Restructuring Strategy
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CHAPTER ONE

Restructuring Strategy

James Henderson, Karel Cool, and René Abate

Introduction

An industry consists of a complex web of rivals, customers, suppliers, providers of substitutes and complementary products (Rivkin and Porter, 2000). Typically industry structures or this web of relationships remain relatively stable over time. Change tends to remain incremental. For example, despite the bankruptcies, the US airline industry has been dominated by the trunks for the last 50 years. The soft drink industry has remained a comfortable duopoly between Pepsi and Coke. The automobile industry has remained a highly concentrated industry despite the inroads from the Japanese and Koreans. Industry structure historically has changed relatively slowly.

However, numerous triggers during the last decade including rapid globalization, technology jolts, shifts in consumers’ needs, and regulatory changes have confronted a number of industries at an increasing rate. As a result, the environment has become increasingly volatile, turbulent, and uncertain. Hyper-competition has often been used to capture these new realities where companies face escalating competition from a number of fronts: from existing rivals, new players coming from different geographies, from substitute industries, or buyer or supplier industries. As a result, old barriers may crumble and in their place new ones may rise. Yet, the challenge for many incumbent industries, networks, companies, and management is to determine whether these changes are indeed “revolutionary” resulting in entirely new industries (e.g. the PC industry), “enabling” resulting in new end states for existing industries (such as Internet distribution of airline tickets, music, software etc.), or whether they are “complementary” resulting in small changes to the existing structure (such as physical distribution over the Internet). The test is to know which strategies and practices, regardless on what level of analysis (industry, network, or firm), are robust during these periods of potential industry restructuring.

This book provides a glimpse of successful strategies and management practices during periods of industry structuring and restructuring both from a theoretical and empirical perspective. At the end of the book the reader should have a better ability to answer the following questions. How is it that the Champagne industry still manages to earn significant above normal profits despite the change in the balance of
power in the wine industry from the “old world” to the “new world?” How did the Italian motorcycle industry flourish (where in other countries it has failed) during the onslaught of the Japanese motorcycle manufacturers into Europe? How can pharmaceutical companies maximize their likelihood of drug leads when technology (e.g. genomics, biotechnology) is rapidly changing? Which e-consulting companies are most likely to survive an industry shake-out where demand plummeted due to the bursting of the Internet bubble? How should incumbents react in the face of a “disruptive” technological threat? How should companies expand overseas when the new country environments are radically different? What advice should we have for managers in these periods of industry structuring and restructuring? Finally, how should companies be governed during these periods of industry structuring and restructuring?

Industry Structuring and Restructuring Phases

Typically industries during periods of structuring or restructuring pass through several phases: an external triggering event, a period of experimentation or an era of ferment, and finally a movement back to the existing structure, or a shift to a new industry structure.

Triggers

What sparks the entry of new businesses, new business models, and/or new competitive positions prior to a system-wide industry restructuring is an external event or trigger. Typically this spark can come from changes in technology, changes in globalization, changes in consumer needs, or changes in regulations.

Changes in technology. A change in technology may disrupt an industry in a number of ways. Christensen (1997) refers to technological disruptions because incumbents are wedded to their existing customer base, which would prefer to remain with existing rather than try new, often inferior, technologies. Yet, once the low-end technology gains hold in a smaller market segment, it is improved to the point that it satisfies the larger customer base. For example, he showed how the incumbents kept changing with each successive introduction of a new size in the disk drive industry resulting in a turbulent industry structure over time. The US steel industry has seen significant restructuring due to the introduction of minimills, or steel produced from recycled scrap. The minimill steel manufacturers, having first entered in the late 1960s, have evolved from low-end rebar manufacturers to high-end steel sheet manufacturers in the 1990s. Nucor, a minimill steel producer, rather than one of the traditional leading integrated manufacturers such as US Steel, Bethlehem etc. is now the largest steel manufacturer in the US.

New technologies can also disrupt industry structures because they render the existing incumbents’ competencies obsolete (Tushman and Anderson, 1986). For example, the decline of Swiss watch manufacturers in the 1970s–1980s, the leaders in the global watch industry, could be traced to the commercialization of quartz technology by the Japanese. The new technology destroyed many of the existing
watchmaking skills; employment in the industry dropped from 90,000 in 1970 to 32,000 in 1985. The global watch industry structure was dramatically altered.

Finally, new technological innovations may come from the altering of the product architecture or how the core and peripheral sub-systems interact. As Henderson and Clark (1990) argue, incumbents find it challenging to understand or comprehend new architectures because existing competencies may be structured around the existing product architecture. For example, Xerox, the pioneer of the plain paper copier, was unable to capture the lead in the small copier market despite the fact that architecture of the product was only altered in a seemingly minor way.

Yet these radical technological changes are infrequent. For example, Utterback (1994) was only able to collect a total of 22 such events over the last century. In many cases incumbents may possess complementary assets that allow them to weather the oncoming technological storm. For example, the introduction of the Internet, bar code scanners, radio frequency identification devices, satellite communications, and automatic distribution equipment only helped, not hindered, the dominance of such retailers as Wal-Mart in sustaining their cost advantages. Thus it is indeed a challenge for incumbents to determine how “disruptive” these new technological changes are going to be to their existing strategies and positions within their industry.

Changes in globalization. In addition to changes in technology, we have witnessed over the last several years a relentless march towards a global economy. Liberalization of trade through the removal of tariff and non-tariff barriers has resulted in significant increased trade. The creation of regional trading blocs including the European Union (EU), the North American Free Trade Agreement (NAFTA), the Association of South East Asian Nations (ASEAN), and Mercosur has opened new markets for many different industries. For example, European insurance, banking, and airline industries have been significantly consolidated due to the reduction of regulations and non-tariff barriers. Regulations have been further and further standardized across these pan-regional blocs. For example, in the pharmaceutical industry, regulatory approval is now only required for the whole of Europe – previously it had to be done country by country. Even technologies and communications are spreading rapidly worldwide, allowing companies to extend their control farther distances. Finally, customer tastes are becoming more and more homogeneous as communications and companies have spread their messages and brands worldwide. What was once a formidable barrier to entry, distance, has increasingly been erased. The result has been a greater push toward global efficiency, and new global competitors. In some cases, it has meant significant change to existing domestic industry structures. For example, over the 1990s Toys ‘R’ Us redefined the Japanese toy retailing industry wiping out many of the small independent toy store owners that previously were able to survive in the highly regulated environment. However, in other cases, domestic incumbents are not only able to survive the globalization onslaught but also embrace it. For example, the structure of the sparkling wine industry still is dominated by Champagne producers despite the emergence and growth of the “new world” wines.

Changes in consumer and demographic needs. Shifts in customer segments, needs, or wants may signal different ways to compete in an industry: either at a new cost level
or providing differing drivers of perceived value. For example, as US households have become more affluent they continue to purchase second and third cars, larger homes, several golf sets, more clothes, more toys, etc. As a result, new industries have been spawned due to this continuous consumption of goods. For example, closet storage companies such as California Closets have flourished as households have had to cope with their increased amount of stuff. In the personal computer industry, as corporate purchasers and consumers became more at ease with the technology during the 1990s, handholding and expertise from resellers and computer salespeople became less important. This increase in experience fueled the success of the direct PC companies, Dell and Gateway, over the traditional incumbents, resulting in a changed industry structure. Yet not all changes in customer needs result in changes in industry structure. For example, the demand for increased consumer choice in cars has resulted in a proliferation of models and options. As Boston Consulting Group’s Morieux, Blaxill, and Boutenko (this volume) explain, in 1950, Renault’s range of passenger cars consisted of one model (the 4 CV) with two versions (Normale and Luxe) whereas today customers can choose from 14 Renault passenger car models, one with up to 39 different versions (Clio), up to 35 options, 17 exterior colors, 9 interior trims and two types of dashboards. While these combinations have increased 1,000-fold over the last 50 years due to this increased demand for choice, the global automobile industry has still remained reasonably stable over time.

Changes in regulations. Many legislative and court decisions may change the nature of industry structuring and restructuring by changing the mix of buyer value and cost that companies are allowed to offer. For example, telecom deregulation in the 1990s led to a torrent of competitive local exchange carriers who were previously shut out; but their entry did not significantly alter the structure of the telecommunications industry dominated by the Regional Bell Operating Companies, AT&T, Sprint, and Worldcom. On the other hand, US banking deregulation has led to the creation of numerous universal banks that were previously non-existent. Breaking Napster’s free distribution of music over the Internet gave the music industry some breathing room as it has been rapidly moving to another end state, music distribution over the Internet, to the detriment of the music retailers. The two-year unsuccessful battle to break up Microsoft ultimately left it, and consequently the personal computer industry, intact. However, numerous companies at the time were preparing for another potential industry structure.

There is evidence that the pace of these environmental changes or triggers has been increasing over time. For example, it took the telephone 35 years to get into 25 percent of all US households, the television 26 years, the radio 22 years, the PC 16 years and the Internet 7 years (Hammonds, 2001). Every region of the world has experienced dramatic increases in trade volumes in the 1990s (55 percent increase during 1990–8), achieving record levels prior to the Asian crisis. The proportion of mobile phones in the developing world has increased so quickly that they take up nearly one-third of mobile phone traffic. Migrant workers are more than ever looking for work outside their own countries. State governments in the developed and developing worlds have increasingly deregulated their industries including airlines, telecommunications, electricity, etc.
In summary, numerous external changes can trigger the entry of new businesses, the creation of new business models and competitive positions. Some of these changes will indeed result in the structuring of new industries or the restructuring of existing industries through changed power relationships between buyers and suppliers, unseating of incumbents or changes in concentration. Yet, in other situations, these changes may lead to a temporary jolt to the existing order. While incumbents may respond to the changes, they are not completely unseated from their positions of power.

Experimentation

An external trigger such as a change in technology, regulation, customer habits, usually leads to new trial and error search from both incumbents and entrants. New entrants may try out new business models, new positions, and different configurations of activities to deliver various combinations of price and perceived value to the customer. For example, numerous entrants into the Internet e-commerce world experimented with a number of different ways to earn revenues: referral fees, advertising revenue, product revenue, and information selling. Similarly with the advent of genomics, thousands of new companies have entered: those focusing on genomics technology building blocks, genomics information provision, those providing contract research services using their new search technologies, and finally those who were trying to become full-fledged bio-pharmaceutical players (e.g. Millennium Pharmaceutical and Human Genome Science).

Existing companies may modify their existing business, launch new internal ventures, or invest in external ventures as a way of shaping the future industry structure or of hedging bets should the final structure veer in another direction. For example, with the numerous technological and regulatory changes in the telecom industry, many incumbents established corporate venture capital funds to cope with the uncertainty, an amount of approximately $1.6 billion in 2001. Similarly US automobile companies have been investing in differing amounts in response to the advent of telematics or wireless services for the car. GM’s response has been a full-fledged commitment in a new business unit called OnStar whereas Ford and DaimlerChrysler’s responses have been more experimental, based on their differing views on the ultimate potential of the new opportunity.

The result of this increased activity and pace of change has certainly fueled more uncertainty and volatility. Between 1991 and 2001, the number of listed companies accounting for 80 percent of the world’s market capitalization rose from 5,000 to 8,000. Furthermore, the number of listed companies comprising the remaining 20 percent rose from 3,000 to 13,000 over the same period (Morieux et al., this volume). The 120-month average of monthly amplitudes of the Dow Jones Industrial Average increased from 5.5 percent in 1947 to approximately 9 percent in 2001. The 36-month average of the NASDAQ composite index jumped from 6 percent in 1985 to 21 percent in 2001 (Morieux et al., this volume). Earnings have become more difficult to forecast. For example, the average absolute error on analysts’ one-year forecasts has increased from 4 percent to 8 percent over the last 10 years (Morieux et al., this volume).
Often in response to this uncertainty and lack of information, entrants and incumbents seek to gain knowledge from others through alliances. Yet, these alliances can also be conduits for rampant imitation as new business models are quickly mimicked by others. As a result, too many companies may crowd into a new opportunity. For example, with the advent of the Internet, more than 100 e-consulting firms sprouted from 1995 to 2000, many seeking initial public offerings (IPOs) during the time and afterward (Prats and Nanda, this volume). Furthermore, capital providers such as venture capital companies can also get wrapped up in the mania as they are working with the same lack of information. For example, venture capital funding climbed from $13 to $93 billion from 1997 to 2000 during the Internet boom.

How these experiments play out ultimately affects the oncoming industry equilibrium. The challenge for incumbents is to determine how disruptive the changes may be, what actions they can take to shape the future of the industry into a new equilibrium or respond to them such that their existing positions of power remain intact.

Converging to new, shifting back to old

Many of the entrants during the experimentation phase will fail. For example, in the newly developed e-consulting industry, Prats and Nanda (this volume) show that of the 100+ firms that were in existence only 40 were still standing by December 2001. Numerous high profile e-commerce companies including Streamline, WebVan, Peapod (grocery delivery), Buy.com, Value America, and eToys (consumer goods), FreePC, and Gobi PC (free personal computers in return for Internet service provision fees) have all but disappeared. Yet, some remain standing and have ultimately redefined industry boundaries. For example, Cisco, a newcomer in the 1990s, has completely dominated the networking equipment industry putting enormous pressure on the previous incumbents Lucent and Nortel Networks. Dell, like many other entrants into the PC industry, started as a direct distributor of build-to-order machines for large customers. This distribution method ultimately dominated the industry by the late 1990s as Dell had become the undisputed industry leader. Yet in other situations, despite the vast increase in experimentation, the status quo remains. Often incumbent strategies are robust through these periods of turmoil. With the exception of Amazon.com, existing “bricks and mortar” players such as Wal-Mart and Toys ‘R’ Us remained on top of their respective retailing spheres despite the attempts of other pure Internet players including Buy.com, Value America and eToys.

It was reasonably straightforward for incumbents such as Wal-Mart to incorporate the Internet into their existing way of competing in the industry. The Internet was simply another ordering option for customers who would prefer the convenience of purchasing while remaining at home. Wal-Mart could still leverage its enormous bargaining power, and logistics system from their existing businesses into this new distribution channel.

Yet, the key is to determine whether the changes and the ultimate increase in experimentation will in fact result in a convergence to a new industry order or a shift back to the existing status quo. What are industries, networks, companies, and management supposed to do during these periods of industry upheaval? We call it “restructuring strategy” and the following chapters provide a glimpse. We divide the
book into three sections focusing on three different levels of analysis: the industry, the firm, and management. They are entitled Industry and Network Competitiveness, Successful Business Strategies during Periods of Industry Structuring and Restructuring, and Superior Management and Governance Practices.

Industry and Network Competitiveness

The first section of the book concerns industry and network competitiveness. Despite an environment of increasing volatility, complexity, and uncertainty, how do industries and networks of firms maintain and sustain their competitiveness? The chapters in this section build on the “relational based view of the firm” (Dyer and Singh, 2000) by illustrating the robust value of developing cooperative relations across firm boundaries in order to increase the benefit of the industry as a whole or of the network of firms allied together. Clearly, under increasing volatility, complexity, and uncertainty, mechanisms should be put in place to maximize interaction value rather than minimize interaction costs. Each chapter illustrates this important finding but from slightly different angles: understanding the mechanisms to avert opportunism in order to maximize benefits; determining the mechanisms to maximize relational benefits; optimizing the knowledge landscape in which the company is embedded; and finally reorienting the company to embrace rather than avoid complexity during periods of industry restructuring.

In the second chapter, Cool and Henderson build on a detailed case study of the French Champagne industry to develop a model of maintaining collective assets for supply chain performance. We have witnessed the dramatic restructuring of the global wine industry with the shift from the “old world” to the “new world.” Interestingly, one old world industry, Champagne, has been somewhat immune to this dynamic. Rather than suffering dramatically, it has consistently outperformed other supply chains in the industry, for example Bordeaux. The authors argue that the Champagne supply chain has consistently been able to profit from its “collective asset,” the reputation and quality of the Champagne name, despite the fact that it is owned by no one and accessed by everyone. Theory would suggest that this common asset should be subject to a “tragedy of the commons” through non-contribution, overuse and hold-up. However, based on the study of the functioning of the Champagne supply chain, the authors identify nine drivers that affect the nurturing of the common asset. These drivers include self-regulation which lowers governance costs and enables five mechanisms that avert hold up, underinvestment, and overuse: restricted access to the Champagne common (defined boundaries); full contribution to the common asset (through a common fee imposed on the growers and producers of Champagne); multiple issues in negotiations (to ensure a higher likelihood of a cooperative solution); transparency in the use of the common (through the availability of statistics); and the establishment of formal and informal enforcement mechanisms. However, they also argue that opportunistic behavior is conditioned by the number of investment options; the level of the discount rate; and the track record of cooperation as a benchmark and signal.

While the second chapter focuses on the mechanisms to avert opportunistic behavior in order to sustain a common asset, in the third chapter, the authors discuss the
mechanisms to maximize relational capital. Based on extensive fieldwork conducted on the Italian motorcycle industry, Lipparini and Lorenzoni document a number of managerial actions aimed at leveraging the knowledge generated, accumulated, and transferred across a network of suppliers. For example, the design of relational structures supporting and fostering reciprocal learning processes, the creation of a trust-based relational environment, the early involvement of suppliers in knowledge generation activities, and the development of relational capabilities are deliberately designed management practices with positive effects on product innovation, therefore increasing both the lead firm’s and its network’s competitiveness. Their findings support the idea that in industries where know-how is broadly dispersed, a strategy aimed at maximizing a firm’s relational capital and creating a fertile environment for joint learning, efficiency, and flexibility can be a source of competitiveness despite industry restructuring threats. Indeed, this “relational capital” may be one reason why Italian motorcycle companies such as Ducati, Piaggio, and Aprilia have thrived despite the entry of the Japanese producers, Yamaha, Kawasaki, and Honda, whereas others in Europe (e.g. France and UK) have not.

While the previous chapter focuses on the mechanisms to maximize relational capital to maintain industry and network competitiveness, the fourth chapter discusses the importance of the content behind those relationship ties. Yao and McEvily introduce the concept of “knowledge landscape” to describe the distribution of knowledge in alliance networks. This landscape can be evaluated by mapping the size of a company’s knowledge stock, the Euclidean distance between the firm’s and its partner’s knowledge stocks and finally the Euclidean distance among its partners’ knowledge stocks. The authors suggest that a firm’s position in its knowledge landscape affects the quality and diversity of the information and knowledge it is exposed to, and thereby its innovation performance. They indeed find empirical support for these assertions from studying over 150 alliances based in the global pharmaceutical industry. The results suggest that despite the decreasing trend for new drug approvals, increasing research and development budgets, and an ever consolidating pharmaceutical industry, those companies could improve their innovative outcomes by optimizing the knowledge landscape in which they are embedded.

The final chapter in the Industry and Network Competitiveness section concerns the changes that companies must embrace as they are increasingly faced with an environment of increasing complexity. Historically, companies attempted to avoid complexity and concentrate on strong environmental signals through organizational streamlining and simplification. However, in this chapter, the authors, Morieux, Blaxill, and Boutenko skillfully show through signal theory, network topology, and organizational sociology, the implications of the rising supply and demand for interactions: noise. They suggest that organization structures that “face” complexity and “leverage” weak signals will succeed in maximizing interaction value. The authors argue that organizations such as Cisco, which “face” complexity, have built up very successful and dense horizontal communities of practice where customer ideas and problems can be quickly solved through internal networks of contacts. They also argue that incentives should be designed to increase interactions rather than avoid them and that information and communication technologies should be focused on increasing effectiveness (value-generating ideas) rather than improving organizational efficiency.
In summary, those companies that can use mechanisms to avert opportunism and maximize relational capital, optimize their knowledge landscapes across organizational boundaries and organize their structures to embrace complexity, are likely to perform better individually and collectively, as a network of partners or as an industry as a whole, during periods of industry structuring and restructuring – as we have witnessed throughout these past couple of years. However, there may be strategies that entrants and incumbents can still deploy that position them particularly well during these tumultuous periods. It is to these individual company strategies, we now turn.

Successful Business Strategies in Industry Structuring and Restructuring

The second section of the book concerns successful business strategies during periods of industry structuring and restructuring. In an environment of increasing volatility, complexity, and uncertainty, how do new industry participants survive? How do incumbents respond? The following chapters emphasize a similar theme: the importance of strategy. Each chapter highlights this theme from a slightly different perspective. For example, the sixth chapter suggests that small companies entering into a new rapidly growing industry should focus on a particular area of expertise and should not grow too quickly (especially through acquisitions). The seventh and eight chapters argue that incumbents need not immediately enter into new arenas despite being potentially disrupted by upstarts. They can delay entry as they have the requisite complementary assets or robust product development capabilities, which may take entrants several years to develop. Finally, when faced with transferring competitive advantage, incumbents seem to be better off copying exactly their existing practices rather than adapting to local circumstances.

The sixth chapter illustrates a period of industry structuring in its purest form. E-consulting, the industry under study, experienced a dramatic rise in demand triggered by the introduction of the Internet. As a result of the many changes the Internet created, many company executives began assessing their own business and technology strategies, their marketing, sales, and pricing activities, their operations and organizational structures, and their relationships with customers, suppliers, alliance partners, and employees. Many “old economy” firms felt at a significant disadvantage (rightly or wrongly) to their “new economy” start-ups. E-consulting became a booming industry as old and new economy companies looked for help to navigate through the complexity. Yet, as Prats and Nanda show, the e-consulting party did not last particularly long, a phenomenon they refer to as “an entrepreneurial bubble.” Through an exploratory cluster analysis of the performance drivers for 31 newly formed e-consulting firms over the period January 1998 through December 2001, the authors determined that those competitors who stuck to their strategies were most likely to survive through both periods. They found that those firms which sustained superior performance throughout the mania and shakeout periods of the bubble did not get embroiled in the rapidity of change. Rather they focused on a narrow rather than broad portfolio of skills, expanded organically rather than through acquisition, and finally grew less rapidly than those companies which only succeeded during the expansionary period of the industry.
While the previous chapter focused on robust strategies for entrant firms in a newly forming industry, Chapters 7 and 8 focus on optimal response strategies for incumbents facing a potentially disruptive technology. In Chapter 7, the authors, Lévesque and Shepherd, propose a theoretical model that determines an incumbent’s optimal time of entry. Their model takes into consideration (1) the possible tradeoff between profit potential and mortality risk in early entry, (2) the incumbent’s stock of resources and the value of those resources relative to those of the pioneer(s), and (3) any changes in the external environment that may affect entry timing. Lévesque and Shepherd provide a very useful example of their model using a “bricks and mortar” retail firm entering the “virtual” grocery market place. In Chapter 8, the author, Neil Jones, empirically examines one of the previous model’s effects: the incumbent’s stock and value of resources compared to the entrants’, in particular “robust” product development capabilities. Jones develops and tests the impact of such capabilities following radical competence-destroying technological change, in this case, the switch from electromechanical to semiconductor component systems in the telephone switching industry. Using data drawn from 39 product development projects over a 16-year period, Jones found that while entrant firms initially possessed superior capabilities in the new technology, over the medium and longer term incumbent firms through their robust product development capabilities improved more rapidly and eventually outperformed entrants. This finding suggests that incumbent product development capabilities may be positive or negative depending on the time frame considered. Furthermore, incumbent firms may manage technological transitions more effectively in the long run than has been contemplated by the recent literature.

While Chapter 6 examined the robustness of entrants’ strategies in periods of industry restructuring or industry shakeouts and Chapters 7 and 8 showed how important the existing incumbent firm resource base is in surviving and indeed thriving during industry turmoil, Chapter 9 focuses on another critical area of complexity: how assets should be configured in different environments. How robust is a business model across borders? In particular, Szulanski and Jensen examine how the internal transfer of knowledge assets should be adapted to fit local conditions in a host environment. Given that the ex-ante understanding of a host environment, even for the host, is limited, the configuration of knowledge assets when adaptation begins may differ from the final form when adaptation efforts abate. In this chapter the authors explore the impact of one possible adaptation mode, an initial adaptation based on a presumed understanding of the host environment. Through an in-depth field investigation of an international expansion of a franchise organization, Mail Box etc., Szulanski and Jensen explore how adherence or non-adherence to recommended franchise expansion practices affects the rate of network growth in the host country, in this case, Israel. The authors find, contrary to received wisdom, that initial changes or presumptive adaptation causes poor network growth, while closely following the original practice results in rapid network growth. Thus, similar to the previous chapters, successful strategies can be robust across several different environments and that adaptation based on presumed understanding of the environment can ultimately be detrimental to performance.

In summary, we see from these brief chapter summaries that successful companies faced with tremendous environmental change whether it comes from severe demand
decline, technology shifts or geographic differences can rely on robust strategies. Rather than immediately shifting according to the environmental change, collectively these chapters suggest that relying on the qualities of the existing strategy – focus, use of complementary assets, and well-honed routines and capabilities – can often enhance not only the company’s survival but also performance. Yet, ultimately it is the quality of management and corporate governance which translates this focus, use of complementary assets, and well-honed routines and capabilities into actions that will allow companies to successfully navigate through these tumultuous periods, the subject of the last section of the book.

Superior Management and Governance Practices

The last section of this book concerns how companies can be steered in the proper directions through management or corporate governance practices. In an environment of increasing volatility, complexity, and uncertainty, what should management do? How important are top and/or middle management’s actions? How much should they be constrained by corporate governance practices? What corporate measures work during these periods of industry structuring and restructuring? Each chapter in this section provides a glimpse of the newest thinking on managerial and corporate governance practices especially during these periods. For example, the tenth chapter suggests that managerial actions rather than resource heterogeneity explain performance differences across companies within a similar industry. The eleventh chapter indeed illustrates how managerial actions, in this case, middle manager entrepreneurial behavior, can be so performance enhancing. Finally, the last two chapters argue the importance of the process rather than structure of corporate governance in enhancing decision quality and ultimately corporate performance.

The tenth chapter shows that the current thinking behind the source and sustainability of competitive advantage, the resource-based view, requires reconsideration. The authors indeed provide a telling example of one reason why. The resource-based logic would suggest that no Idaho farmer who grows potatoes and has access to essentially the same resources – seed potatoes, fertilizers, equipment, and labor, weather, air, water and soil quality – would realize a competitive advantage vis-à-vis other farmers in the region. Yet, some farmers clearly enjoy a competitive advantage as evidenced by their survival, expansion, and wealth relative to their neighbors, some of whom are forced into bankruptcy. Hansen, Perry, and Reese argue that these gaps between theoretical and practical utility of the resource-based view come from the overgeneralization and vagueness in the specification of the relationship between resources and competitive advantage. However, the authors suggest that the gap can be narrowed in two ways. First, the connection between resources and competitive advantage may be enhanced by the explicit recognition of Penrose’s (1959) distinction between resources and services. This distinction suggests how important managerial actions are in converting resources into valuable services. Second, Hansen, Perry, and Reese argue that the statistical techniques should reflect that the resource-based view is a theory about extraordinary performers or outliers rather than means. The authors use a novel Bayesian Hierarchical methodology to examine
actions taken by new CEOs that allows one to make meaningful probability statements about individual rather than groups of firms.

While the authors in the tenth chapter argue how important managerial action is to transform resources into services, the eleventh chapter provides some empirical support. Mair argues that despite prior research on middle management, we still do not know whether and how their behavior translates into superior performance. This chapter thus examines whether and how middle manager entrepreneurial behavior within the same corporate context affects profitable growth at the sub-unit level. Empirical analysis on 118 middle managers of a large Dutch financial services firm suggests that entrepreneurial behavior does trigger profitable growth at the sub-unit level through the innovative use of resource combinations to explore and exploit opportunities. Furthermore, the results reveal that personal and unit-specific characteristics are significantly related to superior performance.

Even if the quality of management is at the heart of making good strategic decisions especially during periods of industry structuring and restructuring, their actions still need to be checked and monitored to ensure that those decisions are indeed in the best interests of the shareholders. In fact, the response to many of the latest corporate governance scandals – Tyco, Enron, Adelphia Communications, etc. – has been to increase the degree of monitoring through newly enacted laws such as the Sarbannes–Oxley Act in the US and KonTraG in Germany. Yet, as the authors, Nippa and Petzold, argue in Chapter 12, increased uncertainty coupled with bolstered external monitoring and pressure can trigger managerial reaction and ultimately costly justification behavior in the form of modifications to previously made decisions, decision-making processes or interactions between shareholders and management. Under increasing justification pressure, top management may deviate from their intended decision and conform to the shareholder view, which may not necessarily be economically favorable. For example, Kodak may cave in to the demands of shareholders to reinstate its dividend rather than spend it on digital photography pursuits to enhance the survival of the company. Furthermore, justification pressures may make top management spend more resources on evaluation, information gathering and selection issues resulting in decision delays, extra time, and cost. Finally, managers may increase their reporting to shareholders through investor relations, improve the translation of their actions into shareholder friendly terms, may spend effort obtaining outside certification of their decisions by well-known consultants and/or further educate shareholders through investor conferences. All of these efforts also take time and cost money. Indeed, the authors are the first to show the importance and cost of this phenomenon “justification” in strategic decision making that may limit the perceived benefits of increasing corporate governance pressure.

In addition to increasing monitoring, the received view in corporate governance has been to focus on board structure and independence as mechanisms to improve strategic decision making and ultimately corporate performance. However, in the final chapter, authors Mooney and Finkelstein argue that these “usual suspects” concerning board structure and independence – the number of outside board directors, director shareholdings, board size, and whether the chief executive officer (CEO) also holds the Chair position – do not always ensure a board is truly effective. Rather,
they argue that board process is the key to making boards work better. Based on structured interviews with members of corporate boards, the authors suggest a number of process mechanisms that may improve the effectiveness of boards on strategic decision making. Constructive or cognitive conflict allows the members to debate the specific decision at hand without members feeling threatened through affective conflict. Building an integrated team enables easy information exchange and joint decision making. Finding the right degree of decision involvement ensures that the board is not micro-managing. The importance of decision comprehensiveness ensures that the board is drilling down to understand the specific issues of each decision. Finally, the authors provide some suggestions as to how boards could improve these process mechanisms, thus enhancing their effectiveness overall and the quality of a company’s strategic decisions.

In summary, we find from these brief chapter summaries that above all it is the quality of management, and corporate governance practices that will navigate incumbents and entrants through these periods of industry restructuring and restructuring. Personal characteristics and entrepreneurial behavior, especially at the middle management level, allow an incumbent to maintain its position while exploring new opportunities at a local level. Finally, corporate governance processes where there is a healthy, informative, constructive dialogue between management and shareholders will likely result in superior decisions and ultimately improved corporate performance.

Conclusion

A common reaction to the increased pace of change that may result in radically altered industry structures has been to postpone strategy setting or abandon it. Many have argued that incumbents have to remain flexible. With the influx of so many companies during the Internet bubble, for example, the general conclusion was that companies had to be ready to change their goals and strategies virtually overnight. Some have argued that establishing a strategy is fruitless as it would be rendered obsolete immediately to the pace of environmental change (Stepanek, 1999). Thus, rather than focus on strategies and efforts that are robust through these periods of turmoil, companies would be better off learning, executing, refining etc.

Yet, strategy and uncertainty resolution go hand in hand. Strategies can shape the very industries that companies are trying to understand. Rather than being obsolete, the explicit setting of strategy, and the underlying factors that improve existing industry orders, network competitiveness, and incumbents’ positions, are in fact more important than ever. Qualities of the existing strategies – relational capital built through strong networks, focus, use of complementary assets and well-honed routines and capabilities – do seem to matter. Furthermore, the role of management and corporate governance is crucial in understanding how these strategies can be set and executed during these periods. This book thus sheds new light on this very important topic of restructuring strategy or how new and existing industries, firms, and management can best take advantage of the increasing pace of change that is facing them.
References


PART I

Industry and Network Competitiveness

2 Maintaining Collective Assets, the Tragedy of the Commons, and Supply Chain Performance: The Case of the Champagne Industry  
Karel Cool and James Henderson

3 Organizing around Strategic Relationships: Networks of Suppliers as Knowledge Generators in the Italian Motorcycle Industry  
Andrea Lipparini and Gianni Lorenzoni

4 Assessing the Knowledge Landscape across Firms in Alliance Networks and its Impact on Organizational Innovation Performance  
Beiqing (Emery) Yao and Susan McEvily

5 Generative Interactions: The New Source of Competitive Advantage  
Yves Morieux, Mark Blaxill, and Vladislav Boutenko
Introduction

The dominant view in supply chain management is that supply chain competitiveness comes from forging long-term recurrent bilateral relationships with a number of suppliers to maximize transaction value rather than minimizing transaction costs (see e.g. Dyer, 1997). Through exchange of information, coordinated decision-making, self-enforcing safeguards such as goodwill, and trust, hold up is minimized while suppliers make specific investments beneficial for the relationship (Dyer, 1997; Corbett et al., 1999). Yet this view and analysis of supply chain management underestimates the importance of horizontal coordination among the various players within each stage of the supply chain (see e.g. Sako, 1996; Lazzarini et al., 2001). Indeed, an increasing number of longer-term supply chain initiatives involve a large number of players both along the supply chain (vertical) and within each stage (horizontal) in building common assets: setting up new distribution channels such as satellite systems; agreeing on product standards and guarantees; introducing new technical standards (e.g. GSM, Bluetooth); developing payment system (e.g. smart-cards); creating industry-based research and development centers (e.g. Sematech, National Oil Research Alliance), building information systems (e.g. EDI, B2B exchanges); ensuring a collective reputation for quality (e.g. Japanese automobile exports, Cognac, Port, Rioja); or environmental responsibility (e.g. Responsible Care Program of chemical manufacturers) or marketing a common brand name (e.g. milk, pork, oil, gas, etc.). In such cases, the players involved may not only be linked vertically as buyer and suppliers but also horizontally as competitors.
Supply chain competitiveness may increasingly be linked to the abilities of other firms both vertically and horizontally in managing and nurturing common assets built up over time. For example, the competitiveness of the Japanese automobile supply chain due to its common asset, the high quality and reliability of its cars, has been linked to not only well-known long-term vertical contracts with its suppliers (see e.g. Dyer, 1997) but also the horizontal coordination of its supplier associations (Sako, 1996; Hines and Rich, 1998). Given that networks of firms or supply chains are increasingly competing with each other (see e.g. Gomes-Casseres, 1994), the lack of research on this topic is surprising (cf. Monge et al., 1998).

We argue that establishing and maintaining collective assets may not only be subject to hold up along the vertical axis of a supply chain but also the “tragedy of the commons” along the horizontal axis (see e.g. Hardin, 1968). Hardin (1968) developed the tragedy metaphor to illustrate the problems of non-contribution to and over-use of common resources such as fisheries, common pastures, or forests that are accessed by similar players. Hardin asked the reader to imagine what would happen to a common pasture if each herder were to add a few sheep to his herd. Since each grazer would reap all the profits from these extra sheep but bear only a fraction of the cost of overgrazing, the result would be a tragic loss of common pasture for the entire community. His conclusion was that “freedom in the commons brings ruin to all” (Hardin, 1968: 1244).1

Supply chain competitiveness hinges upon the development and proper use of collective assets (e.g. standards, brand names, reputation for quality) such that firms’ strategies are better coordinated, transaction costs are minimized; joint payoffs are increased, and all the players in the chain are better off. Yet these collective assets are prone to opportunistic behavior both vertically and horizontally: some firms may invest too little; others may abuse the collective assets, while others will hold out for higher profits. The purpose of this chapter, therefore, is to explore, to date, this under-researched topic: how collective assets are maintained and nurtured to improve supply chain performance while averting non-contribution, over-use and hold-up. The objective of this chapter is not to determine how a collective asset is established (see e.g. Monge et al., 1998 for propositions concerning the provision of public goods in alliances) but to explore how collective assets are maintained and nurtured in multi-firm partnerships (Dyer, 1997), networks (Sydow and Windeler, 1998) or constellations of firms (Jones et al., 1998) along a supply chain. We do so by exploring the mechanisms in which the French champagne supply chain has successfully managed its common asset, the reputation of the Champagne brand. We focus on two stages of the champagne supply chain, namely the growers and the houses2 and examine both their vertical and horizontal relations.

The chapter is thus organized as follows. We first highlight our research methods and describe the industry in which we carried out our field study. In the section thereafter, we build on an in-depth case study of the champagne industry to introduce a model for maintaining collective assets for supply chain performance. In so doing, we highlight the key drivers and how they may interact in nurturing a common asset. In the last section, we conclude by exploring the generalizability of this model.
Methods

We pursued our research by iterating inductive and deductive reasoning to develop our proposed model. While concerns for external validity and generalizability indeed remain, qualitative, historical research was chosen over pure deductive reasoning in order to gain greater insight into a phenomenon that has not been completely understood: the maintenance of collective assets through horizontal and vertical coordination (Yin, 1984; Eisenhardt, 1989). However, as we were studying the phenomenon, we compared our findings with transaction cost economics and public goods and commons literature. This way we were able to “infold the literature” on the topic (Eisenhardt, 1989).

Research setting

The model is based on 3 years of historical and field-based research on the functioning and dynamics of the French champagne supply chain, located southeast of Paris. The industry which represents approximately 7 percent of the total sales of sparkling wine worldwide, counts over 15,000 growers, 8,000 with less than one hectare (2.5 acres) of land; 4,500 grower-producers, 45 cooperatives and 260 champagne houses who grow approximately 10 percent of their own grapes. Champagne, similar to any wine, is an experience good such that the quality of the drink can only be ascertained after use. Thus, a consumer’s willingness to pay may be related to the reputation or information of the past quality of the Champagne brand. Given the vast numbers of players in the champagne supply chain, we may assume that consumers may base their decisions on the “collective reputation” of champagne (e.g. its superior product quality and brand image with respect to other sparkling wines) rather than, or in addition to, the reputation of one particular firm, such as Moet et Chandon, Laurent Perrier, Mumms or any of the champagne coming from the grower-producers (see e.g. Sharp and Smith, 1991). Indeed, in their study on Bordeaux wine, Landon and Smith (1997) found that both the individual firm’s quality and collective reputation of the regions (e.g. Medoc, Graves, Pauillac etc.) affected a consumer’s willingness to pay for a bottle of Bordeaux.

However, the large number of parties and significant uncertainty surrounding the weather and the long time lags between production and sale suggests that managing the collective asset, the reputation of the “Champagne” name, would be subject to a tragedy because of non-contribution, over-use and hold-up (see e.g. Stigler, 1964; Olsen, 1965). In the absence of any established rules, what rational grower or house would help to contribute to the reputation of the Champagne name when non-contributors could benefit as much as the contributors? Furthermore, unless certain incentives are established, the payoffs to “over-fertilizing” to increase the yields, to pressing the grapes a few more times, or to fermenting champagne for less than one year, far outweigh a grower-producer’s or house’s share of a common cost shared by all, the depreciation of the collective reputation of Champagne. Finally, the growers and houses could hold each other up over the distribution of the benefits from the
common asset thus tarnishing the industry’s reputation. Yet, despite these incentives to behave opportunistically through non-contribution, over-use and hold-up, the supply chain has been remarkably successful at maintaining the reputation of the name, Champagne. Prior to exploring the factors that contributed to this success, we first present the historical context and the data collected for the study.

**Industry background.** Grapes had been grown in the Champagne region for several millennia. However, it was not until the seventeenth century that local producers, including Dom Perignon and his Benedictine monks, developed a reliable method for the production of sparkling wine: “la méthode champenoise.” The first champagne house, Ruinart, was founded in 1729 under royal permission.

From its earliest days, the production of champagne was divided between two different groups of firms: the **récoltants** who grew the grapes and the **négociants** who fabricated and sold the champagne. The growers formed an association to represent their collective interests, Syndicat Général des Vignerons de Champagne (SGV) in 1882, and the producers a similar association, the Syndicat du Commerce des Vins de Champagne (SCVC) in 1904. In 1911, the two groups organized their first joint meeting to discuss pricing of grapes. However, little success was made in establishing formal price agreements. The following 25 years would see the development of laws defining the production of champagne (**appelation d’origine contrôlée**). It was also during this period, in 1927, that the grape growing area in the Champagne region was defined.

The industry’s first crisis occurred in the 1920s. Sales of champagne had peaked at 39 million bottles in 1910 but fell back to 12 million in 1921. In the same period, the Champagne region produced abundant harvests. Stocks reached 150 million bottles in 1934, over 5 years’ supply; the price of grapes crashed. The growers were starving and showed their anger by rioting in the streets of Reims, the capital of the Champagne region. Action was taken by the government and professional bodies: a decree of September 28, 1935 limited the yield per hectare of vineyard and specified production quantities. The surplus began to reduce. Since then, annual meetings have been held between the growers, producers and the government to determine the amount of grapes (in kilos per hectare) that benefit from the appellation designation. Production above this amount was turned into wine, distilled or trashed.

After 6 years of successful negotiations, the growers and houses instituted a state-approved inter-industry body: the Comité Interprofessionel du Vin de Champagne (CIVC), which represented the interests of both parties. The organization defined its role quite broadly: to act as a forum for organizing the yearly negotiations, to act as a center of information and research on the industry, to conduct research and development on champagne growing and production methods, and to provide marketing assistance for the Champagne brand. Agreements covered a number of issues: price, yield, number of pressings, and the minimum alcohol quantity, for a period of up to 6 years. These agreements were the beginning of a new period of prosperity and stability that lasted approximately 30 years.

In 1971, the era of the multinational “luxury good” company arrived in Champagne when Moët et Chandon, then controlling 25 percent of the market, merged with the cognac firm, Hennessy, and later took over the House of Dior.