Theory of the Firm for Strategic Management

Economic Value Analysis

Manuel Becerra

CAMBRIDGE

Theory of the Firm for Strategic Management

Economic value analysis

MANUEL BECERRA
Instituto de Empresa Business School, Madrid

CAMBRIDGE
UNIVERSITY PRESS

CAMBRIDGE UNIVERSITY PRESS
Cambridge, New York, Melbourne, Madrid, Cape Town, Singapore, São Paulo, Delhi

Cambridge University Press
The Edinburgh Building, Cambridge CB2 8RU, UK

Published in the United States of America by Cambridge University Press, New York

www.cambridge.org
Information on this title: www.cambridge.org/9780521681940

First published 2009

Printed in the United Kingdom at the University Press, Cambridge

A catalogue record for this publication is available from the British Library

Library of Congress Cataloguing in Publication data
Becerra, Manuel, 1964–
Theory of the firm for strategic management : economic value analysis / by Manuel Becerra.
p. cm.
Includes bibliographical references and index.
ISBN 978-0-521-86334-6 (hardback) – ISBN 978-0-521-68194-0 (pbk)
1. Strategic planning. 2. Management. 3. Business enterprises. I. Title.
HD30.28.B43 2009
658.4′012 – dc22 2008037805

ISBN-13 978-0-521-86334-6 hardback
ISBN-13 978-0-521-68194-0 paperback

Preface

The theory of the firm addresses the fundamental questions that we could ask about business organizations, including those regarding their role, their organizational boundaries, and their performance. It is not surprising that economists have made substantial contributions to our understanding of these issues, from neoclassical economics to the new industrial organization economics. However, it is more puzzling that the field of strategic management has not been able to absorb selectively the abundant literature on the economic theory of the firm and to adapt it to its own goals regarding strategic decision making. Simply put, economic theories like transaction costs economics were not designed to facilitate strategic analysis.

At this moment, strategy does not yet have a core theory of what firms do and their performance in the market, although the entire field somehow deals with an applied and instrumental perspective about the actions of firms and their implications for business performance. A large variety of approaches to the nature of the firm coexists within strategic management, currently dominated by the resource-based view of the firm. Unfortunately, the lack of a core foundation makes progress for the field more difficult through unnecessary controversies, such as market positioning versus resource analysis of competitive advantage.

This book is one step towards the goal of developing a reasonably comprehensive theory of the firm for strategic management. Relevant ideas from transaction costs economics, the resource-based view, competitive dynamics, diversification, globalization, and even corporate social responsibility can be integrated within a framework that begins with the most basic questions and leads to critical strategic decisions of a firm regarding how it should deal with its customers, its resources, and its competitors. I will argue throughout the book that the systematic analysis of how firms create and capture economic value is an especially useful approach to address these questions as far as strategic analysis is concerned.

I wrote this book for academics and advanced students in business administration who may look for a structured map of state-of-the-art ideas in strategic management from an economic perspective. The analysis of value provides the glue that connects the wide range of topics covered by the book. Obviously, a few hundred pages cannot summarize the huge literature in strategic management, but a value-based theory of the firm can serve as a basis to get acquainted with the economic foundations of the strategy field. The first part of the book covers these theoretical foundations and the second part explores the implications of economic value analysis for the key strategic decisions of a firm, including business, corporate, international, and social strategy.

Three years were necessary to finish the book. It would have been impossible without the support of many people, including the great editorial team from Cambridge University Press. I would also like to thank all of my colleagues at IE Business School (Madrid) and very especially Juan Santaló, who helped me with lively discussions and detailed comments to each chapter.

More than anyone else, I have to thank my wife Yoana, who made writing this book much easier and life much happier.

Manuel Becerra
Madrid 2008

Contents

Figures

Tables

PART I

Theories of the firm

1 *Introduction*

The emergence of strategic management

As an area of knowledge, business administration covers a wide variety of fields that contribute to our understanding of the management of firms, such as marketing, finance, accounting, human resources, operations, and strategic management. Since business education quickly spread in the mid-twentieth century, undergraduate and graduate programs have traditionally included some courses in strategic analysis and implementation, though their names, contents, and methods have evolved through time. Let us begin this investigation into the core questions about the theory of the firm in strategy with a brief review of its evolution as an academic field.[1]

The origins of strategic management can be traced back to the core course, usually called Business Policy, which used to be part of most programs until it was changed to Strategic Management in the late seventies. Following the lead of Harvard, this course provided an integration of the different functional areas from the perspective of the general manager.[2] One influential early textbook claimed that business policy was the study of the responsibilities of senior management, the crucial problems that affect the total enterprise, and the decisions that determine its direction.[3] This approach relied heavily on careful analysis of real business cases that was presumably valid only for the specific organization that was analyzed. Strategic management was

[1] Rumelt *et al.* (1994) provide a brief history of the research and the teaching in strategic management in the first chapter of their edited volume as well as some of the fundamental questions in the field, discussed later in the following chapters. Hoskisson *et al.* (1999) provide a more detailed description of the evolution of the field, focusing particularly on the internal versus external debate about sources of competitive advantage associated with the resource-based view and the Porterian industrial organization approach.

[2] Early contributors to the foundations of the strategy area include Barnard (1938), Selznick (1957), Chandler (1962), and Ansoff (1965).

[3] See Bower *et al.* (1991).

mostly considered an art that requires analytical skills rather than a science to be expanded through empirical testing.

According to this highly applied perspective with little theoretical core, strategic analysis is primarily based on the internal appraisal of a firm (its set of resources, strengths, and weaknesses that may generate its distinctive competence) and the external environment (trends, threats, and opportunities, from which key success factors can be identified). The main goal of strategy was considered to be the appropriate matching of key success factors at the industry level with the distinctive competences at the firm level in order to achieve high performance for the firm.[4] A firm's strategy can be regarded as an adaptive response to the external environment and to the critical changes occurring within it.

Environmental influences and how to deal with them have played a key role in strategy from the very beginnings of the field. For instance, the importance of understanding the industry in which the firm operates has been stressed by scholars such as Michael Porter in the eighties, who were inspired by industrial organization (IO) economics. From a very different perspective, the fit between the organizational structure and the environment, as well as a firm's dynamic capability to learn from and change its environment, have been studied by contingency theorists in the 1960s and also by scholars from the resource-based view of the firm in the 1990s.

This match between internal resources and external conditions underlies the foundations of strategic management and its crucial goal of understanding the reasons for the success or failure of businesses. Many of these ideas can be traced to the early framework suggested by Andrews (1971). In short, the appropriate matching between the external environment and the firm's resources may converge into an internally consistent strategy that potentially results in a sustainable competitive advantage leading to the superior performance of some firms.[5] Expanding from this basic model, most undergraduate

[4] For instance, Amit and Schoemaker (1993) refine the notion of external key success factors and internal resources as an essential part of strategy. Vasconcellos and Hambrick (1989) provide a supportive empirical test of its effect on firm performance for mature industrial products. A more critical view about "industry recipes" is developed by Spender (1989).

[5] See Rumelt (1997) for a summary of this approach applied to the evaluation of business strategies.

and graduate-level textbooks analyze the so-called strategic management process, frequently going through topics like vision, external and internal analysis, strategy formulation at different levels and industry contexts, and implementation issues like structure, planning, and control.

Despite its widespread use for teaching strategic management, the notion of matching internal resources and external environment is neither sufficiently powerful nor precise enough to be the cornerstone of strategy on which the field can be built and developed further.[6] Many important topics cannot be addressed within this framework, including critical questions like why firms exist in the first place, what determines their size, and how they should innovate. Furthermore, it is hard to explain precisely performance differentials from the concept of internal–external fit without falling into after-the-fact theorizing about firms that must somehow fit better with their environment if they have proved to be successful.

Fortunately, the strategy field has expanded well beyond this model of internal–external matching,[7] using the traditional scientific method of theory development and hypotheses testing. Despite the important debates among strategy researchers, a distinct academic field has emerged in the last three decades.[8] At the turn of the century, strategy is an established field within business administration alongside other areas like finance, marketing, and organizational behavior. Having absorbed and moved beyond its highly applied but unscientific initial stages, the field is still in search of a theoretical core that could provide greater coherence and consistency to the fundamental issues in the theory of the firm that this book explores.

6 As an analogy of the limitations of this internal–external fit approach, we can observe the development and decline of contingency theory within organization theory. See Child (1972) for the role of strategic choice in the performance consequences of the structure–environment fit.

7 See Mintzberg *et al.* (1998) for an interesting critical review of the major approaches to strategy, including the matching "design" approach.

8 The Business Policy and Strategy (BPS) division of the Academy of Management was created in the US in 1971, and the first academic journal dedicated exclusively to strategy, the *Strategic Management Journal*, was launched in 1980. In the early eighties the first graduates from doctoral programs in strategy came out as academics specialized in this growing field. In 2007 the BPS division was the second largest within the Academy of Management, very close in size to the Organizational Behavior division.

A model of strategy as organization–environment match

Kenneth Andrews provided a highly influential view of strategy in his book published in 1971. In his own words, "Corporate strategy is the pattern of decisions in a company that determines and reveals its objectives, purposes, or goals, produces the principal policies and plans for achieving those goals, and defines the range of business the company is going to pursue, the kind of economic and human organization it is or intends to be, and the nature of the economic and noneconomic contribution it intends to make to its shareholders, employees, customers, and communities." (Andrews, 1987: 13)

This elaborate conceptualization of strategy combines aspects of formulation (goals), implementation (plans and organization), firm boundaries (pursued businesses), and value (personal, economic, and broader social contributions). Andrews identifies four main components of strategy: (1) identification of opportunity and risk, (2) determining the company's resources, (3) the personal values of the chief executive and his/her team, and (4) the noneconomic responsibility to society. Basically, these four components refer to what the firm might-can-want-should do, respectively. He first raises the critical questions that top managers should address when they go through the entire process of strategic analysis and implementation, and then makes some recommendations, e.g., is the strategy in some way unique?

In this early and highly applied approach to strategic management, the performance of an economic strategy is primarily determined by the match between the market opportunities that the firm pursues and its distinctive competence (a concept introduced by Selznick, 1957). On the one hand, the firm can identify the possible opportunities and risks from the analysis of environmental conditions and trends. On the other hand, the firm should analyze its distinctive competence and the corporate resources (i.e., strengths and capabilities) that can be applied to exploit market opportunities. The best match between opportunities and resource should drive the strategic choice of products and markets for the firm, which today we summarize in an analysis of SWOT (strengths, weaknesses, opportunities, and threats) and key success factors. Though not yet fully developed, the main elements of strategic management that we will discuss throughout this book were already present in Andrews's model.