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## Introduction

In this paper, the question whether *industry and firm performance differences exist* in theory is assessed. The discussion draws upon insights from the neoclassical micro-economic, industrial organization, business policy, economic history, evolutionary economic and organization theories. It will be shown that the representatives of each theoretical viewpoint agree that performance differences *can* exist. They differ however widely in their assessment of *why* these differences occur and whether they are *negligible* or *not*.

Performance differences can occur at the two levels of aggregation: the corporate level and the industry/business unit level. The industry level is considered first. This because it will be shown that the intensity of competition and the ability to gain and sustain (a) competitive advantage(s) are central concepts for achieving and maintaining superior performance. Moreover, competitive strategy issues usually go before corporate strategy ones. Indeed, Grant (1991: 22) asserts that only when a firm has established (a) competitive advantage(s) in any of its current activities, issues of corporate strategy will become relevant.

### 1. Performance Differences at the Industry and Business Unit Level

Here it will be argued that the question on whether performance differences can exist at the industry level, and whether they are substantial, *depends on the perspective on the nature of competition*.

The major elements of the discussion are structured around a common framework, which roots in a conceptual scheme developed by Daems and Douma.(1989: 41). This framework is

helpful while discussing the different viewpoints, because it structures the reasoning, making the distinctive differences between perspectives very apparent.

## 1.1 Neoclassical Economic and Industrial Organization Theories: Competition as a Structural Concept

In micro-economics and in industrial organization competition is regarded to take place at the industry level. According to Scherer and Ross (1990: 16) in economic theory competition is usually defined as a structural concept, not emphasizing the *process of rivalry* in an industry.

The question then becomes whether performance differences can exist at the industry level. This question can then be decomposed into two parts. On the one hand, one can ask whether the rates of return can differ across industries. On the other hand, the existence of performance differences within industries can be analyzed.

### 1.1.1 Zero-Economic-Profits-in-the-Long-Run

Neoclassical economic theory presented by Scherer and Ross (1990: 16), poses that in a fully competitive economy *all industries* are in *competitive equilibrium*. Then markets are purely competitive, the total value of the output is maximized and the available resources are allocated efficiently.

Stigler (1963: 54) argues that eventually the rate of return will tend toward its competitive level. He even suggests that this proposition is the most important one in economic theory, while arguing:

'... There is no more important proposition in economic theory than that, under competition, the rate of return on investment tends toward equality in all industries.'

Sufficient conditions for pure competition exist whenever homogeneous products are traded in an atomistic market structure, according to Scherer and Ross (1990: 17). In purely competitive markets sellers have no *enduring market power* over price. By consequence, Hirschleifer (1984: 217) concludes, in a purely competitive industry *no economic profits*<sup>1</sup> can be gained. This implies that in such an industry the economic profits of *any* firm are zero.

The fact that economists adhere the general equilibrium theory, proposing that in the long run the performance of firms will converge to the competitive rate of return, however does *not* mean that economists propose that *all firms are alike*.

Indeed, neoclassical economists acknowledge that *Ricardian rents* can make that some producers benefit from a relative advantage vis-à-vis their competitors. However, economists as Nelson (1991: 64) argue that those differences are not discretionary, but only reflect the different circumstances those firms face. They argue that if conditions would be reversed, also the performance and the behavior of the firms would be overturned.

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<sup>1</sup> Economic profits are defined as the excess of revenues over the best alternative foregone, a surplus return to capital

However, although neoclassical economic theory recognizes the existence of individual differences between firms, Nelson concludes that neoclassical economists regard these differences as relatively unimportant. He (1991: 64) claims:

'... Neoclassical theory [...] militates against paying attention to firm differences as an important variable affecting economic performance.'

Therefore, from neoclassical economic theory one may conclude that in purely competitive markets surplus returns do not exist, while in the long run *every* industry will tend to earn its competitive rate of return.

However, the competitive rates of return are not necessarily equal across industries. *Inter-industry differences* between the level of the competitive rate of return *can exist*. Daems and Douma (1989: 42) point out that is due to the simple reason that the *riskiness* of the activities in different industries can differ significantly. This important risk-return relationship is well acknowledged in finance, see for instance Brealy and Myers (1984: 172-173) where industry measures are calculated to account for the riskiness of the business activity.

It should be noted that this conclusion that *sustainable differences between the competitive rates of return of different industries can exist*, does *not* invalidate Stigler's proposition. *On the contrary*, as these differences reflect differences in business risk and do *not* represent the existence of economic profits, the zero-economic-profits-in-the-long-run proposition still holds.

### 1.1.2 Entry Barriers to Explain Positive Deviations from Competitive Rate of Return

While neoclassical economists presume that in the long run no surplus return can be gained because no firm will be able to exercise enduring monopoly power, other economists have shown that *one should not await the long run* or demand the stringent conditions of pure competition to end up in a scenario where no economic profits can be realized.

Indeed, economists as Baumol, Panzar and Willig (1982: 7-8) have shown that even if the conditions of pure competition are not met, excess returns cannot exist if markets are perfectly *contestable*. They show that in a perfectly contestable market where an equilibrium exists, *no* firm can exercise *market power* and therefore, excess returns cannot exist. According to Gilbert (1989: 527) in Schmalensee and Willig (1990, volume 1) a market is purely contestable market if:

'... an *equally efficient* entrant is unable to find a combination of price and outputs that enables it to enter and earn a profit.'

Industrial organization economists however acknowledge that sustainable deviations from the competitive rate of return *can exist* if the underlying conditions for a purely competitive or a contestable market structure are not met. Central to their argumentation is the *theory of contestable markets* and the resulting concept of *entry barriers*.

Contestability theory, explained by Gilbert (1989: 530) in: Schmalensee and Willig (1990, volume 1) rests on the *mobility of capital proposition*. Whenever factors interfere with the mobility of capital in and out of an industry, *sunk costs* exist. Sunk costs, according to Grant (1991: 44-45) exist if entry into an industry requires investments in *industry-specific assets, unrecoverable while exiting*.

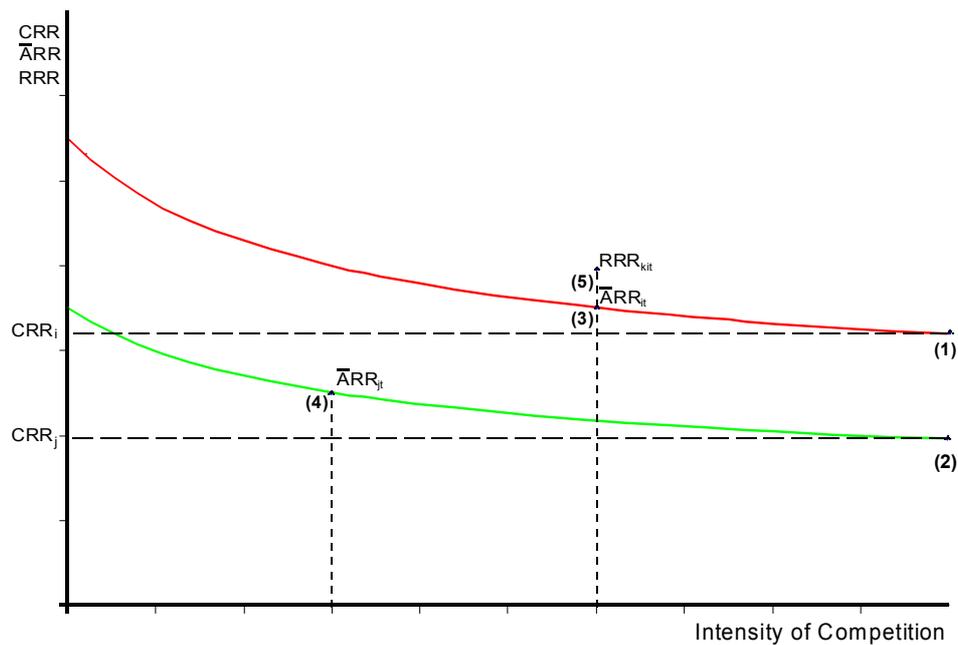
These industry-specific investments create *barriers to entry* around the industry, lowering the level of rivalry. These barriers to entry 'isolate' industry incumbents from competitive pressure of potential entrants. The height of these entry barriers determines the extent to which incumbents can earn supra-normal profits. Industrial organization economists as Gilbert (1989: 530) in Schmalensee and Willig (1990, volume 1) therefore define an entry barrier as:

'... a rent that is derived from incumbency.'

Thus, the height of the barriers to entry around an industry explains the existence of inter-industry economic performance differences. Indeed, if entry barriers exist, the industries are not perfectly contestable. The level of inter-industry competition differs. This can be shown as two parallel lines in Figure 1.

Here, it is assumed that the average rate of return deviates positively from the competitive rate of return in each of both industries. Consequently, economic profits are earned. Due to the occurrence of Ricardian rents an individual firm can even realize a higher actual rate of return, denoted in Figure 1 as (2).

Figure 1: Rate of Return Framework



Source: Daems and Douma (1989: 43)

### 1.1.3 Mobility Barriers to Explain Intra-Industry Performance Differences

However, industrial economists as Caves and Porter (1977: 249) also acknowledge that intra-industry performance differences can exist. They introduce the *strategic group* concept as an *element of market structure*, as an explanation for the occurring heterogeneity. According to Martens, who reviewed the literature on strategic groups from the perspective of industrial economics, these studies understand the strategic group concept and the resulting notion of mobility barriers as an element of market structure. He (1988: 26) concludes:

'... the major focus in these studies is on the level of rivalry and its impact on industry performance.'

Cool and Dierickx (1993: 48) reviewing the industrial organization literature on strategic groups up to 1993 reach to the same conclusion. Industrial economists' focus remains

rather *industry oriented*. Entry barriers and mobility barriers are seen as elements of the structure of the industry, influencing the *level* of rivalry and the performance at the *industry level*. These views are strongly rooted in their Structure-Conduct-Performance-paradigm of competition.

Consequently, Martens (1988: 26), Cool and Dierickx (1993: 48) denote that industrial organization economists did *not explicitly consider* the impact of strategic groups on the *individual performance of a firm*. Early work in industrial organization used to perform strategic group analysis on a *set of industries*. Martens (1988: 27) notes that the more recent studies acknowledge the difficulties with these cross-sectional studies and he advocates for more carefully conducted, industry-context related analyses.

Recent research in industrial organization is shifting towards a more *dynamic concept of competition* more in line with the view of scholars in strategic management. This perspective will be discussed in paragraph 1.2. At the same time a *new economic theory of the firm* is being developed, paying more attention to individual firm differences.<sup>2</sup> This recent theory of the firm is focussing on analytical models that view the firm as a *contract* between multiple parties.

Holstrom and Tirole (1989: 61-133) in: Schmalensee and Willig (1990, volume 1) give an overview of the insights which have been gained from this perspective. Williamson (1981: 136) founded this stream of research, *transaction cost economics*, which extends the neoclassical theory in an interesting, firm-oriented way. In transaction cost economics it is tried to answer

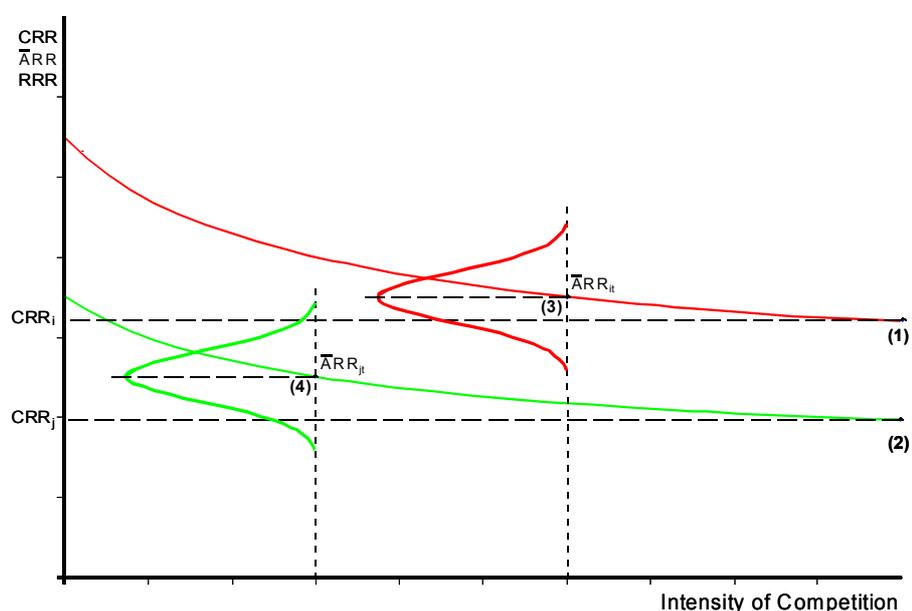
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<sup>2</sup>Lai (1991: 897) describes these trends as *new currents* which have emerged in the field of Industrial Organization since the end of the 1970s.

questions as why do so many *different forms* of organizations exist, from a contractual point of view.

These recognitions from neoclassical economists and from researchers in industrial organization that firm differences exist, and therefore also firm performance differences exist, can insightfully be pictured in the framework of Daems and Douma in Figure 2.

Figure 2: Framework with Intra-Industry Performance Differences



Source: Own conceptualisation based on based on Daems and Douma (1989: 43)

The individual firm performance differences can be pictured as a positively skewed distribution around the average rate of return of the industry as it is evaluated at a moment  $t$ . Suppose for instance<sup>3</sup> that the intensity of the competition in an industry  $i$  at time  $t$  is equal to (3). An average firm in industry  $i$  at time  $t$  will earn a rate of return equal to  $RR_{it}$ . In point (3) an average firm will earn supra-normal profits.

<sup>3</sup>Of course, this example is only illustrative. The actual positioning on the Figure can easily be changed. This does however not invalidate the insights gained through the conceptual framework. As the framework serves the purpose of more clearly showing how economists argue *whether* and *why* in theory performance differences *can* exist, an illustrative positioning on the framework is not less informative than a more general description. It can be argued that on the contrary, the insights can be gained at less effort.

Because individual differences can exist, the actual (realized) rates of return  $RRR_{kit}$  are distributed among  $RR_{it}$ .<sup>4</sup> The competitive rate of return,  $CRR_i$  will serve as a lower bound. No firm can earn less the  $CRR_i$  in the long run.<sup>5</sup> One can argue that if the level of competition will not change, this could represent a sustainable situation. Firms benefitting from sustainable Ricardian rents, for instance, will continuously realize a  $RRR_{kit}$  deviating positively from the  $RR_{it}$ . Firms realizing a negative deviation from  $RR_{it}$  can remain in the industry however, because most of them are still earning supra-normal returns.

Also the strategic group concept can be introduced in the framework. Strategic groups can be pictured as separate distributions<sup>6</sup> where the intra-group variation is smaller than the inter-group variations, see (8), (9) and (10) in Figure 3. According to industrial economists this intra-group variation should be smaller because firms belonging to the *same strategic group* have *similar structural characteristics*.

Of course this situation does not need to be sustainable at all. First, as a positive deviation exists between  $RR_{it}$  and  $CRR_i$ , new firms will be attracted to the industry. If they can enter successfully, the market structure and the level of the competition will change into

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<sup>4</sup>It can be disputed how the *actual* distribution of these rates of return should look like. For convenience it was decided to opt for a normal distribution. Of course, one can argue that the actual distribution will look more like a positively skewed one, representing e.g. the fact that some firms will earn substantial Ricardian rents. But once again, this argument does not really add to the discussion. The framework, as most concepts, is only meant to stretch and structure thinking, by making the argumentation more apparently clear through visualization.

<sup>5</sup> This argument can serve as an extra element to propose that the actual distribution is more likely to be positively skewed. Indeed, the realized rate of return in the long run can only lay in the interval  $[CRR_i, +\infty]$ . Transient effects can cause the  $RRR_{kit}$  of a particular firm  $k$  at time  $t$  to be lower than the  $CRR_i$ , but this situation will not be sustainable.

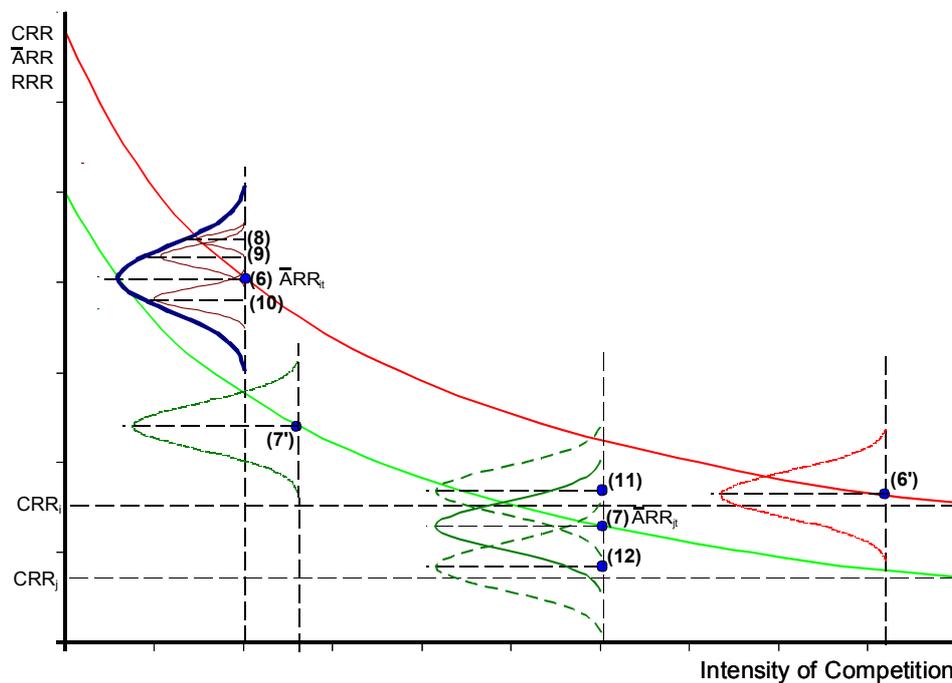
<sup>6</sup> Again the exact shape of the distributions and their exact location can be debated upon. However, as was already argued previously, this does not really add to the insights gained from the conceptual framework.

the direction (6'). When this occurs inefficient firms will be forced to exit the industry, because their  $RRR_{kit}$  will start falling below  $CRR_i$ .

A similar reasoning can be made for industry j, operating at a higher level of competition (7) and at a lower business risk than industry i,  $CRR_i > CRR_j$ . This results in a lower long run rate of return for an average firm in industry j than in industry i,  $RR_{it} > RR_{jt}$ .<sup>7</sup>

Of course, economists also acknowledge the distortion by *temporary* influences. Temporary economic fluctuations cause the *actual* average rate of return to deviate from its long run prospect,  $RR_{it}$ . Such disturbing influences can for instance, be due to general economic conditions.

Figure 3: Strategic Groups in Extended Framework



Source: Own Conceptualization based on Daems and Douma (1989: 43)

<sup>7</sup> Of course this situation can be easily reversed. If one would for instance assume that at time t the level of competition is (6') for industry i and (7') for industry j,  $ARR_j > ARR_i$ . As was already noted before, this by no means diminishes the power of the conceptual framework.

In times of a general economic upswing it is possible that the realized average rate of return deviates positively from its long run prospect  $RR_{jt}$ . The reverse holds of course in terms of a general economic recession. Also this scenario can be captured by the extended Daems and Douma framework. These scenarios are illustratively pictured as (11) and (12) in Figure 3. These influences generally only represent temporary shifts away from  $RR_{jt}$ . If these shifts tend to get permanent this will result in an adjustment of  $RR_j$ .

The perspectives in economic theory offer interesting insights. However, Nelson (1991: 65) who argues that economic theory is still failing, by taking a firm's choice set of options as clear and the firm's optimal choice unequivocal has a lot of merit. He argues that due to this failure economists are still *not* viewing firm differences as *discretionary and* are still *downplaying* the reasons for firm differences. He (1991: 65) claims that:

'... the reasons for firm differences [...] are ultimately driven back to differences in initial conditions, or to the luck of a draw, which makes choice sets different. Given the same conditions, all firms will do the same thing.'

So, for neoclassical economists and industrial organization economists, firms and firm performance are not (necessarily) alike, differences exist, but they do not matter much and they are not regarded as the result of conscious managerial actions.

## 1.2 Dynamic and Evolutionary Economic Theories: Competition as a Process

Besides viewing competition as a rather static structural concept, it can also be interpreted as the *process of rivalry*. The attention then shifts to the understanding of the conduct of firms within their industry.

Dickson (1992: 71) pictures this distinction as follows:

'... the neoclassical theory of the firm is, in large part, the study of heterogeneity in buyer demand and heterogeneity in seller supply. In contrast, a theory of dynamic competition is the study of heterogeneity in *changes* in demand and heterogeneity in *changes* in supply.'

In this paragraph dynamic theories of competition are discussed.<sup>8</sup> These theories can be grouped according to their emphasis on the impact of *conscious managerial action*. On the one hand, there are theories stressing that innovation and organizational change are not discretionary to the management of the firm. On the other hand, there are theories which emphasize the role of managerial decision making.

### 1.2.1 Organizational Change Is Not Discretionary

Authors as Alchian propose that innovation is driven by luck. Hannan and Freeman defend a Darwinian theory of organizational change that does not leave much room for conscious managerial action either.

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<sup>8</sup>No attempt will be made to discuss all the available theories and paradigms on competitive rationality. For a review see Dickson (1992: 69-83). Only the most important theories and their major representatives will be briefly discussed.

### 1.2.1.1 Alchian: Innovation Is Luck

Alchian (1950: 211) presents a Darwinian evolutionary theory of natural selection and innovation, opposed against the neoclassical economic theory. The economic system, the economic environment, is regarded as an *adoptive mechanism* that *selects* the surviving firms. A firm can survive if it realizes *positive profits*, firms which record losses will disappear. Alchian (1950: 213) notes that this criterion of positive profits is less stringent than the classical micro-economic presumption of maximizing profitability.

Alchian's analysis proposes two important insights. He (1950: 213) argues that:

'... First, success (survival) accompanies relative superiority; and, second, it does not require proper motivation but may rather be the result of fortuitous circumstances.'

With this conclusion, according to Dickson (1992: 73), Alchian argues that the firm which is lucky to be at the right place, at the right time, with the right strategy will outperform its competitors. Competitive advantage and market evolution are determined by chance. This combined with his dynamic, evolutionary perspective on firm behavior suffices to categorize Alchian as a representative of the 'dynamic, non discretionary decisions' point of view.

This however does not imply that Alchian believes that purposive behavior is absent in reality. He (1950: 217) states that:

'... The essential point is that individual motivation and foresight, while sufficient are not necessary. Of course, it is not argued here that therefore it is absent.'

In his explanation on how innovation can be sustained in an economic system, Alchian (1950: 218) certainly leaves room for discretionary managerial action. He agrees that competitors observe the performance differences, will develop an understanding of the drivers of these successes and will try to imitate if they expect that imitation will bring benefits to them. Rivals will however not succeed in imitating perfectly, which will create other innovations and which will trigger a competitive process, interprets Dickson (1992: 73). But the core of Alchian's reasoning is that the economic environment is an adoptive selection mechanism.

#### 1.2.1.2 Hannan and Freeman: A Darwinian Ecological Theory of Organizational Change

Organization ecologists as Hannan and Freeman (1989: 19-20) apply *Darwinian evolutionary principles* to describe intra- and inter-organizational<sup>9</sup> processes. These researchers (1989: 13) who adhere to the principle of natural selection, clearly use a *process oriented definition of competition*.

Indeed, while neoclassical economists define the goal of a firm in terms of profit maximization, organization ecologists determine the *survival* of the firm as its main objective. To survive, according to Hannan and Freeman (1989: 91) firms are, in analogy with organisms, in *continuous competition* with other firms for the scarce resources. As a result,

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<sup>9</sup> This view contrasts strongly with the neoclassical micro-economic theory of the firm which downplays individual firm difference and argues that eventually these differences wipe out.

only the strongest, the best performing firms, will be selected. This view on competition corresponds perfectly to Darwin's process of natural selection, the survival of the fittest, which he considers to be the driving force behind the evolutionary process.

According to Darwin the most important factor in the selection process is the environment. In correspondence, organization ecologists as Hannan and Freeman (1989: 91) consider the firm's environment to be the critical factor.<sup>10</sup> The environment will determine which firms will survive or will fail. From this, Denecker (1993: 21) concludes that organization ecologists downplay the possibilities for strategic decision making in a firm. According to the Darwinian perspective, organizational change is not planned, it simply happens. Organization ecologists argue that *evolution is blind*.

Darwin argues that the process of natural selection can only occur if there exists variation. Therefore, organization ecologists claim that no process of selection can exist without variation between individual firms. Consequently, *individual firm differences form the core* of the organization ecological perspective, decides Denecker (1993: 20).<sup>11</sup>

Carroll (1993: 244) continues that the best performing firms, the most efficient ones, will be the firms which characteristics correspond best to the requirements of the environment. In organization ecology the environment determines which organizational form will outperform the others.

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<sup>10</sup> They acknowledge though that the social environment of an individual firm mainly consists of other organizations.

<sup>11</sup>This view contrasts strongly with the neoclassical micro-economic theory of the firm which downplays individual firm differences and argues that eventually these differences wipe out.

## 1.2.2 Organizational Change Is Discretionary

Besides the theories which do not leave much room for active managerial decision making, there are theories that *stress* the role of managerial actions by viewing innovation as the motor of economic development and organizational change as a process of learning and adaptation.

### 1.2.2.1 Schumpeter: Innovation, the Source of Economic Rents

Schumpeter (also) starts from the neoclassical general equilibrium theory.<sup>12</sup> His theory of economic development, innovation, is clearly *a process oriented* one. According to him the processes in the economic system can be conceived as partial phenomena *towards* an equilibrium. He (1968: 64) argues that:

'... Every [...] process of development [...] rests upon preceding development. [...] Every process of development also creates the prerequisites for the following. Thereby the form of the latter is altered and things will turn out differently from what they would have been if every concrete phase of development had been compelled first to create its own conditions.'

He also acknowledges the *influential, discretionary role of the entrepreneur*,<sup>13</sup> as he (1968: 66) describes development as:

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<sup>12</sup> This view contrasts strongly with the neoclassical micro-economic theory of the firm which downplays individual firm differences and argues that eventually these differences wipe out.

<sup>13</sup> Schumpeter (1968: 74-75) defines an entrepreneur as follows:

'... These concepts are at once broader and narrower than the usual. Broader, because in the first place we call entrepreneurs not only those 'independent' businessmen in an exchange economy who are usually so designated, but all who

'... the carrying out of new combinations '

or as (1968: 63, emphasis added)

'... only such changes in economic life, as are not forced upon it from without but arise from its *own initiative, from within.*'

and he (1968: 65) agrees that:

'... It is the producer who initiates this economic change.'

To sum up, Schumpeter argues that an entrepreneur can *only* succeed in earning economic profits through *shifting* the production function. This is the same as noting that *innovation* is the *only* source of sustainable economic rents. These differences in technology can lead to different positions for the firms, resulting in performance differences.<sup>14</sup>

These insights lead to classifying Schumpeter as an advocate of the process oriented view of innovation, comparable to Alchian. However, contrary to Alchian, Schumpeter explicitly acknowledges the impact of managerial decision making, where Alchian argues that innovation is merely a random process, driven by luck.

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actually fulfil the function by which we define the concept, even if they are, as is becoming the rule, 'dependent' employees of a company, like managers, members of the board of directors [...]. Our concept is narrower than the traditional one in that it does not include all heads of firms who merely may operate and established business, but only those who actually perform that function.'

<sup>14</sup>Schumpeter's insights have been inspired by other researchers such as von Böhm-Bawerk and von Wieser, who formed the 'Austrian School' of economic thought. This Austrian School views competition as an evolutionary process.

### 1.2.2.2 Nelson and Winter: A Lamarckian Evolutionary Theory of Organizational Change

Comparable to Hannan and Freeman, Nelson and Winter leave the neoclassical micro-economic theory on profit maximizing behavior for an evolutionary theory of organizational change, where the economic equivalent of Darwin's natural selection principle rules. They (1982: 4) argue as follows:

'... Rather, our firms are modeled as simply having, at any given time, certain capabilities and decision rules. Over time these capabilities and rules are modified as a result of both deliberate problem-solving efforts and random events. And over time, the economic analogue of natural selection operates as the market determines which firms are profitable and which are unprofitable, and tends to winnow out the latter.'

From this it is clear that Nelson and Winter's evolutionary theory (1982: 10) is a *process oriented* one. They (1982: ix) and Nelson (1991: 67) are certainly relying on Schumpeter's process oriented view of competition. They (1982: 18, emphasis added) agree that:

'... The core concern of evolutionary theory is with the *dynamic process* by which firm behavior *patterns* and market outcomes are jointly determined over time.'

and that (1982: 19):

'... the firms evolve over time, with the condition of the industry in each period bearing the seeds of its condition in the following period.'

In contrast to Hannan and Freeman, Nelson and Winter's evolutionary theory is Lamarckian oriented. They (1982: 11) say:

'... our theory is unabashedly Lamarckian: it contemplates both the "inheritance" of acquired characteristics and the timely appearance of variation under the stimulus of adversity.'

Compared to Darwin, Lamarcke integrates an aspect of learning in his evolutionary theory. If one accepts that one can learn from experience and incorporate what is learned in subsequent behavior, one can say that the evolutionary theory is more Lamarckian than Darwinian oriented, concludes Denecker (1993: 21).

In Nelson and Winter's theory the adaptive learning aspect is incorporated in the role they attribute to the notion of *routines*. In their theory (1982: 14) a routine is the term for every regular and predictable behavioral pattern, which plays the role that genes play in biological evolutionary theory. Routines are (1982:14):

'... a persistent feature of the organism and determine its possible behavior (though actual behavior is determined also by the environment); they are heritable in the sense that tomorrow's organisms generated from today's (for example, by building a new plant) have many of the same characteristics, and they are selectable in the sense that organisms with

certain routines may do better than others, and, if so, their relative importance in the population (industry) is augmented over time.'

With this, they (1982:14) argue that a firm's behavior is determined both by the "inherited" routines and by the environment, while Darwinian theories propose that the environment is the main determinant. Therefore, Nelson and Winter's perspective by the roles they attribute to 'organizational routines' and the concept of 'search' leave room for deliberate managerial action. By introducing the concept of search which is a deliberate routine-changing process which is partly determined by the routines of the firm, the conscious decision-making is incorporated in their theory.

Carroll argues that both adaptation models, Nelson and Winter-type ones, and selection models, Hannan and Freeman-type ones, should be incorporated in theory. However, the limited empirical evidence available to date confirms Hannan and Freeman's theory. Carroll (1993: 245) concludes:

'... So it looks as though major adaptations involve great survival risks, even if the intended change would increase survival probabilities if successfully changed.'

### 1.2.3 Chandler: The Logic of Economic History

Chandler (1990: 11) studies economic history to provide insights on the gaining and sustaining of economic development. He shows that the study of history leads to the detection of *similarities and patterns* in the beginning and the growth of managerial

enterprises. These similarities are then used to develop an explanatory theory on economic development and industrial success.

According to Chandler, industrial success is driven by a dynamic logic of growth and competition. He (1990: 132) refers to this as the *logic of managerial enterprise*. He (1990: 8, 31, 34) argues that the first companies which invested in manufacturing to exploit scale and scope advantages, in marketing and distribution activities and in the recruitment of a managerial hierarchy which coordinates and monitors the current operations, while also planning and allocating resources for future activities, quickly gained and sustained a dominant position within their industries. These insights lead to categorize Chandler as a representative of the process oriented class of theories, recognizing the impact and the importance of managerial decisions.

Compared to the Darwinian inspired researchers as Alchian and Hannan and Freeman, Chandler certainly recognizes the influence of managerial actions on the success of a firm. *He explicitly recognizes the managerial role*, as he (1990: 9) argues that:

'... the institutional history told here is the outcome of innumerable decisions made by individual entrepreneurs, owners, and managers. For these decision-makers the choices among alternatives were limited and the outcomes uncertain, but almost always there *were* choices.'

Moreover, he stipulates that precisely thanks to the development of a managerial hierarchy, firms have been able to survive, sustain and develop their competitive

positions.<sup>15</sup> Firms that failed to appoint managers as their corporation grew or as the nature of competition changed due to the changing of industrial structures, did not survive, or at least moved to less favorable competitive positions.

Although Chandler acknowledges that the environment can impose pressure upon a firm, he strongly advocates an active role for the management of a firm. This puts Chandler's view closer to Schumpeter's than to the Darwinian oriented ones. However, Schumpeter's and Chandler's insights are not completely equivalent. Schumpeter (1968: 58-60) explicitly opposes the view that he is reasoning from the perspective of economic history.

#### 1.2.4 An Integrative Framework for All these Theories

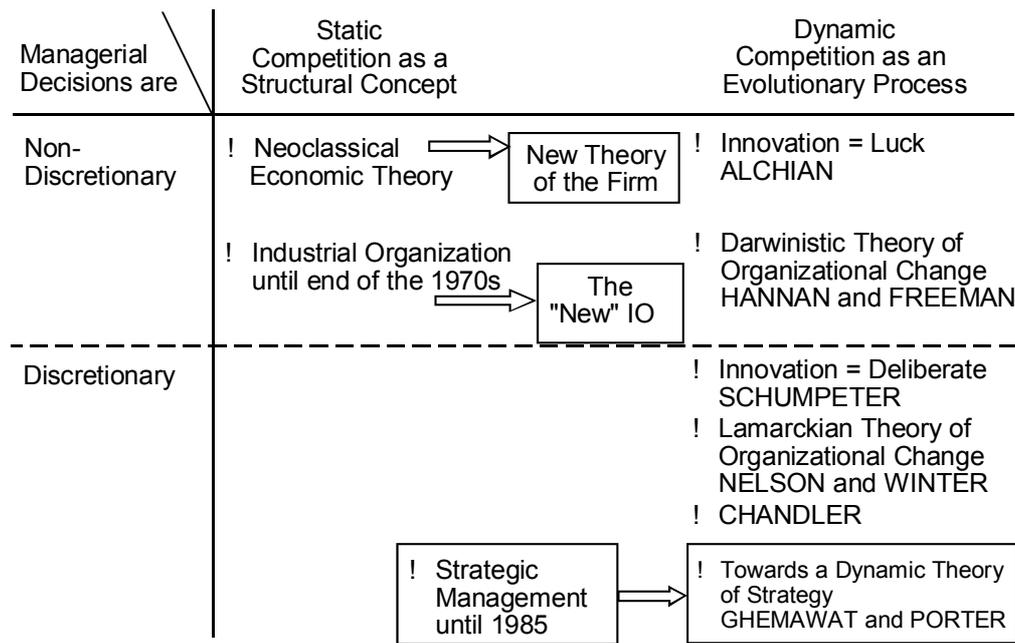
Before proceeding by discussing how scholars in strategic management reason about the occurrence of performance differences at the level of the industry, it will be attempted to integrate the previous theories in a framework.<sup>16</sup> This framework will prove helpful in discussing upon which theories the insights in strategic management draw. It will also help in showing how the insights in the domain of strategic management have progressed.

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<sup>15</sup>Numerous examples of successful firms are cited e.g. the history and development of Bayer, BASF and Hoechst, see Chandler (1990: 474-479)

<sup>16</sup> The focus is on assessing how much is known about performance differences in particular from the perspective of scholars in strategic management. Therefore, it is rather evident that the insights from other fields serve as a frame of reference to better understand the progress in the domain of business policy.

Figure 4: Integrative Framework of Economic Theories



Source: Own Conceptualization, based on Literature Review

On the horizontal axis the distinction is made between the two opposing views on the concept of competition: the structural view, which describes competition mainly as a *level of rivalry*, and the dynamic view, which denotes competition as a process, the *intensity of rivalry*. On the vertical axis the distinction is made whether the different theories perceive managerial actions as having a discretionary, influential impact on the performance of a firm.

In the *upper left box*, the neoclassical economic theory and the industrial organization theories until the end of the 1970s are situated. Lai (1991: 897) refers to this period from the 1930s till the end of the 1970s, where the locus of attention was on static inter-industry analysis, as the *classical* era of industrial organization.<sup>17</sup> Shepherd (1990: 455, 458) denotes this

<sup>17</sup>This delineation of the time periods is also confirmed by the shift in research questions found in the overview of the empirical research from the second half of the 1940s till now. These findings were further discussed in Vandingenen and Bostyn (2003/2004a). Of course, the delineation of the time frames is always somewhat arbitrary. But more than the exact delineation of the time periods, it is the relative overview of the differences in perspectives on whether and why performance differences (can) exist, that matters.

period as the 'mainstream field in industrial organization'. This classic industrial organization theory roots in the influential structure-conduct-performance paradigm, see for instance Sherer and Ross (1990: 5). Both micro-economic and the mainstream industrial organization theories apply a rather static, equilibrium notion of the competition concept, leaving not much room for discretionary managerial action. Indeed, in these theories the reasons for differences between companies are downplayed to differences in initial and/or structural conditions. Under similar conditions, every firm would choose the same options. These perspectives were described in more detail in paragraph 1.1.

In the *upper right corner* are the non-discretionary dynamic theories such as Alchian's, which attribute the existence of innovations to the simple luck of a draw. The lucky firm, with the right strategy, at the right time, at the right place, will innovate and will outperform the others. Although the rivals will try to imitate the successful ones, the initial success factor is *pure luck*. In such a theoretical perspective not much room is left for managerial action.

Also the Darwinistic population ecology view of Hannan and Freeman is situated in this box. In this theory organizational change is mainly driven by environmental pressure, through processes of variation, selection and retention. Only the well-adapted firms will survive. However, in this theory although dynamic, not much room is left for conscious, discretionary managerial action. Whenever the environment changes, firms of which the characteristics do no longer fit with the environmental requirements will have very little possibility to adapt. They will drop out of the population. In the Hannan and Freeman perspective only well adapted firms, fitting to the environment will be successful.

In the *lower right corner* Schumpeter's theory on economic development, the Lamarckian inspired evolutionary theory of Nelson and Winter and Chandler's view on the development of managerial enterprises are situated. These theories are process oriented, stressing the impact of managerial decisions on the firm's outcome.

The *lower left box* appears to be empty. No important economic theories using a structural concept of competition, while focussing on the importance of managerial actions seem to exist.

However, some *shifts* are appearing in the framework. As discussed in paragraph 1.1 economists start paying more attention to individual differences at the firm level. As a result a *renewed theory of the firm* is developing. One could argue that the insights of economic theory are being extended in the *direction* of the upper right box.

Also industrial organization economics broadened its perspectives, resulting in a 'new IO theory'. Shepherd (1990: 460) distinguishes three supplementary perspectives in industrial organization: the Chicago-UCLA view, the contestability theory and the game-theoretic modelling approach.

According to Shepherd (1990: 461) the Chicago-UCLA school with scholars as Harold Demsetz and Yale Brozen claims that monopoly is rare, weak and transient. The research hypotheses are threefold. First, market dominance represents superior efficiency, suggesting that causation runs from performance to structure. Second, the only genuine source of monopoly power is collusive behavior. Third, monopoly profits are seldomly earned because monopolists must spend in advance on costly monopoly-seeking activities.

The contestability school with representatives as Baumol, Panzar and Willig also rests on three assumptions. One assumes that entry is free and without limit, entry is absolute and exit is perfectly reversible. The game-theoretic modelling approach is theory driven. According to Shepherd (1990: 463) it is:

'... pure theory, with little or no empirical testing or fitting to real cases.'

Shepherd (1990: 464) argues that these 'new' schools do *not* replace the traditional 'mainstream research' but should rather be seen as complements to it, while he (1990: 478) concludes that:

'... Despite their valuable insights, the 'new' schools have tended toward overstatements and a faith in mere rigor. Their contributions need to be fitted into the ongoing mainstream field, rather than used to displace it.'

To summarize one might say that in recent work a process oriented view of competition is used. The field of industrial economics is trading its 'traditional, structural perspective' for a conduct oriented one. This corresponds to a shift to the right in the framework. However, both economic and industrial organization theories are still failing in capturing the complex managerial decision-making processes in their analytical models, according to Nelson (1991: 65).

### 1.3 Where does Strategic Management Fit In?

With this framework in mind, the question can be posed where the theories in strategic management enter the picture.

### 1.3.1 A Dynamic Concept of Competition

Scholars in business policy as Porter (1987: 65) go along with economists in considering competition to take place at the level of the industry. However, while in economic theory, competition is (still) more frequently defined as a structural concept, researchers in strategic management have been using a more *dynamic, process oriented concept of competition*, emphasizing the *conduct* of buyers and sellers for a long time. Their conceptualization also relates more closely to the definition that managers-in-the-field usually adopt, conclude Daems and Douma (1989: 44) and Scherer and Ross (1990: 15-16).

Not only is the concept that researchers in strategic management use more process oriented, it is also extended. While economists focus on market structure determinants, business policists use a broader concept of competition.

#### 1.3.1.1 Competition as a Notion of Extended Rivalry

Michael Porter (1980: 6) introduced the extended concept of competition and denoted it as *extended rivalry*. It means that the intensity of competition in an industry is determined by five competitive forces: the threat of entry, the threat of substitutes, the bargaining power of buyers, the bargaining power of suppliers and the rivalry among incumbents. Daems and Douma (1989: 93) regroup these five forces into three sources of competitive pressure: internal rivalry,<sup>18</sup> external rivalry<sup>19</sup> and potential rivalry.<sup>20</sup>

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<sup>18</sup>Internal rivalry corresponds to Porter's rivalry among incumbents.

### 1.3.1.2 Competition as a Source of Mutual Gain

Traditionally, competition is regarded as a process of rivalry, a zero-sum game. In the second half of the 1980s however, a trend towards cooperative behavior became apparent. Since then, the insight has grown that the impact of a firm's strategy on other firms, including its competitors, might be positive, see Miles, Snow and Sharfman (1993: 163).

According to Miles, Snow and Sharfman (1993: 164), this requires a dynamic, *evolutionary* industry-level perspective, proposing that firms co-evolve. This viewpoint roots in the evolutionary economic theories such as Hannan and Freeman and Nelson and Winter, which have been discussed in paragraph 1.2. Following Miles, Snow and Scharfman (1993: 164), if incumbents are to realize the benefits of cooperation, *industry variety* is essential, i.e. individual firm differences should exist.

With this in mind, now it can be discussed *whether* and if so *why* performance differences *can exist* according to scholars in strategic management.

### 1.3.2 Competitive Strategy to Create Sustainable Performance Differences

As business policy scholars as Porter (1991: 99) also acknowledge that firms are competing at the level of the industry, this discussion will start by assessing whether sustainable

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<sup>19</sup>External rivalry groups the bargaining power of buyers and suppliers.

<sup>20</sup>Potential rivalry consists of the pressure coming from substitutes and potential entrants.

performance differences can exist at the level of an individual business unit.<sup>21</sup> As in paragraph 1.1 the framework of Daems and Douma (1989: 36) will be used and further elaborated upon to discuss the perspectives of theories in business policy.

As in the previous framework strategists as Daems and Douma (1989: 42) agree that across industries differences between the competitive rate of return can exist due to the difference in the riskiness of business activities. This is reflected in the different levels of the competitive rate of return.

Earlier it was noted that the strategy researchers presume that (most) firms will try to earn a rate of return higher than the competitive rate of return.<sup>22</sup> Grant (1991: 97) argues that the profitability above the competitive rate of return is the result of *market power*.

He (1991: 97) also notes that most sources of market power are privately owned by individual firms, while some other ones can be owned jointly by all members of the industry. This distinction forms the basis for business policists to conclude that there are in essence two factors driving the performance of a business unit.

Indeed, as was already noted in Vandingenen and Bostyn (2003/2004a), paragraph 1.2 the performance of a business unit is determined by on the one hand the attractiveness of the industry and on the other hand the relative advantage of the business unit vis-à-vis its competitors. As mentioned earlier this viewpoint was mentioned first by Vanlommel and

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<sup>21</sup>Three levels of aggregation can be specified: the corporate level, the business unit level and the functional level. The industry level corresponds to the level of a business unit.

<sup>22</sup>In this discussion it is attempted to depart as little as possible from the definitions introduced in paragraph 1.1.

De Brabander (1975: 46), (1976: 471). Now it is widely acknowledged in the strategic management literature by for example, Schmalensee (1985: 343), Daems and Douma (1989: 29), Porter (1991: 100) and Douma (1993: 55). Porter (1991: 100) literally says:

'... profitability can be decomposed into an industry effect and a positioning effect.'

Superior performance<sup>23</sup> can be attributed to the fact that a business unit operates in an industry where the long term profit potential exceeds its opportunity cost of capital and/or to the fact that the firm enjoys a favorable competitive position. The determinants of superior performance are shown in Figure 5.

#### 1.3.2.1 Industry Attractiveness: A First Driver of Superior Performance

Industries can differ with respect to their long term profit potential. Industries where an 'average firm'<sup>24</sup> has better long term profit prospects than in other industries are called attractive industries. Industries with lower long term profit prospects are labeled as unattractive, see Daems and Douma (1989: 29).

It should be noted that as it is circumscribed *here*, the attractiveness of an industry is measured in *relative terms*: industries are more or less attractive than other industries.

However, as an attractive industry is per definition an industry where supra-normal profits

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<sup>23</sup>Superior performance is defined as 'earning a higher rate of return than a firm's opportunity cost of capital'.

<sup>24</sup>Daems and Douma (1989: 119-129) define an 'average firm' as the firm which is the most representative for the industry as a whole, measured on a set of strategic dimensions. They determine 13 generic strategic dimensions on which business units can differ significantly. Tough, these dimensions are 'generic', however they are not equally relevant in each industry.

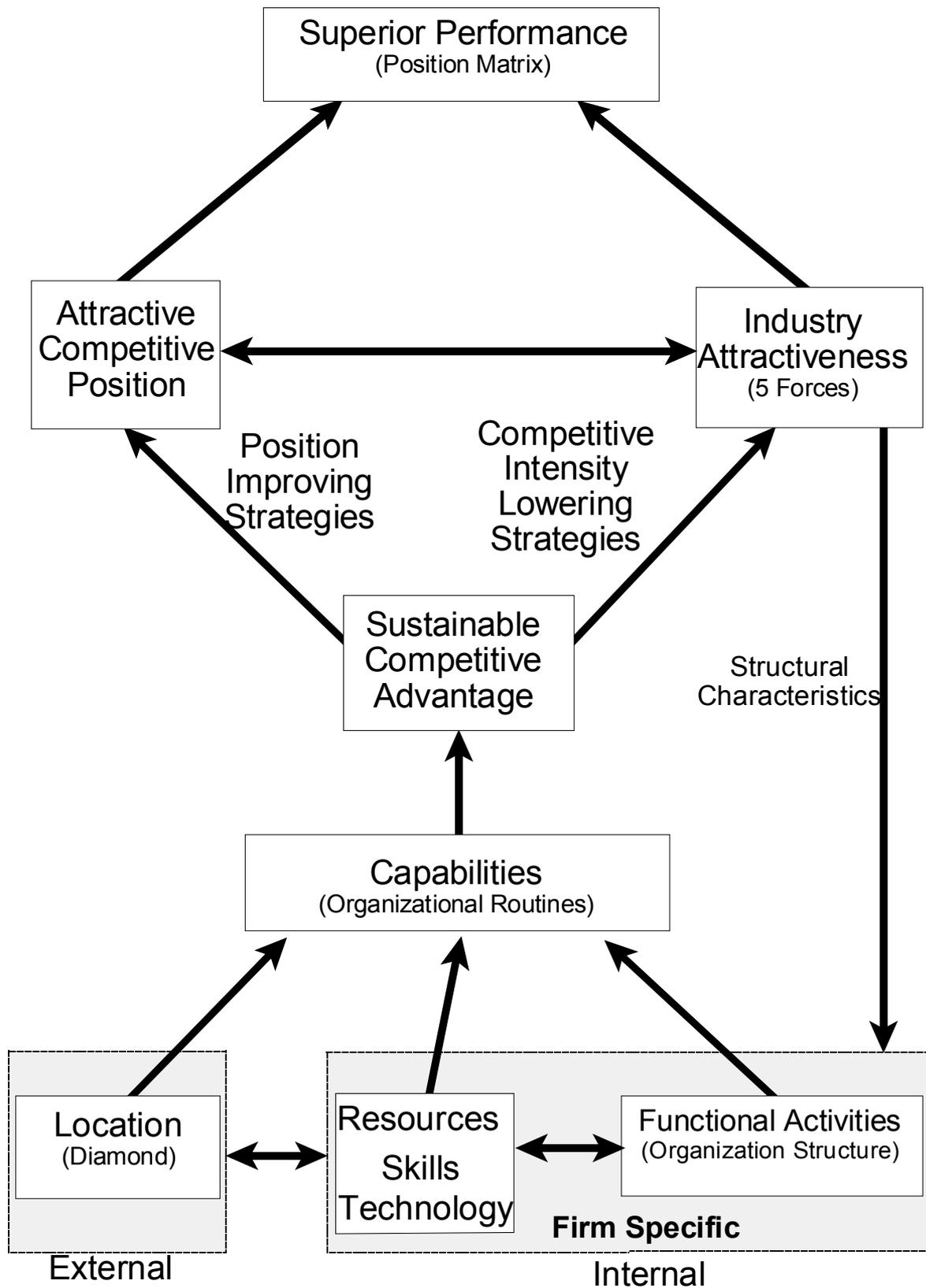
are gained by the average firm, the attractiveness of an industry can be measured on an *absolute* scale as well.

The distinction whether the attractiveness of an industry should be measured on an absolute or a relative scale is a rather marginal one. Because obviously the competitive rate of return will serve as a lower bound, while apparently the higher the long term prospects are the more profitable it is to invest in that industry.

Daems and Douma (1989: 32) assert that the long term prospects of an industry are on their turn determined by two drivers: the intensity of competition and the industry evolution.

If an industry is attractive, the long term profitability prospects exceed the competitive rate of return for that industry, this can only be because the 'average firm' has

Figure 5: Drivers of Superior Firm Performance



Source: Adapted from Daems and Douma (1989: 36); Grant (1991: 100) and Porter (1991:100)

succeeded in lowering the *intensity of competition*, conclude Daems and Douma (1989: 42).

The lower the intensity of competition, the higher is the attractiveness of the industry.

The intensity of competition in strategic management is determined by five structural determinants.<sup>25</sup> Porter (1991: 100) notes that:

'... [The industry structure framework's] ultimate function is to explain the *sustainability* against bargaining and against direct and indirect competition.'

It is here that the concept of *barriers to entry*<sup>26,27</sup> enters the literature in strategic management. Barriers to entry make the industry less contestable by lessening the threat of potential competition, conclude Daems and Douma (1989: 100). Consequently, incumbent firms can earn supra-normal rents.<sup>28</sup>

Entry barriers can be classified according to several criteria. First, one distinguishes between structural and strategic entry barriers. Structural entry barriers result from the structural characteristics of the industry, while strategic entry barriers result from the

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<sup>25</sup>For a definition of these structural determinants see notes no. 18, 19, 20

<sup>26</sup>This is a clear example of the fruitful interchange between theories in industrial organization and business policy. As Martens (1990: 610) notes industrial organization is one of the four fields from which important insights have been transferred to the domain of strategic management.

<sup>27</sup>This is only one example of the possible fruitful interchange between fields of interest. Strategic management and other domains as well can clearly gain from the insights of multi-disciplinary trained researchers and interdisciplinary research.

<sup>28</sup>This definition corresponds to the broad definition of barriers to entry. In the literature also a narrow definition is frequently found. In that case an entry barrier is circumscribed as: the *cost* disadvantage a potential entrant has vis-à-vis the incumbent firms; see Douma (1993: 138).

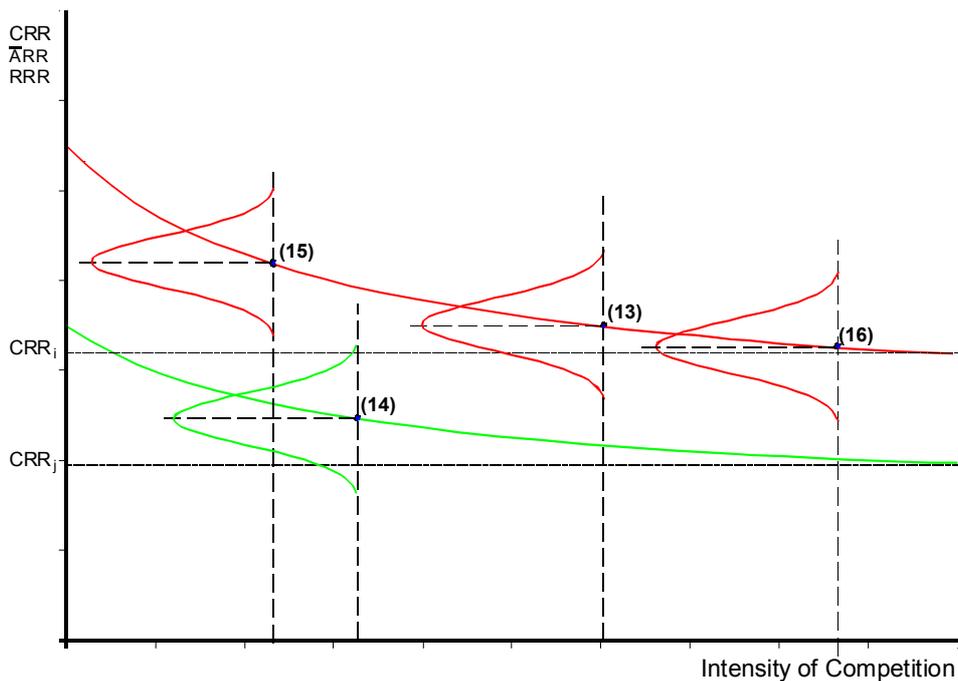
conduct, the strategic moves of the incumbent firms, explain Daems and Douma (1989: 100).<sup>29</sup> Second, according to van Witteloostuijn and Schreuder, in: Douma (1993: 141) a distinction between institutional and natural entry barriers can be made. Institutional entry barriers result from the legislative rules of the regulatory instances. Natural entry barriers are independent of the discretionary decisions of the regulators.

As Porter (1980: 14-15) notes, entry barriers may not be seen as static. They can and do change, sometimes even for reasons outside a firm's control. This implies that the current existence of entry barriers does *not* guarantee the sustainability of supra-normal profits. Due to technological change for instance, some firms probably could bypass the barriers to entry, driving the supra-normal profits down.

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<sup>29</sup>For a more elaborate discussion on the different types of entry barriers one can for instance consult: Porter (1980: 7-17); Daems and Douma (1989: 100-110), Grant (1991: 44-48) or Douma (1993: 141). For this discussion it suffices to note that barriers to entry can result in average industry profitability exceeding the competitive rate of return.

Figure 6: Absolute and Relative Attractiveness of Different Industries



Source: Own conceptualization based on Daems and Douma (1989: 43)

The insights resulting from business policy can be pictured in the extended Daems and Douma framework as well, which are pictured in Figure 6 and Figure 8. Assume that the intensity of competition in an industry  $i$  is depicted by (13) and the intensity of competition in industry  $j$  by (14).<sup>30</sup> Then, one can say that an average firm in industry  $i$  will have more attractive long term profitability prospects than an average firm in industry  $j$ .

Industry  $i$  is more attractive than industry  $j$ . On an absolute scale however, one could as well reason that also industry  $j$  is an attractive one as an average firm will be able to earn a rate of return exceeding the competitive rate of return for that specific industry.

However, also the *industry evolution* influences the attractiveness of an industry and therefore has an impact on the long term profitability prospects in an industry. Indeed, the

<sup>30</sup>Of course the same remarks apply as in the description of the framework seen from the perspectives of economists, see notes no. 3, 4 and 5, but this time from the perspective of scholars in strategic management.

horizontal axis of the extended Daems and Douma framework only shows the underlying factor of the first driver, the intensity of competition.

This does not necessarily mean that the framework is incomplete and partly fails to discuss the theoretical insights of the business policy theories as it not explicitly pictures the industry evolution factor.

Daems and Douma (1989: 67) note that the *industry evolution*<sup>31</sup> has a direct as well as an indirect effect on the attractiveness of the industry. The indirect effect influences the intensity of competition. This effect can easily be pictured in the framework. It can be indicated as a *shift* of the competitive intensity either to the left or to the right, depending on whether the competitive pressure is falling (15) or rising (16).

The direct effect of industry evolution on the long term prospects in an industry cannot as easily be integrated in the framework. However, one can argue that in attractive industries there will be a 'natural tendency', a 'natural evolution' towards a decline of the long term attractiveness.

Indeed, as in attractive industries supra-normal profits are gained, the industry will attract new entrants, driving the attractiveness of the industry towards its competitive rate of return. The reverse relationship holds for an industry in disequilibrium. Less efficient players will be forced to exit the industry, making the industry move towards equilibrium.

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<sup>31</sup>Daems and Douma (1989: 75, 82-83) point out that the industry evolution is determined by on the one hand four groups of drivers: demand-side, supply-side and regulatory/institutional and industry-specific factors and on the other hand, by the fact whether or not the structure of the industry is in equilibrium.

Daems and Douma suggest that to sustain or increase its performance, a firm can try to lower the intensity of competition. In the 'extended' Daems and Douma framework this would correspond to a move towards the left.

However, 'competitive intensity lowering strategies' are reserved for firms having earned a favourable competitive position in their industry. Firms lacking the necessary market power, cannot build or sustain the entry barriers around an industry. This is also pictured in Figure 5.

#### 1.3.2.2 Attractive Competitive Position: The Second Driver of Superior Performance

The *second major driver* contributing to superior performance according to researchers in business policy is that a firm can earn a higher rate of return if it enjoys *individual market power*, reflected in a *favorable competitive position*. Porter (1991: 101) notes in this respect that:

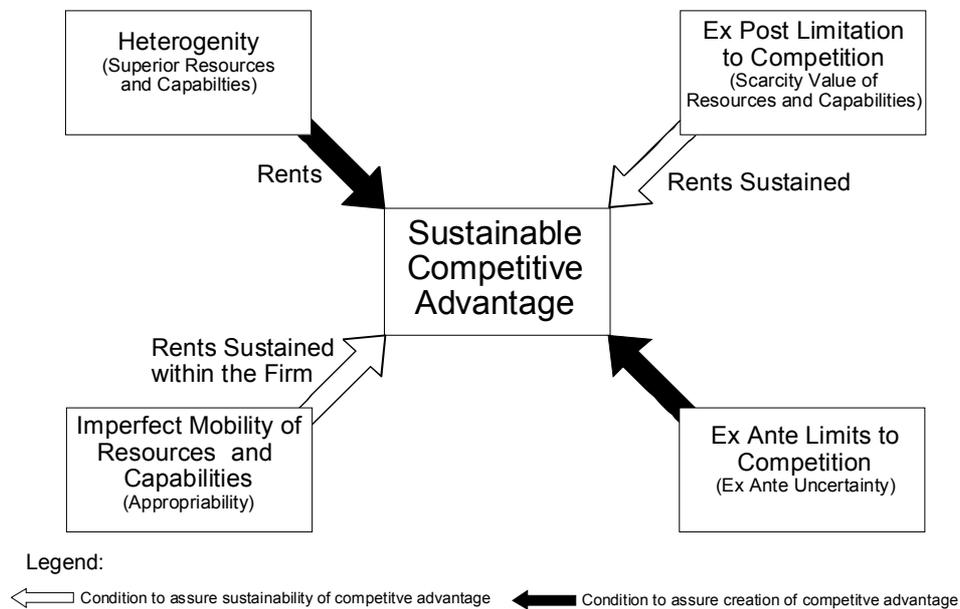
'... Holding industry structure constant, a successful firm is one with an attractive relative position.'

The question to be answered then is how an attractive position can be attained and protected. The answer is that a firm must have *(a) sustainable competitive advantage(s)* over its rivals.

However, sustainable competitive advantages do not fall out of the sky! Peteraf (1993: 180) defines four necessary and sufficient conditions to assure the sustainability of a competitive advantage. These four conditions are presented in Figure 7 and can be grouped into two

conditions to assure the existence of a competitive advantage and two conditions to guarantee its sustainability.

Figure 7: Four Conditions for a Sustainable Competitive Advantage



Source: Adapted from Peteraf (1993: 186)

- Two Conditions to Assure the Existence of a Competitive Advantage

*Heterogeneity* in the available *resources and capabilities* is the most basic condition for performance differences to be able to exist. Peteraf (1993: 180) argues:

'... Firms with marginal resources can only expect to breakeven. [...]

Firms with superior resources will earn rents.'

This heterogeneity in resources may correspond to the existence of Ricardian or monopoly rents. She notes that heterogeneity is a *conditio-sine-qua-non* for a competitive advantage to exist. Henderson agrees with this viewpoint. He (1989: 141) notes that the differences between firms are the basis of any competitive advantage.

Therefore, one can conclude that *in contrast to micro-economists*, who acknowledge the existence of firm differences but downplay their importance, researchers in *strategic management focus* on those firm differences. Henderson argues that *only* by distinguishing itself from its competitors a firm can earn a *competitive advantage*. Therefore, heterogeneity in resources and capabilities is the most important requirement to be able to gain rents.

Peteraf (1993: 185) defines another condition which ought to be met before a firm can have a competitive advantage, namely the superior resource position may not be competed away in the factor markets. She refers to this condition as the existence of *ex ante limits to competition*. This means that competitive advantages can only result from *ex ante uncertainty*. Only if these two requirements are met, a firm will be able to earn a competitive advantage.

A competitive advantage defined by Daems and Douma (1989: 20, 30) is 'an extra something' which the rivals of a firm do not possess, which enables the firm to earn higher profits than its competitors. A competitive advantage according to Porter (1985: 11) enables a firm to earn higher profits than an 'average firm' in the industry.

In essence there are two types of competitive advantages: *differentiation* and *cost advantages*. A firm has a differentiation advantage if it can supply its products and/or services so that its customers are willing to pay a price premium for it,

exceeding the extra costs for differentiating. A cost advantage is gained if a firm can offer the products and the services its competitor's offer at lower cost.<sup>32</sup>

According to Grant (1991: 100) the building blocks of a firm's competitive advantage are its resources, skills and capabilities.<sup>33</sup> This is also pictured in Figure 5. Grant (1991:100) distinguishes between tangible and intangible resources. Tangible resources consist of the physical assets and the financial resources a firm owns. The intangible resources contain a firm's human technology, its reputation and skills. However, Grant (1991: 104) argues that most resources however do not have built-in value. The *resources* should contribute to the gaining and sustaining of capabilities.

The resources, skills, technology and capabilities of a firm can be detected, analyzed and evaluated by decomposing a firm into its elementary *activities*. Several tools can be used to do this.<sup>34,35</sup> The *structural drivers* underlying these discrete activities will determine why some firms can perform some activities at lower cost or create superior value.

Capabilities result from performing activities over time while employing the available resources, skills and technology to their fullest extent. Capabilities result

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<sup>32</sup>This distinction is widely acknowledged in the literature. See for instance: Porter (1980: 35-38); Porter (1985: 33); Daems en Douma (1989: 173); Ghemawat (1991: 70); Hax and Majluf (1991: 83-84); Grant (1991: 138) and Douma (1993: 124)

<sup>33</sup>Without going too much in detail, it will be argued that the main internal sources of a firm's competitive advantage and therefore its rent-earning capacity, are its resources, skills, technology and resulting capabilities.

<sup>34</sup>One can unfold the activities of a firm by using Porter's value chain concept or the related business system framework of McKinsey, see for instance Grant (1991: 107)

<sup>35</sup>For a discussion on these techniques see: Porter (1985: 37) and Grant (1991: 107)

from the resources and activities interrelating and working together efficiently and effectively. In this respect Nelson and Winter (1982: 14) developed the notion of routines to describe these regular and predictable patterns of behavior of a firm. Porter (1991: 103) notes that a firm performing an activity or a group of interrelated activities will create skills, organizational routines and knowledge.

These capabilities determine what a firm *can do better* than its rivals. What a firm does better than its competitors, is that 'extra something' that enables a firm to outperform its competitors.

If one accepts that the core of a firm's competitive advantage roots in its capabilities and therefore in the interplaying of its resources, skills, technology and activities, it becomes clear that a competitive advantage's *real sources* are not always 'visible' for competitors. It can rest on a *complex web* of coordinated routines across activities.

To obtain a competitive advantage, a firm will have to formulate a *competitive strategy*. Based on the two types of competitive advantages, Porter (1980: 35) defines three generic types of competitive strategies, because he (1991: 101) denotes that a competitive advantage is attained within certain scope dimensions. Daems and Douma (1989: 173) on the other hand, develop based on the two types of competitive advantages, two basic types of position improving competitive strategies. This is also shown in Figure 5.

According to Daems en Douma (1989: 15, 174) and Douma (1993: 124) a competitive strategy is a deliberate plan of action that formulates how a firm is going to

position itself within its industry, how it will gain a *sustainable* competitive advantage. Indeed, as a firm strives to outperform its competitors persistently, a competitive advantage should be sustainable, agree Porter (1980, x), Porter (1985: 11), Daems and Douma (1989: 20) and Ghemawat (1991: 122). To guarantee the sustainability, Peteraf formulates the two remaining conditions.

- Two Conditions to Assure the Sustainability of a Competitive Advantage

To assure the *durability* of those rents two other conditions must be met. A first condition is the existence of ex post limits of competition, Peteraf asserts (1993: 182). Ghemawat (1991: 84) refers to this idea by the concept of the scarcity value of sticky factors. Ghemawat (1991: 84-85) as well as Peteraf (1993: 182) define the threat of substitution and the threat of imitation as two critical factors that determine the scarcity value or the ex post threats to competition respectively.

The threat of substitution as a rent reducing force was already acknowledged by Porter in his five forces framework. The threat of imitation is directly related to Rumelt's notion of 'isolating mechanisms' and Caves and Porter's concept of mobility barriers, Peteraf notes (1991: 182-183). The concept of mobility barriers and its impact on the existence of performance differences according to researchers in strategic management will be explained further on.

The second condition to assure sustained supra-normal returns Peteraf proposes (1993: 185) is the imperfect mobility of resources. The imperfect mobility of resources will guarantee that the resources will remain available to the firm and that the rents will be shared by the owners and the firm employing them. This

condition is closely linked to Ghemawat's (1991: 85) appropriability condition for sustainability. This condition should allow a firm to reap the benefits from its superior position.

However, competitive advantages will never sustain without *continuous investment* in the maintaining, the building up and the replacement of its building blocks: its resources, skills, technology and capabilities. Dierickx and Cool (1989: 1506) use an insightful metaphor to illustrate this idea. They compare the necessary continuous investments with a leaking *bathtub*.

Instead of within the firm the core of a firm's competitive advantage may also be external to the firm linked to its *location*, the environment where a firm is operating. To assess the influence of a firm's location, Porter (1990: 72) developed his Diamond-framework. This framework has four components that influence a firm's competitive advantage: the locational factor conditions, the characteristics of its local demand, the presence of suppliers and related and supporting industries and the context for competition at that particular location.<sup>36,37</sup>

The complete framework in Figure 5, on the determinants of superior performance, attempts to link the *choices* of a firm's management team to its industry structure, its positioning and its way of configuring its business system to

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<sup>36</sup>A full description of the complex interrelations between these factors and how they can help gaining and sustaining a competitive advantage falls out of the scope of this research. A complete discussion is available in Porter's Competitive Advantage of Nations. An article highlighting the most important aspects appeared in the Harvard Business Review, March-April 1990, No. 2, pp. 73-95

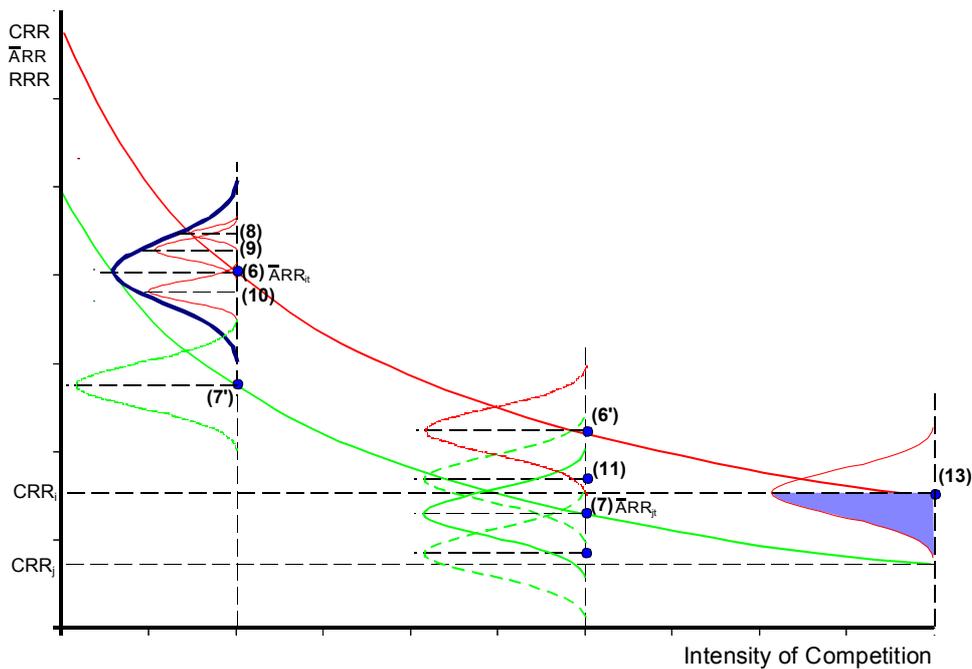
<sup>37</sup>It is interesting to note that Porter's framework incorporates far more influencing factors besides the locational factor conditions which are often stressed by micro-economists as the source of superior rents. On the contrary, Porter notes that paradoxically enough it is often the *lack* of basic input factors that spur innovation and form the source of an advantage.

its resulting outcome. These managerial choices form according to Porter (1991: 101), the essence of strategy.

In Vandingenen and Bostyn (2003/2004a) it was already noted that a firm's *realized performance* reflects the outcome of its commitment-intensive choices. Considering the complex interrelationships between all the influencing factors, and the inherent uncertainties in all these choices which have to be made, by now it should not be surprising that firms can differ significantly and that their actual performance can deviate substantially from their *intended* one, their objectives.

These insights from strategic management can be pictured in the extended Daems and Douma framework as well. This framework is presented in Figure 8.

Figure 8: Extended Framework within the Strategic Management Perspective



Source: Own Conceptualization based on Daems and Douma (1989: 43)

From the previous discussion it is apparent that the scholars in business policy *focus* on firm differences: as a firm is presumed to strive for (a) sustainable competitive advantage(s), this implies that the actual performance of firms will almost inevitably not be equal.

Again, the fact that the performance of individual firms will almost certainly differ, can be represented by a distribution around the industry's average long run rate of return.<sup>38</sup> Also here one can argue that in the long term the competitive rate of return will serve as a lower bound for any individual firm.<sup>39,40</sup>

<sup>38</sup>One could dispute how the actual distribution around the  $RR_{it}$  should look like. Once again it was decided to opt for a normal distribution although also this time one could argue that the distribution will be positively skewed, representing the fact that some firms will have substantial competitive advantages. But, also here this does not add much value to the discussion. For the remainder of the argumentation see footnote no. 5.

<sup>39</sup>Also in this case this argument can serve as an extra element to defend that the actual distributions of return is more likely to be positively skewed. Indeed, the realized rate of return in the long term can only be situated within the interval  $[CRR_i, +\infty]$ ;  $\forall i \in \text{Ind}_i$ ;  $i: 1, \dots, n$ .

<sup>40</sup>Of course, transient effects can cause the realized rate of return of a particular firm at time  $t$ ,  $RRR_{kit}$  to become lower than the  $CRR_i$ , but this situation can not be sustainable in the long term. Firms earning sub-

Firms having sustainable competitive advantages will continuously realize a rate of return that deviates positively from the  $RR_{it}$ . Firms suffering from inferior positions and which are not able to gain and sustain a competitive advantage will realize a rate of return below the  $RR_{it}$ . It is possible however that these firms do not leave the industry, if they still succeed in earning a rate of return in excess of that industry's competitive rate of return. Whether a firm will decide to leave the industry will then, and this according to researchers in strategic management, depend on the other strategic options this firm has.

Scholars in strategic management are well aware of the fact that the attractiveness of an industry or the competitive advantages of firms are not granted forever automatically. On the contrary, they understand very well that new firms will be attracted to attractive industries. This threat of entrants or their actual entry will drive up the competitive pressure, pulling the long term profitability prospects of that industry in the direction of its competitive rate of return. This phenomenon was already discussed earlier, by the assessment of the impact of industry evolution on the overall attractiveness of an industry.

Of course, researchers in business policy as Rumelt (1991: 172) also acknowledge the distorting effect of temporary influences. Temporary economic fluctuations can cause the *actual* average rate of return to deviate from its long term value,  $RR_{it}$ . For instance, general economic conditions such as a recession or an economic uprise, can cause these deviations. However, also individual differences can impact the realized rate of return of a particular firm. A strike, a fire or an unexpected windfall profit can cause the realized rate of return

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normal profits for a longer period of time, will eventually be forced to leave the industry. Only if a business unit belongs to a corporate concern with deep pockets and if the business unit is of 'strategic importance' to the concern, sub-normal profits can be sustained for a longer period of time.

of an individual firm at time  $t$  to deviate from its prospect. In Figure 8 the temporary fluctuations at the industry level have been illustrated conceptually as scenarios (11) and (12).

One other element needs further explanation. Due to the importance of the notion of a sustainable competitive advantage, scholars in strategic management agree, that even in an unattractive industry, even if the long term prospects are poor, it remains possible for individual firms to realize supra-normal profits, agree Porter (1985: 11) and Harrigan (1980: 599). In Figure 8 this situation is denoted as scenario (13).

#### 1.3.2.3 Intra-industry (Dis-)Similarities: Strategic Groups

In the previous paragraph it was argued that within an industry almost certainly firms will differ considerably. However, competitors in an industry will also show similarities.

Firms that show considerable similarities can be considered to follow comparable *competitive strategies* and these firms can be *grouped*. These groups are denoted in the business policy literature as strategic groups, argue Daems and Douma (1989: 129) and Douma (1993: 102). However, a literature review up to 1988 conducted by Martens (1988: 45) shows clearly that there is still *not a common definition* available in strategic management upon which everyone agrees. This is probably a major reason why the comparison of the research findings on strategic groups in strategic management is a difficult task. Most definitions Martens cites seem to stress the resemblance of firms on a number of strategic dimensions, *discretionary* to the management of the firm.

More recent definitions go further in this direction, stressing the recent insights on the building blocks of a competitive advantage. Nohria and Garcia-Pont (1991: 111), for instance, define a strategic group as:

'... Strategic groups are defined as firms with similar strategic capabilities.'

During the 1970s and the 1980s considerable research has been done in strategic management on strategic group structures. Researchers as Jegers (1994: 343-344, 346-347), in: Daems and Thomas (1994) have focused on the selection of the relevant strategic dimensions, the methods to use to identify strategic groups and the resulting performance implications.

Apparently, the primary objective in strategic management studies is to understand the positioning of the *firm* within its industry and its resulting performance, decides Martens (1988: 45). This opposed to the research in Industrial Organization that is more concerned with the profitability at the industry level.<sup>41</sup>

One of the major reasons for the interest of the researchers in strategic management in strategic group analysis is the proposition that *performance differences* do exist between firms belonging to different groups, Martens (1988: 56) explains. Business policists often regard the notion of the existence of differences in *strategic capabilities* and *mobility barriers* within an industry as an explanation why some firms succeed in earning persistently higher profits than others. However, the available empirical results do not offer much evidence for this proposition yet, agree Martens (1988: 56), Cool and Dierickx (1993: 49) and Douma (1993: 103).

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<sup>41</sup>See supra, paragraph 1.1.2.

Martens (1988: 57-58) suggests three possible explanations for these poor results:

- it might be that there does not exist a simple relationship between strategic groups and performance;
- the quality of the data might be too poor, which is also acknowledged by Douma (1993: 103-104);
- the models may be misspecified.

Cool and Dierickx (1993: 47-59) attempt to shed some light on the first of these three explanations. They (1993: 47) *propose* that the strategic group structure might have an *indirect effect* on firm performance as it affects the *conditions of rivalry* within an industry.

Cool and Dierickx suggest that the within-group rivalry might influence the firm's performance in another way than the between-group rivalry. They (1993: 49-50) put forward two research questions:

- Do significant differences exist in the effects of within-group rivalry and between-group rivalry?
- Are the conditions of rivalry determined by the strategic group structure, and if so to what extent?

These authors find *evidence* that an *indirect relationship* between strategic group membership and profitability exists. The shifts in strategic group membership are linked to the effects of changing intensity of within- and between-group competition, while these measures of rivalry explain variation in profitability.

With this original approach, Cool and Dierickx seem to have made a significant contribution towards explaining intra-industry performance differences at the firm level. More research in this promising direction is welcome.

Also Nohria and Garcia-Pont propose that there might exist an *indirect effect* of the strategic group membership and firm performance. They suggest that the direction and the intensity of cooperation agreements (strategic linkages) between firms belonging to the same and/or different strategic group create a 'super-structure' across firms. They (1991: 109) call these networks of interrelationships *strategic blocks*.

While van Witteloostuijn en Schreuder, in: Douma (1993: 186) argue that the competition then will shift from the level of the firm to the level of the network, Nohria and Garcia-Pont (1991: 122) conclude that these strategic blocks succeed in equalizing the strategic capabilities across firms. On this basis they hypothesize that this will probably result in the levelling off intra-industry performance differences. The authors however do not perform empirical analyses to test this hypothesis.

Again, these insights on strategic groups, mobility barriers and firm performance can be shown in the extended Daems and Douma framework. The same remarks on the exact location and the shape of the distributions remain. Three illustrative strategic groups were drawn in Figure 8, representing scenarios (8), (9) and (10). Although the general picture looks the same as in the perspective of the industrial organization economists, there are two apparent differences.

First, industrial organization economists still tend to view the strategic group concept as *structurally* determined, while researchers in business policy view the strategic groups as determined by the similarities between the *competitive strategies* of the firms. Their perspective is more conduct-oriented. The strategic group structures are seen as the outcome of the *discretionary decisions* of the managers of the firms, as the strategic groups represent similarities in the *resources* and *capabilities* of the incumbent firms. Second, industrial organization economists mainly used the strategic group concept to explain variability in *industry profitability*, while scholars in strategic management focus on *firm performance*. This distinction however is blurring.

With these remarks in mind, it becomes clear that even though the frameworks look alike, and use similar concepts to explain that performance differences *can* exist, the arguments the representatives of each of these perspectives use to explain *why* they exist are fundamentally different.

### 1.3.3 Strategic Management Positioned in the Framework

Based on this analysis and on the dimensions of the integrative framework the domain of strategic management can be situated. It will be shown that strategic management theories draw on all these paradigms.<sup>42</sup>

Martens (1990: 602) situates the start off the academic interest in strategic management issues in the second half of the 1960s. Before that period, strategic management was more a synonym for long term planning.<sup>43</sup> In 1965 Andrews published his strategy model. This model still forms the basis of the content oriented 'Harvard-School' of business policy, stipulates Mintzbergh (1990: 172). Publications still root in the powerful formulation-implementation structure.<sup>44</sup> Strategic management is considered as a logical, rational, sequential process consisting of several steps, guided by *top*-management, explains Martens (1990: 605).

Although strategy formulation and implementation are seen as a process, critics argue that they are too rationally oriented, stressing too little the organizational *dynamics*, of on the one hand the internal processes in the firm, and on the other hand the many influential

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<sup>42</sup>For this discussion, the insights gained through the course Strategisch Management, K.U.Leuven, 1992 thought by Rudy Martens and his literature review proved to be very helpful.

<sup>43</sup>Although one doesn't always agree upon the exact delineation of the time frame, this shift in perspectives from planning to management is recognized by several authors, see for instance Day (1984: 7-11) and Aaker (1988: 10-13).

<sup>44</sup>See for instance, DAEMS, H. and S. DOUMA: Concurrentiestrategie en Concernstrategie, Kluwer Bedrijfswetenschappen, Deventer, 1989, 309 p.; HAX, A. and N. MAJLUF: The Strategy Concept and Process: A Pragmatic Approach, Prentice-Hall International, Englewood Cliffs, New Jersey, 1991, 430 p.; GRANT, R.: Contemporary Strategy Analysis. Concepts, Techniques, Applications, Blackwell Publishers, Cambridge, 1991, 394 p.; DOUMA, S.: Ondernemingsstrategie, Kluwer Bedrijfswetenschappen, Deventer, 1993, 370 p. and DAEMS, H.: Designing a Competitive Strategy, Concepts and Tools, K.U.Leuven, 1996, 76 p.

environmental processes, explains Martens (1990: 607-608). Therefore, the domain of strategic management until the second half of the 1980s can be situated somewhere in a middle position on the structural-process oriented axis in Figure 4. The position of the field on the vertical axis is self-evident: discretionary managerial actions and their resulting impact on firm performance form the core of strategic management.

Martens (1990: 608) argues that on the shortcomings of the traditional content oriented model, in the seventies more *process oriented* models were developed. From a theoretical perspective Martens distinguishes the strategy model of Van Cauwenbergh and Van Robaeys (1986: 35-39) which roots in the research of Aharoni, Bower and Parsons. This model reduces the role of top management, while the role of the middle managers is stressed. On the empirical side there are for instance, the contributions of Mintzberg and Quinn, explains Martens (1990: 609). Therefore, one can say that from the 1970s onwards strategic management became even more process oriented. This corresponds to a shift to the right in the framework.

#### 1.3.4 Strategic Management Drawing on Several Perspectives and Paradigms

The insights in the domain of strategic management have benefited from the theories rooting in several disciplines and research paradigms which were discussed in paragraph 1. In Vandingenen and Bostyn (2003/2004a) it is argued that though an organization has multiple objectives, reflecting the interest of different stakeholders, in the end the interest of every stakeholder is financially related. Although this focus does not correspond to the profit-maximizing hypothesis of neoclassical micro-economic theory, strategic management (still) (ought to) rest(s) on *micro-economic theory*.

Also *industrial organization* is a fruitful discipline for business policy. Not only the powerful structure-conduct-performance paradigm from the 'mainstream field' (still) represents a lens through which strategic management researchers look at their domain, but also the 'new' schools in industrial organization form a basis for new insights in business policy. Especially Porter should be mentioned, who succeeded superbly in transferring the insights from industrial organization to the domain of business policy, agree Caves (1984: 127) and Martens (1990: 110).

Business policy has also gained from research in *sociology*, especially from the contributions from researchers studying organization theory, and the processes of organizational change in particular. Here, the work of Nelson and Winter and Hannan and Freeman for the population ecology perspective should be mentioned as valuable contributions.

Business policy can benefit enormously from longitudinal *historical research*. Chandler's careful historical analyses of the development of managerial enterprises form a landmark proof of this. Alchian's insight that the success of a firm is also determined by *pure luck*, is well acknowledged among strategy researchers. Scholars in business policy, Ghemawat (1991: 42-45) for instance, agree that the outcome of major strategic decisions is largely uncertain. As discussed by Vandingenen and Bostyn (2003/2004a), this viewpoint was already implicitly taken by Mancke as well.

Finally, strategic management has always seen *competition as a dynamic process* in the Schumpeterian sense of the word. Competition is an interactive process, competitors are mutually dependent. This is exactly one of the core reasons why firms need a strategy. Especially in oligopolistic industries the strategic moves of a firm will influence the competitive position of its rivals, eventually resulting in differences in performance. These

moves might cause competitive retaliation, again influencing the position of the incumbent firms, agree Porter (1980: 88), Daems and Douma (1989: 16-17) and Douma (1993: 100).

This discussion on whether and why performance differences can exist at the industry level, clearly shows that researchers from several disciplines recognize that performance differences can exist. They diverge however widely in their opinions on why these differences occur. Many argumentations can be brought back to the varying perspectives on the concept of competition and the influential impact of discretionary managerial decisions on firm performance.

## 2. Performance Differences at the Corporate Level

A corporation is defined as a firm active in more than one industry, a multi-business firm<sup>45</sup>

Performance differences at the corporate level can be attributed to two factors: the *composition of the portfolio* of business units and the *value added* by the corporate center.<sup>46</sup>

### 2.1 Composition of the Business Portfolio

Performance differences between corporations can exist because some corporations succeeded in selecting a '*better performing portfolio*' of business units. To compose the portfolio, corporate management has to decide whether a firm should *enter* an industry, *expand* or *divest* its activities. It must decide what businesses to be in, how diverse the portfolio should be and how to allocate resources among business units.

#### 2.1.1 Attractiveness of a Business Unit on a Stand-Alone Basis

Whether a firm should enter a particular industry, expand or divest its current activities within an industry first of all depends on the long term prospects of that business unit on a stand-alone basis, i.e. the *structural determinants* of the industry and the *competitive position*

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<sup>45</sup>This definition is frequently acknowledged in the literature on business policy, see for instance, Porter (1987: 43), Daems and Douma (1989: 221), Grant (1991: 20) and Douma (1993: 11).

<sup>46</sup>This leads Porter (1987: 43) to conclude that a firm's corporate policy should answer two questions: what businesses to be in and how to manage these business units.

it (can) attain(s) in that industry.<sup>47</sup> A profound industry and competitor analysis will reveal the long term prospects of a business unit and its industry.<sup>48</sup>

Several techniques have been developed to assess whether a corporation should expand or divest its activities in an industry, evaluated based on its stand-alone position. These techniques can jointly be denoted as *portfolio management tools*.

Portfolio management tools map the business units of a corporation according to different dimensions, usually in a matrix format. On the one hand, there is the purely quantitative Boston Consulting Group (BCG)-matrix. On the other hand, there are for instance, the matrices developed by A.D. Little, Shell, General Electric, McKinsey published in Grant (1991: 341-342) and Marakon presented by Hax and Majluf (1991: 183) which use both quantitative and qualitative criteria.<sup>49</sup>

Although Daems and Douma originally developed the 'position-matrix' to assess the players within an industry, this tool can be used as a technique to analyze a portfolio of businesses of a corporation as well. In the spectrum of available portfolio analysis tools, the

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<sup>47</sup>This corresponds to Porter's (1987: 46) first two *critical conditions* which must be met if a firm considers *entering* an industry. First, the industry structure should be attractive or have potential to be made attractive. Second, the cost of overcoming the barriers to entry may not exceed the expected future profits.

<sup>48</sup>Inherently, a firm should only enter attractive industries and/or strive to attain or retain a favorable competitive position within an industry. For a complete argumentation, see supra paragraph 1.3.2 and Figure 2.5.

<sup>49</sup>An extensive overview of the available portfolio techniques and their advantages and drawbacks falls out of the scope of this paper. Herefore, the review of for instance, HAX, A. and N. MAJLUF: *The Strategy Concept and Process: A Pragmatic Approach*, Prentice-Hall International, Englewood Cliffs, New Jersey, 1991, p. 182-194; GRANT, R.: *Contemporary Strategy Analysis. Concepts, Techniques, Applications*, Blackwell Publishers, Cambridge, 1991, p. 338-344; JOHNSON, G. and K. SCHOLLES: *Exploring Corporate Strategy, Text and Cases, Third Edition*, Prentice Hall, Hemel Hempstead, 1993, p. 144-146 and EPPINK, D.: *Portfoliomanagement, Chapter 8 in: DOUMA, S.: Ondernemingsstrategie*, Kluwer Bedrijfswetenschappen, Deventer, 1993, p. 199-206 can be consulted.

position matrix can then be considered as (one of) the most sophisticated one(s). It takes many relevant elements into account, quantitative as well as qualitative, to map and evaluate the position of a particular business unit.

The BCG-matrix is the least sophisticated tool, due to the selection of its simple dimensions. Moreover, according to Eppink, in: Douma (1993: 205), compared to the other approaches, the BCG-matrix focusses more on *cashflow* analysis, while other techniques try to assess the *structural profitability* of a business unit.<sup>50</sup>

Haspeslagh (1982: 67-68) analyzed how managers perceive the *benefits* of portfolio analysis. He concluded that managers acknowledge that they gain better insights in how each of their businesses is run. They also recognize that portfolio management tools allow to improve the resource allocation process, facilitate strategic turnarounds, entry and exit decisions.

However, portfolio planning tools have serious *drawbacks* too. First, they are oversimplified frameworks to approach a complex reality, pose Hax and Majluf (1991: 194). Second, they only analyze two dimensions. Consequently, Daems and Douma (1989: 224) argue, they *do not incorporate the value adding role of the corporate center* for the business units, although this forms the core of corporate strategy. Also, the possibilities for exploiting interrelationships between business units are largely undervalued as the business units are mainly considered as independent businesses.

### 2.1.2 Three Generic Corporate Strategies to Alter the Scope of the Business Portfolio

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<sup>50</sup>This distinction should be interpreted with the various dimensions of the performance concept in mind, see Vandingenan and Bostyn (2003/2004a).

When a firm decides to alter the scope of its portfolio, it has *three generic options*. First, the firm can *diversify*<sup>51</sup> into related or unrelated activities, *integrate vertically* or *expand horizontally*. Each of these options can have a national or an international scope, agree Daems and Douma (1989: 235) and van Oijen (1993: 233). Also, every alternative has its specific advantages and disadvantages.<sup>52</sup> van Oijen (1993: 234-247) discusses the most important pros and cons, which are summarized in Figure 9.

Figure 9: Advantages and Disadvantages of the Three Generic Corporate Strategies

STRATEGY	ADVANTAGES	DISADVANTAGES
Diversification	! Economies of Scope ! Risk Reduction ! Competitive Weapon	! Dispersion of Resources
Vertical Integration	! Economies in Distribution and Production ! Reduced Transaction Cost ! Protection against Supplier and Buyer Power ! Protection of Technology ! Control Quality Standards ! Assured Supply and Demand	! Different Minimal Optimal Scale ! Rising Control Costs ! Slowing Down Innovation
Horizontal Expansion	! Concentration of Resources ! Economies of Scale ! Reduced Intensity of Competition	! Presence Required in Different Industries ! Abundant Resources

#### 2.1.2.1 Diversification

<sup>51</sup>It is clear that diversification policy and corporate strategy are by no means synonyms. Diversification is (only) a mode to alter the scope of the business portfolio.

<sup>52</sup>A detailed discussion on the pros and cons of the alternatives falls out of the scope of this paper. An extensive assessment can be found in Daems and Douma (1989: 241-281).

The diversification concept has multiple definitions. Ramanujam and Varadarajan (1989: 524) give an overview of several definitions found in the literature. In line with Berry (1971: 373), (1974: 200) and (1975: 62-63), a firm diversifies if it enters an *industry* in which it had no activities before.

Frequently, a distinction is being made between *related* and *unrelated* diversification. According to van Oijen, in: Douma (1993: 244), if the activities of the business units have similarities with respect to the type of technology used, the product characteristics of the output or the markets served, it is considered as a related diversified corporation. In an unrelated diversified firm there are no clear similarities between the activities of the business units.

Many researchers have explored the complex relationship between diversification and corporate performance. In their literature review on diversification Ramanujam and Varadarajan (1989: 526) develop a conceptual scheme, picturing a network of research issues and interrelationships.

In general, Grant (1991: 316-317) argues, two research hypotheses are formulated. First, diversified firms are expected to earn higher profits than single business firms if one accepts that a corporation can allocate resources, monitor and control operational managers more effectively than the capital market can. Second, related diversification will be more profitable than unrelated diversification due to the realization of economies of scope.

Initially, the empirical research findings confirmed these hypotheses, Grant (1991: 317-319) and Johnson and Scholes (1993: 268) agree. However, in later studies researchers did not find a significant diversification-performance relationship, while others discovered that

unrelated diversified firms outperformed related diversified ones, assert Grant (1991: 321) and Johnson and Scholes (1993: 268-270).

Evidence was also found to support the existence of a curved relationship. Up to a certain limit, performance rose with diversity. Beyond this limit, due to complexity, the relationship inverted, evidence is presented in Grant (1991: 317) and Johnson and Scholes (1993: 270). In addition, Grant (1991: 317-320) and Johnson and Scholes (1993: 270) assert that the actual direction of the causation is questioned. It is not clear whether superior performance fuels diversification moves or whether diversification leads to superior performance.

To summarize, the available empirical evidence to date shows that the benefits of diversification are difficult to materialize in reality, depend on situational circumstances, industry and firm characteristics, industry evolution and business cycle effects, conclude Grant (1991: 320) and Johnson and Scholes (1993: 270).

However, van Oijen, in: Douma (1993: 244) states, one frequently stated advantage of diversification is its potential to reap economies of scope.<sup>53</sup> A second advantage of diversification, mentioned by van Oijen, in Douma (1993: 246) is risk reduction. The cashflow pattern of the corporation will stabilize if the cashflows of the business units are not perfectly positively correlated. Finally, diversification can help defending a business unit's competitive position in a particular industry.

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<sup>53</sup>The economic value of economies of scope and their role in explaining the occurrence of performance differences at the corporate level will be further discussed in paragraph 2.2 concerning the value adding role of the corporate center.

Adversely, van Oijen, in: Douma (1993: 247) warns, diversification can also lead to a dispersion of the available resources. In industries where the commitment of necessary resources is rising continuously, it can lead to a lack of resources at the corporate level. As a result, the competitive position of some of its business units will be threatened, van Oijen, in: Douma (1993: 247) asserts.

#### 2.1.2.2 Vertical Integration

Oster (1990: 268) argues that upstream or downstream vertical integration concerns the internalizing of either input sources or output buyers within the firm. It can lead to economies in production and distribution, lower transaction costs, diminish the market power of suppliers and buyers, help protecting core technologies, control quality standards and guarantee supply and demand, sums van Oijen, in: Douma (1993: 244) up.

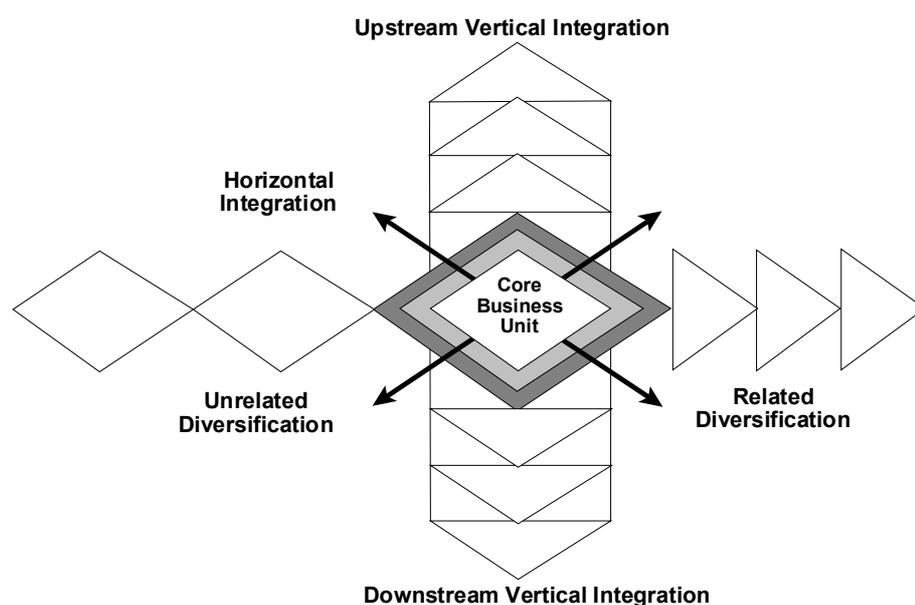
However, there are drawbacks as well. First, the integrated activities may differ in minimal optimal scale. Second, the control costs rise and finally it may slow innovation, asserts van Oijen, in: Douma (1993: 244).

#### 2.1.2.3 Horizontal Expansion

A firm is expanding horizontally if it broadens its activities within the same industry. Horizontal expansion or integration allows a concentration of resources, offers opportunities to realize scale economies and increases the concentration in the industry. On the contrary, it lowers the possibilities to earn rents from being present in several industries, while it also may lead to sub-optimal allocation of excess resources, explains van Oijen, in: Douma (1993: 234-236).

Due to the specific definition of diversification used in this paper, the enumerated generic corporate strategies are interrelated. Indeed, here following Johnson and Scholes (1993: 228) vertical integration is interpreted as a *typical form* of related diversification.<sup>54</sup> The interrelatedness of the types of corporate strategies is pictured in Figure 10.

Figure 10: Three Generic Corporate Strategies Are Interrelated



Source: Own Conceptualization based on Teece, in: Frederickson (1990: 57)

Horizontal integration can be interpreted as an enlargement of a firm's existing activities. Vertical integration corresponds to the incorporation of upstream or downstream activities. Of course, there are also the related diversification moves into non vertically related operations. Finally, there are the loosely coupled, unrelated diversification moves.

## 2.2 Value Added by the Corporate Center

<sup>54</sup>If Daems and Douma's (1989: 126) definition of diversification is applied instead, the three modes of corporate strategies become mutually exclusive.

Evidently, a corporation has only reason to exist if the advantages of bringing the individual business units under joint ownership and control outweigh the disadvantages. With other words, *added value* should be created for the business units or for the corporation as a whole.<sup>55</sup> The added value of the corporate center is the *value created* by the corporate center *minus* the *corporate costs* born to fulfill the value creating role.

First, the three functions reserved for the corporate managers are discussed. Next, the six value creating roles for managing the business portfolio are considered. Then, some guidelines to select the appropriate value creating role(s) are presented. Finally, the nature of the corporate costs will be briefly addressed.

### 2.2.1 Three Functions are Reserved for the Corporate Center

Besides shaping the portfolio and allocating resources, corporate management can create value by *providing coordination* between the business units, *controlling performance* and *handling the external relations* of the enterprise as a whole with the different stakeholders. These opportunities to create value reflect the *three distinct functions* Chandler (1991: 33) reserves for the corporate managers of a multi-business firm.

#### 2.2.1.1 Managing the Portfolio and Coordinating the Business Units

First, corporate management is entitled to alter the business portfolio,<sup>56</sup> assist with the formulation of the competitive strategies of the business units, try to stimulate the

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<sup>55</sup>This corresponds to Porter's (1987: 46) third *critical condition*, the 'better-off' test.

<sup>56</sup>The composition of the corporate portfolio was already discussed in paragraph 2.1.

necessary level of coordination between business units and allocate resources with respect to these goals.

By facilitating and stimulating coordination across business units economic value can be created. Porter refers to the concept of *synergy* as the idea that combining and coordinating different business units has the *potential to create value*.<sup>57</sup> This description still clearly roots in Ansoff's definition of synergy. He (1968: 75) defined synergy as:

'... the effect which can produce a combined return of the firm's resources greater than the sum of its parts.'

In the business literature Ansoff (1968: 75) asserts, it is often called the '2+2=5' effect. To exploit potential synergies, *similarities* have to exist between activities. Identifying these communalities either at the operational level or concerning more intangible managerial activities, is a prerequisite for realizing the potential synergies, poses Grant (1991: 321). According to Porter (1985: 317-318), only firms that succeed in identifying and exploiting the *interrelationships* between the business units, will gain vast opportunities to cost reduction or enhancement of differentiation value. These extra benefits can root in many types of interrelationships, assert Johnson and Scholes (1993: 255).

Porter (1985: 323) distinguishes three types of interrelationships: tangible, intangible and competitor interrelationships. First, *tangible interrelationships* refer to the sharing of value chain activities among business units. Value is created if the sharing lowers cost or enhances differentiation value, asserts Porter (1985: 323-324, 326). Second, *intangible interrelationships*

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<sup>57</sup>This potential to realize synergies is often referred to as a major reason to justify diversification moves, see Johnson and Scholes (1993: 229) and van Oijen, in: Douma (1993: 244).

point to the transfer of (managerial) know-how across value chains. Value creation occurs thanks to the transfer of skills and know-how from one business unit to another, agree Porter (1985: 324, 350) and Daems and Douma (1989: 126). Finally, *competitor interrelationships* result from the existence of inter-industry, multipoint competition. Industries are linked together, consequently, actions in one industry may have an influential impact on other industries, Porter (1985: 325, 353-354) poses.

The concept of synergy integrates these three distinct ways of creating value through the exploitation of these interrelationships. Resultingly, Porter (1985: 325) argues, it is not surprising at all that the synergy concept lacks clarity.

Because synergy is such a broad, vaguely defined concept, often the more specific, more narrowly defined *economies of scope* notion is applied, explain Commandeur and Sleuwaegen, in: Douma (1993: 280). Baumol, Panzar and Willig (1982: 71) define economies of scope as:

'... cost savings [which] [...] result from simultaneous production of several different outputs in a single enterprise, as contrasted with their production in isolation, each by its own specialized firm...'

or more formally Bailey and Friedlaender (1982: 1031) specify,

'...Economies of scope are said to exist [...] if the cost of producing outputs 1 and 2 jointly is less than the total cost of separate production, ...'

Not surprisingly, this economic definition has been transferred to the domain of business policy as well by scholars as Daems and Douma (1989: 105), Grant (1991: 311-313, 321) and van Oijen, in: Douma (1993: 244-245).

Economies of scope arise according to Bailey and Friedlaender (1982: 1026) from the sharing of the joint utilization of resources. These resources can be tangible as well as intangible assets. Economies of scope in tangible assets result from the elimination of the duplication of activities, explains Grant (1991: 311, 321). The fixed costs of these activities are spread over the bundle of products, van Oijen, in: Douma (1993: 245) poses. Also scope economies in intangible assets exist. Know-how, skills, brandnames, reputation are valuable intangibles which can be transferred under certain conditions to other businesses.

Coordination of the activities eligible for the transfer of intangibles or the joint utilization of tangible assets can create significant economic value. The corporate managers can perform a *catalyzing, stimulating role* in this process.

#### 2.2.1.2 Monitoring and Controlling the Business Unit's Performance

Second, the corporate center has to *monitor* and *control* the performance of the business units, check the use of the resources allocated and take corrective actions if necessary. To perform their control function, corporate management can rely on two types of management control systems: the management information system and the systems that regulate the behavior of people, state Johnson and Scholes (1993: 370).

The *management information system* should report whether the firm succeeds in reaching its targets. If the performance deviates negatively from the objectives, top-management can

take corrective actions. However, the corporate management can also monitor and control the business units through the design of *reward systems*. Rewards include both monetary and non-monetary rewards such as promotion or increased status, Johnson and Scholes (1993: 373) explain.

The performance criteria used to evaluate the results of the business units can incorporate every dimension of the performance concept.<sup>58</sup> Of course, as the ultimate purpose of a firm is to sustain its long run continuity, financial performance targets should be incorporated.<sup>59</sup>

### 2.2.1.3 External Ambassador for the Corporation

Finally, the corporate management handles the relations of the enterprise with external stakeholders as for instance, the legislatures and governmental bodies concerning taxes, tariffs and regulations. Compared to the other two functions, which are internally oriented, this function is externally focussed.

Every corporation has to decide *how* it is going to fulfill these functions. It has to determine how the responsibilities for these tasks are going to be allocated between the headquarter's office and the business unit managers. By making these strategic decisions, corporate center will decide on its value creating role.

## 2.2.2 Six Value Creating Roles for Managing the Business Portfolio

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<sup>58</sup>For a discussion on the dimensionality and the measurement of financial performance, see Vandingenen and Bostyn (2003/2004a).

<sup>59</sup>See Vandingenen and Bostyn (2003/2004a), paragraph 1.2.

Depending on which functions the corporate management is performing, six value creating roles can be distinguished. Each of these roles will be briefly described and their differences in allocating responsibilities for the functions between corporate and business unit management will be shown. Consequently, it will become clear that each of these roles creates value in a different way.

The six value creating roles which can be distinguished are investment banker, restucturer of a firm, restucturer of an industry, consultant, coordinator and defender.<sup>60</sup>

#### 2.2.2.1 Investment Banker

The role of investment banker is an important role for a conglomerate, an unrelatedly diversified multi-business firm or a holding company and involves three major tasks. First, the investment banker *attracts capital* from the capital market and *allocates cashflows* to the business units. Value is created because the corporate center can aggregate the capital requirements of all the business units, as such spreading the fixed set-up cost of the financial transactions over the business units, *minimizing* the corporate *cost of capital*. The corporate center can also balance the cash requirements across the business units and hedge the exchange risk for the business units through internal hedging.

Second, the corporate managers can have better information than the external financiers to guide *the allocation* of the available resources, agree Porter (1987: 51) and Daems and Douma (1989: 228). Finally, the corporate center also *monitors* the performance of the business units

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<sup>60</sup>This enumeration is based on Porter (1987: 49), Daems and Douma (1989: 225-226), Grant (1991: 352-354) and van Oijen, in: Douma (1993: 259-260). These references can be consulted for a complete discussion on the corporate value creating roles.

and handles the *external relations*, van Oijen, in: Douma (1993: 260) explains. Value is created in the form of capital gains.

#### 2.2.2.2 Restructurer of a Company

According to van Oijen, in: Douma (1993: 261) a corporation can fulfill the role of a restructurer of a company on a *permanent* or a *temporary* basis. When a corporation decides to become a permanent, 'full-time' restructurer its activities come close to the role of a *raider*. A raider looks for undervalued, poor performing companies, turns them around and resells them. If the structure of the industries in which these firms are operating has promising prospects, this role can create significant value in the form of capital gains, explains Porter (1987: 52).

The core skills of top-management are their abilities to spot undervalued firms with potential. After gaining a controlling participation, the corporate managers have to turn these business units around. Value is created through the use of restructuring knowhow. Here, value is created through the restructuring skills.

The reorganized business units can be sold off when they have regained their competitive position, van Oijen, in: Douma (1993: 261) explains. The corporate center no longer adds value. If corporate management decides to retain the business unit in its portfolio, the role of the corporate center 'downgrades' to the one of investment banker, Porter (1987: 53) argues.

A corporation can also decide to fulfill the role of a restructurer *temporarily* for one or more poor performing business units. Then, the corporate management has the intention

to reorganize the business unit(s) to retain them in the portfolio, van Oijen, in: Douma (1993: 262) posits. Here, the corporate center performs the role of a *crisis manager*.

No capital gains are created, but the goal is to improve the operational activities of the business unit(s). This will result in a higher *operational* cash flow. When the business unit(s) have regained competitive strength, the corporate center can decide to fulfill other roles.

### 2.2.2.3 Restructurer of an Industry

A corporation can also decide to restructure its business unit in a particular industry and by restructuring try to *change* the *fundamental structural rules* within that industry. The corporation is restructuring that industry, agree Porter (1987: 52) and Douma (1993: 228).

This role is only feasible, if the corporation succeeds in turning its strategic business unit around to a *dominant player* within the industry. The firm has to be able to become the *ruler* of the industry and gain sufficient *market power* to be able to *change the 'rules of the game'*.

Of course, this is a very demanding, aggressive and difficult role to perform. It offers however good prospects to create value through the realization of a continuous operational cash flow. Afterwards, the corporation can decide to retain an active role in the management of the restructured strategic business unit(s) or transfer its responsibilities to the business unit management and change roles.

As was argued earlier, a corporate center can also create value for its businesses by trying to exploit the *interrelationships* between the business units. If the realization of real instead of

paper *synergies* becomes an objective of the corporate management, they fulfill (a) completely different role(s), Porter (1987: 54) argues.

#### 2.2.2.4 Consultant

Whenever a corporation decides to perform the role of a consultant, it will focus on the *transfer of skills* and *knowhow* among business units, acknowledge Porter (1987: 87), Daems and Douma (1989: 229) and Grant (1991: 353). The opportunities to transfer knowhow and skills, arise if similarities exist across the activities of the value chain. Often these similarities will reflect *intangible interrelationships*.

However, Porter asserts (1987: 54) the transfer of skills and expertise can only succeed if two conditions are met. First, the similarities between the business units must be clear enough to make sharing meaningful. Second, the transfer of expertise should consider activities relevant to the supporting of the competitive advantage(s) of the business unit(s) and must lead to unique, valued capabilities. Value is created as an operational cashflow increase.

#### 2.2.2.5 Coordinator

The coordinator role is based on the *sharing of knowhow and activities* among business units, states Porter (1987: 55). Here, value is created through the realization of synergies rooting in the *tangible* and the *intangible* interrelationships among business units. The coordinator realizes economies of scope<sup>61</sup> in common resources and activities, agree Daems

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<sup>61</sup>Economies of scope were defined in paragraph 2.2.1.

and Douma (1993: 229-230), Grant (1991: 353) and van Oijen, in: Douma (1993: 264). In its most extreme form this can lead to the *bundling of value chain activities*.

Sharing activities has the potential to create operational value in the corporation, provided that the activities are contributing to the enhancing or the sustaining of the firm's competitive advantage(s), Porter asserts (1987: 55).

The coordinator role has the most chance to succeed if the business portfolio consists of strongly related business units, acknowledge Porter (1987: 57) and Daems and Douma (1989: 229). Then, Grant (1991: 353) and van Oijen, in: Douma (1993: 265-266) concur, the corporate center plays an active coordinating role in the strategy formulation and implementation of the business units.

#### 2.2.2.6 Defender

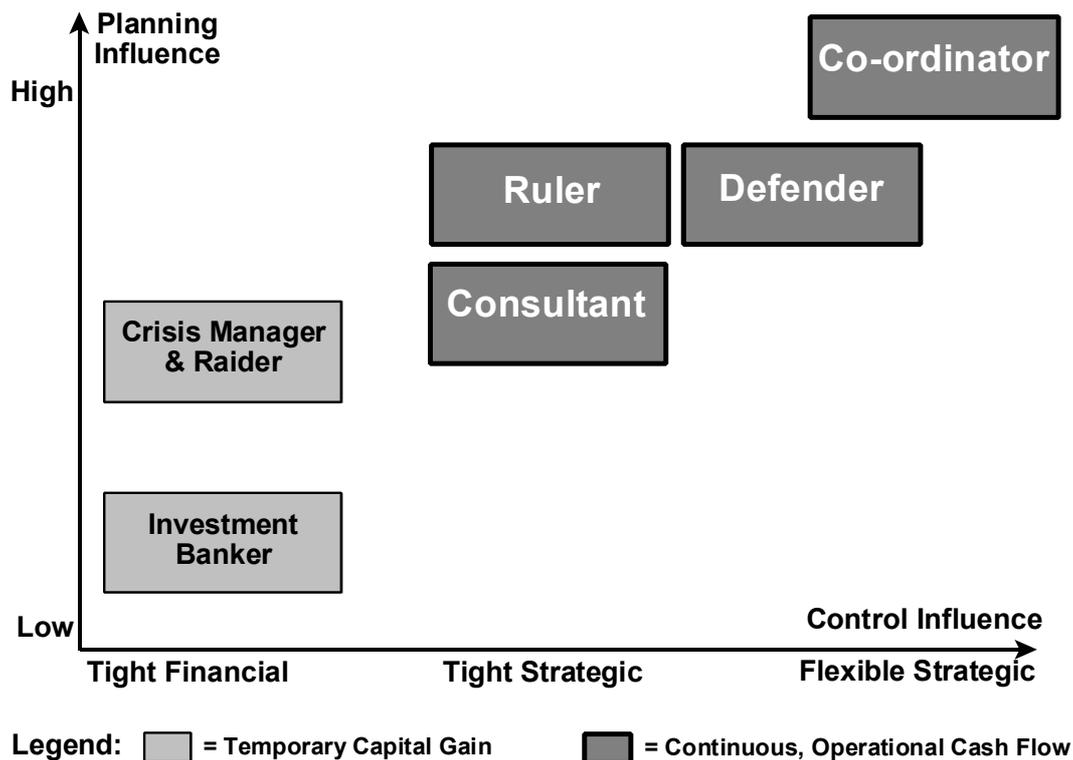
The corporate center performs the role of a defender, according to Daems and Douma (1993: 230) and van Oijen, in: Douma (1993: 265-266) if it chooses to enter another industry with the objective to *defend* its competitive position in its current businesses.

Compared to the other roles which tried to enhance the competitive position of the business units of the corporate portfolio, this role focusses on *lowering the competitive intensity*, states van Oijen, in: Douma (1993: 265) through the exploitation of competitor interrelationships. Value is created through the fact that the defender has more 'cards to play' in the competitive game, explain Daems and Douma (1993: 230).

In the previous paragraphs six corporate roles were described. Each of these roles differs with respect to the responsibilities which are performed by the corporate and the business unit managers. In other words, they differ in which functions are fulfilled by the corporate managers.

In the framework of Figure 11 it is attempted to visualize the differences between these alternative management styles. Herefore, the corporate management styles are situated in a two dimensional framework, representing the two main managerial functions of a corporate center as they were defined in paragraph 2.2.1.<sup>62</sup>

Figure 11: Management Styles Differ According to the Corporate Center's Functions



Source: Own Conceptualization based on Gould and Campbell (1987: 294) and Daems and Douma (1989: 233)

<sup>62</sup>Of course, the exact location of the roles on the dimensions is always a matter of interpretation. However, more than the exact location, it is the relative differences between the roles which are interesting to interpret.

The vertical dimension reflects the *impact* the corporate management has on the *formulation of the strategies* of the business units and its power to allocate the available resources among the business units. It can be interpreted as the degree of managerial intervention from the corporate center, a scale for the managerial autonomy of the business unit managers.<sup>63</sup> This scale can vary from low to high. Goold and Campbell (1987: 36) refer to this dimension as the *planning influence*.

The horizontal dimension shows how the corporate center *monitors and controls* the performance of the business units, see Chandler (1991: 33). This dimension is denoted by Goold and Campbell (1987: 40) as the *control influence*. They (1987: 41) distinguish three types of control influence: tight financial control, tight strategic control and flexible strategic control.

The third function, the external representation as ambassador for the corporate whole, is not shown in Figure 11. This function remains at the corporate level, whatever role the corporate center chooses to perform.

When the corporate center selects the *investment banker* role,<sup>64</sup> it will not intervene much in the managerial issues at the business unit level. The business units are relatively autonomous. However, the corporate center allocates the resources, while also imposing strict financial controls. Value is created through capital gains.

A *restructurer of a firm* has more planning influence, while also imposing strict financial controls on the business unit(s) he is trying to turn around. A permanent restructurer, a

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<sup>63</sup>This corresponds to Chandler's (1991: 33) description of the first function for the corporate executives.

<sup>64</sup>The role of investment banker corresponds closely to the role of controller as it is defined by Goold and Campbell, see Grant (1991: 358-359).

*raider*, will try to create value by creating capital gains. A temporary restructurer, *a crisis manager* with the objective to retain the business unit in the corporate portfolio, will try to reorganize the operations of the business unit(s) to create a continuous stream of operational cashflows.

The *restructurer of an industry, the ruler*, has to gain a dominant position within the industry. Therefore, its planning influence on the business unit management will have to be high. He will also impose strict strategic controls. The creation of value is mainly operationally oriented.

The corporate center performing *a consultant* role,<sup>65</sup> is trying to stimulate cooperation between the business units to encourage the sharing of skills and knowhow. Consequently, the planning influence is moderate, while tight strategic controls are set. Value is created in a continuous way in the operational activities of the business units.

When the corporate center is fulfilling the *coordinator* role,<sup>66</sup> its influence on planning is high, because the strategic decisions of the business units have to be integrated at the corporate level. Its control influence is characterized by a flexible strategic style. Operational value is created.

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<sup>65</sup>This role description parallels closely the role of coach as it was defined by Goold and Campbell, see Grant (1991: 358-359).

<sup>66</sup>This role is equivalent to the role of orchestrator as it was defined by Goold and Campbell, see Grant (1991: 358-359).

A corporate center performing the *defender* role, needs a high level of planning influence, while applying a tight or flexible strategic control influence. Also here operational value is created, but this time through the lowering of the competitive intensity.

### 2.2.3 Choosing a Value Creating Role

According to Porter (1987: 57), corporations can *create value with any of the value creating roles* provided that:

‘... they clearly define the corporation's role and objectives, have the skills necessary for meeting the [...] prerequisites, organize themselves to manage diversity in a way that it fits the strategy, and find themselves in an appropriate capital market environment.’

However, he (1987: 57) argues that more shareholder value will be created with the more complex roles, like the consultant and the coordinator role. Daems and Douma (1989: 234) agree that the potential to create value is higher with the more complex roles, but they also point out that this relationship depends on the corporate costs as well. The potential to add value depends on both components.<sup>67</sup>

#### 2.2.3.1 Type of Generic Corporate Strategy Limits Choice of Value Creating Role

Although, also the findings of Goold and Campbell (1987: 162) point out that no single corporate management style is superior, this does not mean that the selection of the

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<sup>67</sup>For a discussion on corporate costs, see paragraph 2.2.4.

corporate management style is arbitrary. Different styles are appropriate for different industries and different types of corporate management.

Also the type of corporate strategy selected limits the choice of the value creating role. Table 2.1 illustrates the possibilities for value creation for each corporate role with respect to the generic corporate strategies.<sup>68</sup>

Table 2.1: Feasible Combinations of Corporate Strategies and Value Creating Roles

Value Creating Roles for Corporate Center						
Generic Corporate Strategies	Investment Banker	Restructurer of Company	Restructurer of Industry	Consultant	Coordinator	Defender
Horizontal Integration	+/-	+	+	+	+	+
Vertical Integration	+/-	+	+/-	+	+	+
Related Diversification	+	+	+/-	+	+	+
Unrelated Diversification	+	+/-	-	+/-	-	-

Legend:  
+ = good opportunities, +/- = moderate opportunities and - = no opportunities to create value

Source: Adapted from van Oijen, in: Douma (1993: 267)

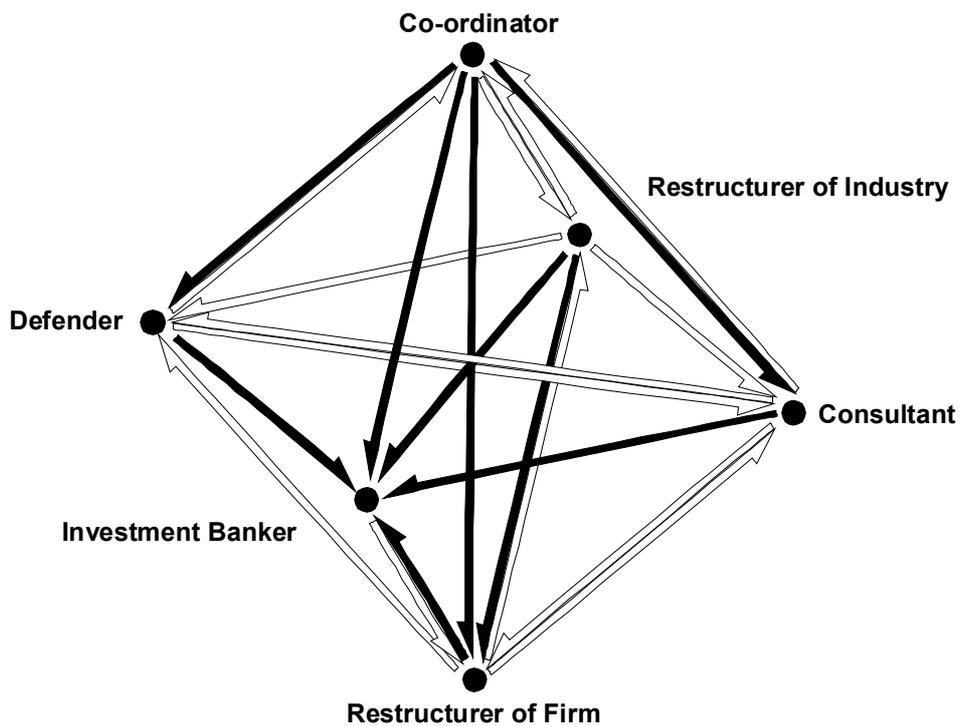
Table 2.1 clearly shows that very diverse, unrelated business portfolio leaves the least opportunities to create value for the corporate center, asserts van Oijen, in: Douma (1993: 266). However, Porter (1987: 57) poses, the corporate center's role can evolve. This means that a corporation can proceed *sequentially* from its initial role to (an)other role(s).

### 2.2.3.2 Performing Multiple Value Creating Roles Simultaneously and Sequentially

<sup>68</sup>The generic corporate strategies were discussed in paragraph 2.1.2.

Figure 12 pictures a 3D-octahedron, a geometric figure with six angles and eight triangular plain faces. On each angle one value creating role is situated. The ribs connect the roles which can be performed simultaneously and/or which can be pursued sequentially. The arrows point into the direction in which combinations and transitions are possible from each starting position.

Figure 12: Performing Corporate Roles Simultaneously and Sequentially



Source: Own Conceptualization

A *black arrow* links two roles which are *easily* combined or from which transitions are easily accomplished. A *white arrow* indicates that certain combinations of roles or sequential movements are *possible*. If *no arrow* is indicated, it means that these combinations are *improbable, unlikely*.

The *investment banker* role offers little opportunities to evolve to other roles. It is possible that an investment banker develops to a restructurer of a firm, performing a raider role.

Reversely, whenever a corporation is fulfilling whatever other role, the investment banker role can be performed simultaneously, almost effortlessly.

If a corporation fulfills the role of a *restructurer of a firm* at a certain point in time, it can easily perform the investment banker role as well. Later transitions to a restructurer of an industry role, a consultant role or a defender role are feasible. Changing from the restructurer of a firm role to a coordinator role seems more unlikely.

A *restructurer of an industry* has more opportunities. He can perform the role of an investment banker or a restructurer of a company as a crisis manager simultaneously. Subsequently, conversions to a consultant or a defender role come within reach. Even a coordinator role belongs to the scope of opportunities, although it is more difficult to accomplish.

A *consultant* has also prospects. He can integrate the investment banker role. Alterations to a role of a restructurer of a firm as a crisis manager, a defender and maybe even a coordinator are not unrealistic. Changing from a consultant role to a restructurer of an industry seems less likely.

The role of a *coordinator* is the most promising. It allows to incorporate the roles of investment banker, restructurer of a firm as a crisis manager, consultant and defender with relative ease. Evolving to a role of a restructurer of an industry is not impossible either.

Finally, the *defender role* offers specific opportunities. It can easily be combined with the role of an investment banker. Eventually, transitions to the role of a consultant and maybe

even a coordinator are feasible. Switching to the roles of a restructurer of a firm or an industry seems less likely.

In the previous paragraphs it was attempted to illustrate that the choice of the management style of the corporate center is not arbitrary. The opportunities that the corporate managers have to create value, depend on several characteristics: the corporation's previous strategic decisions, its current position, the composition of its business portfolio, the structure of the industries in which the corporation is operating, its preferred type of generic corporate strategy and the roles the corporate managers wish to pursue.

From this it is clear that the decision on which management style to apply is by no means simple. It requires serious considering, balancing the opportunities to create value against its expected corporate costs.

#### 2.2.4 Corporate Costs

The corporate costs can be defined as the costs which would not have been made if the businesses had operated as autonomous firms, defines van Oijen, in: Douma (1993: 268).

Three categories of corporate costs can be distinguished. First, there are the *corporate infrastructural costs*. These correspond to what Daems and Douma (1989: 226) denote as the direct costs of the headquarters. They can rather easily be traced in the accounting system.

Second, there are the *corporate operating costs*. These can be attributed to the fact that the corporate center performs its specific functions.<sup>69</sup> They comprise of the additional costs of communication, agree Daems and Douma (1989: 226) and van Oijen, in: Douma (1993: 268) between the corporate center and its business units and the control costs, asserts van Oijen, in: Douma (1993: 268-269) assignable to the monitoring and control function of the corporate executives.

Finally, there are the *opportunity costs*. These are indirect economic costs reflecting the value of the profitable alternatives forgone because the business units can no longer operate autonomously, explain Daems and Douma (1989: 226) and van Oijen, in: Douma (1993: 268-269).

The magnitude of the corporate costs reflects the managerial tasks the corporate center decides to fulfill. The more functions are centralized at headquarters, the higher the corporate costs will become. As such the corporate costs depend on the value creating role(s) the corporate center wishes to perform. In general, Daems and Douma (1989: 231, 233) and van Oijen, in: Douma (1993: 269) explain, the more complex roles offer more opportunities to create value, but coincide with higher corporate costs. The height of the corporate costs also depends on the organization structure of the corporation. This relationship and the impact of the organization structure on SBU or corporate performance will be discussed in paragraph 3.

By now, it should be clear that the decisions concerning the formulation of a corporate strategy and its resulting impact on corporate performance are complex issues. In fact, the selection of a generic corporate strategy, the resulting composition of the business

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<sup>69</sup>These functions were defined in paragraph 2.2.1.

portfolio, the choice of the value creating role(s), the resulting corporate costs and the corresponding organization structure are intertwined. The decisions made on each of these dimensions, shape the feasibility of the alternatives on the other.

Several combinations are possible, however, these strategic decisions have to be coherent. The corporate strategy formulated should match the scope of the business portfolio and the selected value creating role(s). Of course, the value created at the corporate center should exceed the amount of the corporate costs. Otherwise, the added value is negative, resulting in a situation where the corporation as a whole is worth less than the sum of the individual business units. Then, the corporation has no reason of existence and should be split up.

### **3 Organizing to Create Performance Differences**

The organization structure of the firm also contributes to the occurrence of performance differences. First, the different types of organizational configurations will be addressed. Next, the direct effect of the organizational configuration on the performance of the firm will be considered. Then, it will be shown that the performance of a firm also depends on the degree of correspondence between the organization structure and the environment. Finally, it will be demonstrated that strategy and structure are interrelated concepts, both influencing the performance of a firm.

#### **3.1 Configuring the Organization Structure**

In his famous study *Strategy and Structure*, Chandler (1962: 14) defines organization structure as:

'... the design of organization through which the enterprise is administered. This design, whether formally or informally defined, has two aspects. It includes, first, the lines of authority and communication between the different administrative offices and officers and, second, the information and data that flow through these lines of communication and authority.'

A distinction ought to be made between the formal and the informal organization structure, explains Noorderhaven, in: Douma (1993: 336-337). The *formal structure* refers to the allocation of tasks and responsibilities across activities and individuals and the corresponding lines of authority and communication as they were deliberately formulated by top-management. The *informal structure* points to the actual situation, which can differ sometimes even significantly, from the formal structure.

*Several forms of organization structures* can be found. However, one does not seem to agree upon the appropriate taxonomy to classify the different types. At least two approaches can be distinguished. On the one hand, there is the classic organization theory approach, referring to the structure as the *hierarchical* allocation of tasks and responsibilities across organizational departments and individuals. On the other hand, there is the more 'biologically' oriented approach where organizations and thus also firms, are seen as *organisms*.<sup>70</sup> Each of these two approaches will be briefly discussed.<sup>71</sup>

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<sup>70</sup>This metaphor refers to the work of Morgan (1986: 423), who studied organizations from different perspectives. While using different metaphors as lenses to look at the phenomenon of an organization, interesting insights can be gained.

<sup>71</sup>An extensive discussion on the different types of organization structure and their advantages and disadvantages falls out of the scope of this paper. For a review, see for instance, Johnson and Scholes (1993: 345-356), van Oijen, in: Douma (1993: 250-256), Quinn, Mintzberg and James (1988: 276-303).

### 3.1.1 A Firm as a Managerial Hierarchy

When the organization structure is interpreted as a hierarchical structure, the simple structure, the functional structure, the multidivisional structure and the matrix structure are distinguished. Each of these organizational forms has its advantages and disadvantages.

A *simple structure* refers to the firms without any formal structure. This type of organization is common in very small businesses, explain Chandler (1962: 19) and Johnson and Scholes (1993: 345).

A *functional structure* roots in the operational activities of a firm. Chandler (1962: 57) points to this type of organization structure as the multidepartmental structure. Similar tasks are grouped in a separate function. As a result, efficiency gains are reaped through specialization, assert van Oijen, in: Douma (1993: 251, 337) and Johnson and Scholes (1993: 345).

A functional organization structure fits a single business firm, with a relative low degree of product diversity. The functional structure can also be appropriate for vertically integrated corporations. Whenever the product range becomes too broad, another organization structure will become more suitable, explain Johnson and Scholes (1993: 346) and van Oijen, in: Douma (1993: 252). A feasible alternative can be the multidivisional structure.

In a *multidivisional structure* the activities are organized in several business units. Williamson (1981: 1555) denotes this type of organization structure as the 'M-form' structure. Each of the business units operates as a profit center and could operate as a single business. The business units are grouped under the supervision of a corporate center, posit Chandler (1962: 105-110), van Oijen, in: Douma (1993: 252) and Johnson and Scholes (1993: 346).

The corporate center formulates the corporate strategy, selects the business portfolio, chooses the appropriate value creating role(s), allocates resources and monitors and controls the performance of the business units.<sup>72</sup> In addition, the corporate center has to decide the ownership structure and decides upon the control influence of the headquarter office. The appropriate degree of participation depends on the value creating role(s) the corporate center wishes to perform, assert Daems and Douma (1989: 236).

By selecting the value creating role(s) the corporate center decides which functions are centralized at the headquarter office and which functions belong to the responsibilities of the business unit managers. If the corporation prefers to perform the investment banker role, very little functions will be centralized at the corporate center. The corporate center will be little more than a corporate shell, fulfilling the role of a holding company, Williamson (1981: 1556) explains. When the corporate executives select the coordinator role, according to Daems and Douma (1989: 236-237) a lot more functions will be centralized at the headquarters.

The *matrix structure* is in essence a combination of two or more of the previous organization structures. Several combinations are possible, explain van Oijen, in: Douma (1993: 254-255) and Johnson and Scholes (1993: 353), e.g. product and geographical divisions, functional and divisional structures.

van Oijen, in: Douma (1993: 253) and Johnson and Scholes (1993: 353) continue that in reality, only very few organization structures correspond perfectly to one general structural type.

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<sup>72</sup>For a complete discussion, see supra paragraph 2.2.

This because firms either deliberately adopt a hybrid structure or because organizational changes from one structural type to another are only incrementally implemented.

### 3.1.2 A Firm as an Organism

If a firm is viewed as an organism, according to Morgan (1986: 39), it is considered as a living system, operating in a wider environment on which it depends for the fulfillment of its needs. The firm is regarded as an *open system*, 'open' to its environment, consisting of a set of interacting, independent subsystems, Morgan explains (1986: 44-45, 49).

Rooting in this paradigm, Mintzberg (1989: 98-99) and Mintzberg, in: Quinn, Mintzberg and James (1988: 278-279) developed a diagram showing the *six basic parts* of an organization. These elements are the operating core, the strategic apex, the middle line, the technostructure, the support staff and the ideology. He (1989: 101-102) also perceives several *coordinating mechanisms*, which he considers as the most basic elements of the organization structure. Based on the six basic parts, the coordinating mechanisms, the design parameters and some situational factors, Mintzberg composes his typology of organization structures.<sup>73</sup>

Each type of organization structure is denoted as a configuration. The number of configurations increases over time. First, he distinguished five configurations: the simple structure, the machine bureaucracy, the divisionalized form, the adhocracy and the professional bureaucracy, in Quinn, Mintzberg and James (1988: 663). Later but in the same book, he (1988: 302-303) added the missionary configuration. In a more recent publication

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<sup>73</sup>An extensive review of Mintzberg's work on organizations falls beyond the scope of this literature review. Here, it suffices to say that these elements form the building blocks for his taxonomy of organization structures.

(1989: 114-115) seven configurations are presented, the six previous ones and the political organization.

The *simple structure*, also called the entrepreneurial structure, is a very elementary configuration. It has little or no staff, the tasks are loosely divided and unformalized. There are only a few managers, power rests with the chief executive, explains Mintzberg (1989: 117-118).

The *machine bureaucracy*, Mintzberg (1989: 132-133) continues, has an elaborated administrative and support structure, a large operating core, and a middle line usually structured on a functional basis. The power rests with the managers of the strategic apex. It is a centralized structure, with tight controls mechanisms. This configuration comes close to the definition of a functionally organized, single industry firm.

In a *divisionalized form* also denoted as the diversified organization, a set of rather independent entities are kept together by a central administrative structure. The units are usually called divisions, the central administration is called the headquarters by Mintzberg (1989: 155-156). This organizational type corresponds clearly to the definition of a corporation as it was presented in paragraph 2.

The *adhocracy* or the innovative firm can according to Mintzberg (1989: 302) be described as:

'... an organic structure that relies for coordination on mutual adjustment among its [...] experts, which it encourages by the extensive use of the liaison devices - integrating managers, standing committees, [...] task forces and matrix structure.'

It is a flexible structure, where information and decision processes flow informally to promote innovation, Mintzberg explains (1989: 199-200).

In a *professional bureaucracy*, Mintzberg (1989: 174) notes, trained specialists, professionals, work rather independently of their colleagues, close to their clients under the supervision of the profession. It has a decentralized structure with minimal technostructure and middle line hierarchy, but a large support staff.

The *missionary configuration* has a very strong system of values and beliefs, its ideology. Tasks are unusually loosely divided, little job specialization occurs. It is coordinated through a standardization of norms, poses Mintzberg (1989: 223-224).

Finally, asserts Mintzberg (1989: 237-238) and (1991: 57) there is the *political firm*. In a political firm the informal organization structure reigns. Conventional influence structures are replaced or overruled by informal power.

In more recent publications another organizational configuration is proposed, the *network organization*. In a network organization the business functions are performed by individual organizations. Networks can therefore be adapted to the circumstances and can be complex or simple. The networks are assembled through 'brokers' who link the different functions through arms-length market transactions. The network participants rely on interlinked full disclosure information systems. Consequently, Miles and Snow (1986: 64-65) note that a network organization can reach the specialization of a functional structure, the market orientation of a divisional structure and the balancing orientation of a matrix organization.

Again, it should be emphasized that each of those configurations is in fact an 'ideal' type. In reality, no firm fits a single form exactly. However, according to Mintzberg (1989: 115) and (1991: 58), this small number of configurations succeeds in explaining much of the processes which can be observed in organizations in real-life. Sometimes a firm corresponds remarkably well to one type or reflects a clear combination of different types.

The idea that individual firms do not fit these types precisely and can have characteristics of more than one form, led Burns and Stalker (1971: 122) conclude that a *continuum* of organizational forms can be defined with on the one end a *mechanistic* and on the other end an *organic* form. Frequently, firms operate through organization structures having characteristics of the two types.

### 3.2 A Direct Link: Organization Structure - Firm Performance

Researchers as Child and Khandwalla - in White and Hammermesch (1981: 216) - and Lenz (1981: 134, 137) suggest that a direct relationship exists between the firm's organization structure and its performance. Following, several researchers have tried to test the hypothesis that some organizational forms are better suited for particular firms than other.

Armour and Teece (1978: 117) for instance, analyzed whether multidivisionally structured firms outperformed their competitors in the *petroleum industry*. They found that in the period 1956-1968 multidivisionally organized firms realized a 2% higher return on equity than any other firm having a different organization structure.

However, this result did not persist. In the second period from 1969 till 1973, when most of the firms had made the transition to the multidivisional structure, the 'M-form' firms no longer accomplished better results than the others. From this, Armour and Teece (1978: 118) conclude that superior performance is likely to be observed only when inferior alternative forms of organization simultaneously exist within the industry.

Teece (1981: 179) analyzed whether the multidivisional firms also tend to perform better *across industries*. Constructing a matched pair design, he studied 40 firms belonging to 20 different industries. Applying non parametric tests, Teece (1981: 183-184) again showed that the multidivisionally organized companies outperformed the rest. The differential impact on return on equity induced by introducing a multidivisional structure was 2.37%, well in line with the previous results, he (1981: 188) concluded.

Also Thompson (1981: 206) demonstrated that optimally organized multidivisional and functional firms performed better than non optimally organized ones. However, he found evidence that much of this positive performance differential could be attributed to a performance drop of the holdings.

Hill (1985: 214-215) confirmed the finding that the multidivisionally structured companies are better performers. He also revealed evidence which also shows that holding firms were poor performers and more vulnerable to declines in profitability. In addition, some evidence was presented which showed that firms experiencing a process of organizational restructuring realize lower average returns than other companies.

Although the available empirical evidence to date is still limited in scope, it indeed seems to confirm the hypothesis that the configuration of the organization structure has an impact on firm performance.

### 3.3 Contingency Theory: Environment - Organization Structure

Besides the existence of a direct relationship between the structure of a firm and its performance, adherents of the *contingency theory* such as White and Hammermesh (1981: 215) and Lenz (1981: 133) propose that the performance of a firm depends on the *correspondence* between the *environment* and the *organization structure*.<sup>74</sup>

Morgan (1986: 49) argues that:

'... There is no best way of organizing. The appropriate form depends on the kind of task or environment with which one is dealing. Management must be concerned above all else, with achieving 'good fits'. Different approaches to management may be necessary to perform different tasks within the same organization, and quite different types or 'species' of organization are needed in different types of environment.'

It is subsumed by White and Hammermesh (1981: 216) that the environment imposes requirements on the firm and that some organizational configurations are better suited

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<sup>74</sup>But while industrial economists acknowledge the impact of the structure of the industry (the environment) on firm performance, organization theorists usually characterize the environment of a firm according to concepts as uncertainty and variety. This perspective is also reflected in the viewpoints of evolutionary economic theorists as Hannan and Freeman and Nelson and Winter. These theories were discussed in paragraphs 1.2.1.2 and 1.2.2.2.

under certain circumstances than other. This indirect relationship between the environment and the organization structure influences performance.

Mintzberg (1988: 294-295), in: Quinn, Mintzberg and James, proposes some hypotheses on the influence of the environment on the organization structure. First, he suggests that a dynamic and complex environment requires a more decentralized, more organic structure. Second, he adds that a more diversified firm is likely to be subject to more intense environmental pressures to decentralize its activities, thus adopting a multidivisional form.

Lawrence and Lorsch (1967: 45) for instance, show that firms operating in different market and technological environments have to have other types of organization structures. Also they find that firms active under more dynamic and turbulent circumstances have to choose for a more organic structure, which could also vary from one organizational subsystem to another. Several researchers as White and Hammermesh (1981: 215) have tried to test these contingencies, however, the findings are not always consistent. Generally, it is agreed upon that the correspondence between the environment and the structure has an influential impact on performance.

#### 3.4 Strategy and Structure are Interrelated

Besides a direct relationship between the organization structure and firm performance and an indirect one between the environment and the organization structure, other researchers explored the link between the firm's strategy and its structure. The organizational configuration shapes and is shaped by the firm's strategy, according to White and Hammermesh (1981: 217).

### 3.4.1 Structure Follows Strategy

Chandler (1962: 386-387) observed that the development of the industrial managerial enterprise followed a remarkably consistent pattern across industries, although each firm has a unique history. At the end of the 19th century massive opportunities arose, thanks to the underlying changes in the environment. To meet these opportunities, the industrial enterprises started to accumulate massive resources in production and distribution. To be able to administer these large scale activities, gradually *functionally organized firms* arose.

Whenever the possibility occurred that scarce and necessary resources would come under control of a small number of outside parties, the firms often decided to internalize these activities. Consequently, new *vertically integrated enterprises* were created. Unit costs were lowered by rationalizing the functional activities, while through closer coordination of the activities a faster response to market fluctuations was obtained, Chandler (1962: 388) explains.

This period of growth and rationalization was followed by a second period of growth. Chandler (1962: 385) writes in this respect:

'... as [the enterprise] came to the limits of cost reduction through rational and systematic integration and use of its resources, its senior executives began to seek new markets or new lines of business where they might apply some resources only partially used or where existing ones might be employed more profitably. A threatened decline of existing demand even more dramatically increased the pressure to find new markets.'

These markets were found overseas and in new industries to which the resources could be transferred at relative low cost. Still later, these corporations decided to enter new markets with new products. Resultingly, *unrelated diversified firms* developed.

These changes in strategy made a reorganization of the organizational structure of the firms inevitable. The development of a new structure was necessary to guarantee the effective use of the available resources.

The *multidivisional corporations* arose allowing to meet the changed market conditions, Chandler (1962: 385) concluded. In these new structures a corporate center was created, which allowed to systematize the complex strategic issues which characterize these diversified firms.

This pattern recurred systematically within several enterprises active in different industries. Across industries Chandler (1962: 380) observed that:

'... expansion did cause administrative problems which led, in time, to organization change and readjustment, '

The observation of this recurrent pattern led Chandler (1962: 383) to conclude that a firm's strategy determines its structure, or Chandler's (1962: 14) well-known expression that 'structure follows strategy'. From this he concluded that a firm's strategy and structure should be in correspondence. If this is not the case, he asserts that the firm will operate ineffectively. If not adjusted, this will result in a lowering of firm performance.

#### 3.4.2 Strategy Follows Structure

Besides the acknowledgement that 'structure follows strategy', it has been argued that *the reverse relationship* related with this argument, *holds* as well. The existence of this opposite relationship was already acknowledged by Chandler (1962: 45) who argued:

'... The multidivisional structure at General Motors did not come as a response to administrative needs resulting from a strategy of diversification. Rather, its innovators saw it as a new way of administering a combination or a federation of enterprises.'

Mintzberg (1990: 183, emphasis added) asserts in this respect that:

'... Since the assessment of organizational strengths and weaknesses is [ ] a basic *input* to strategy formulation, and since structure is a key component of this, housing the organization's capabilities, then structure *must* play a major role in determining strategy too, by constraining and conditioning it as well as guiding it.'

He (1990: 183) says that the organization structure of a firm reflects an important part of its past. As a firm always carries over its history into its formulation of its future strategy, the organization structure will by definition influence its future strategy.

The structure also mirrors the *power and political relationships* within the firm. An activity which is regarded as important to the firm will be centralized within a separate organizational unit. If a new organizational unit is created, it becomes part of the power structure of the firm, concludes Noorderhaven, in: Douma (1993: 340). These power

structures influence the strategy formulation and formation within the firm. This observation is also shared by Bower (1986: 71, 78) who noted that the organization structure influences the interpersonal or political process which moves an investment project towards funding and organizational commitment.

In addition, Hall and Saias (1980: 156) explain that the organization structure conditions how the *environment is perceived* from within the firm. Bower (1986: 73) argues in this respect that the organization structure shapes the formulation of strategic investment projects by filtering and focussing the managerial perception. The managerial perception is the result of the environmental signals registered and interpreted by the firm's formal and informal channels of communication and information. This perception of the environment and the changes therein, which is determined by the personal characteristics of the firm's personnel and the organizational culture, concludes Noorderhaven, in: Douma (1993: 341)<sup>75</sup> are subjective and partial, Van Cauwenbergh and Van Robaeys (1986: 59) explain. As a firm's strategy is formulated based on this perception, structure has again an impact on strategy formulation and formation.

### 3.4.3 Towards a Reconciliation of the Strategy - Structure Interdependence

From the discussion above it is clear that the strategy-structure relationship is *bidirectional*. Also Hall and Saias (1980: 161-162) share this point of view. Mintzberg, in: Fredrickson (1990: 115) describes this interdependence as:

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<sup>75</sup>Although it is clear that also the culture of a firm influences performance, this element will not be explicitly considered.

'... structure must no more follow strategy than the left foot must follow the right in walking. In other words, structure always follows and responds to the existing structure '

and as a consequence Mintzberg (1989: 183) concludes:

'... None takes precedence; each always precedes the other, and follows it, except when they move together, as the organization jumps in a new position.'

Since this observation a vast amount of research has been done to investigate the strategy-structure relationship and its impact on firm performance. Rumelt, in: Lenz (1981: 135) for instance, notes that the direction of diversification and the selection of an efficient organization structure contribute to superior performance. High performers diversify into related businesses and choose for a multidivisional structure. Low performers are either vertically integrated, functionally organized or unrelated diversified conglomerates applying a variety of organizational configurations.<sup>76</sup> Although Rumelt's study has been criticized and the findings of the numerous subsequent studies are inconclusive, certainly with respect to the direction of the causal relationship, the results at least suggest that indeed an indirect relationship between a firm's strategy and structure exists, which influences the performance of a firm, concludes Lenz (1981: 137-138).

It seems rather paradoxal: on the one hand does structure follow strategy while on the other hand, strategy also follows structure. Noorderhaven, in: Douma (1993: 342) argues that

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<sup>76</sup>Some other studies concerning the relationship, degree and direction of diversification, the application of a multidivisional form and firm performance were discussed in paragraph 3.2.

this 'contradiction' can be reconciled if it is taken into consideration that also the (*changes in the*) environment influence(s) this interdependence. He asserts:

'... Aangezien de strategie nooit helemaal gedetermineerd wordt door de bestaande structuur, maar ook samenhangt met (veranderingen in) de omgeving, hoeft de uitkomst van dit wederzijdse beïnvloedingsproces geen stagnatie te zijn, maar is - meestal geleidelijke, soms abrupte - verandering wel degelijk mogelijk. '

Burgelman (1983: 64) develops a model of strategy formation in large diversified firms from which the bidirectional relationship between strategy and structure can be better understood. This model is similar to the variation-selection-retention evolutionary economic models which were presented in paragraphs 1.2.1 and 1.2.2.

Burgelman (1983: 64-65) distinguishes *two types* of strategic behavior in corporations: induced and autonomous strategic behavior. *Induced strategic behavior* refers to the strategic initiatives which respond to opportunities within the corporation's *current strategic scope*.

He (1983: 65, emphasis added) proposes that:

'... Such strategic behavior is shaped by the current structural context. [ ]

This is the type of strategic behavior documented by Bower. [ ] *It follows corporate strategy.*'

*Autonomous strategic behavior* refers to the introduction of new, entrepreneurial activities. These initiatives fall out off the current organization structure, causing managerial and

organizational problems and *precede changes in corporate strategy*, Burgelman (1983: 65) explains.

Hence, Burgelman (1983: 66-67) argues that *Chandler's* proposition that structure follows strategy refers to the efforts of the corporate managers to bring the strategic process in correspondence with the *current strategic scope*. Chandler also focusses on the role of top-management to *adapt* the organization structure to the requirements of the *new corporate strategy*. However, Burgelman's model (1983: 66-67), by accepting that the organization structure intervenes between the *induced strategic behavior* and the *current corporate strategy*, also leaves room for *Bower's* proposition that strategy follows structure.

With respect to the occurrence of *autonomous strategic behavior*, Burgelman observed that the more abrupt changes in corporate strategy are likely to have been preceded by autonomous strategic initiatives. From this he decides that strategy follows autonomous strategic behavior. Consequently, Burgelman (1983: 67) concludes that:

'... Structure and strategy [ ] exist in a reciprocal relationship to each other. Depending on which part of the strategic process is observed, both "structure follows strategy" and "strategy follows structure" can be correct propositions.'

From the discussion above it should be clear that, in the process of organizing the activities of a firm many strategic decisions have to be made. As there is no best way to organize, the effectiveness of the organization and therefore its performance depends on the *situational balancing* of a firm's strategy, structure and environment.

Van Cauwenbergh, Martens and Bogaert (1992: 14) present in this respect the interesting metaphor of *strategy formulation and formation as a situational puzzle*. They (1992: 14) argue that if:

'... Some underlying pattern of a new puzzle is perceived, then the pieces are screened and evaluated to see if they can fit in the puzzle pattern.'

As firms and their environments are changing constantly, the puzzle pattern and its puzzle pieces *continuously change*. Van Cauwenbergh, Martens and Bogaert (1992: 18) therefore conclude that:

'The situational fit [ ] may [ ] have to be considered as a continuous *strive* for fit [ ]. A perfect fit may never be achieved, only aspired for.'

In line with this argumentation, it can be concluded that a firm will never be able to maximize its performance. Moreover, as every firm (can) perceive(s) another puzzle pattern, while possessing other puzzle pieces - resources, skills, technology and capabilities -, and being subject to a changing environment, it should not be surprising that individual firm differences exist which can result in substantial performance differences.

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