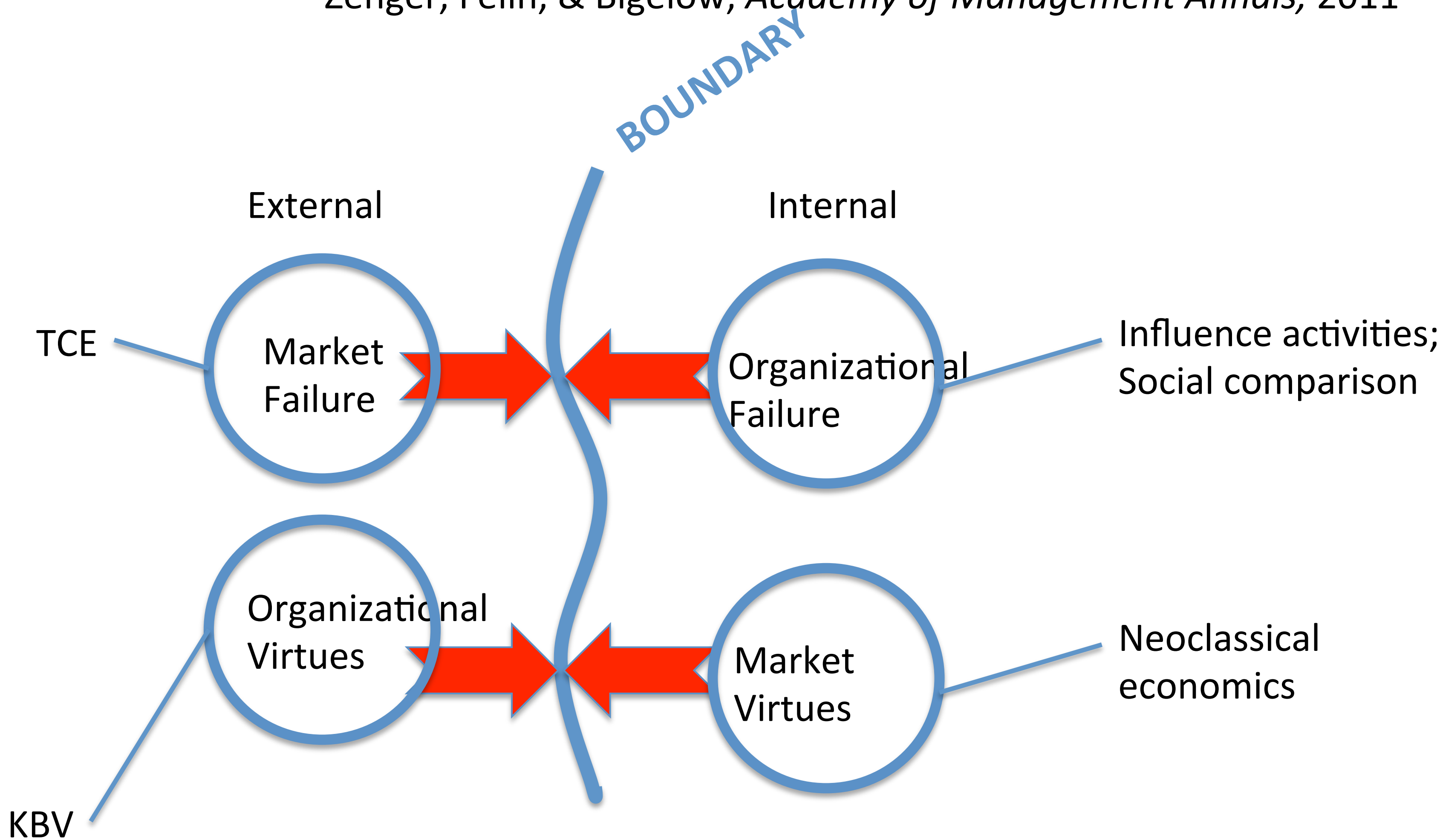
Theories of the Firm-Market Boundary

Zenger, Felin, & Bigelow, *Academy of Management Annals,* 2011



Research Opportunities

- Managers have very poor intuition about why integration fails and how it creates value.
  - Why do hierarchies fail?
  - Why do hierarchies struggle to replicate markets internally?

Thank you