15.903 Wrap-up

R. Gibbons, Spring 2001

1. Overview
   a. What was this course about (and why)?
   b. How does it fit at Sloan (and why)?

2. Substantive Areas
   a. Incentives
   b. Structure
   c. Culture
   d. Boundaries
   e. Hybrids

3. Outside Contributors
   a. Judy Lewent
   b. John Reed

4. Conclusion
   a. Organizations are a mess but not a mystery.
   b. What you might do about it.
   c. Next step
1a. What was this course about (and why)?

This course has been about organizations. (All the shadings in the Venn diagram are in the 311 circle.)

This focus was chosen for several reasons:

1. Understanding organizations is important:
   a. Feedback from 5 years out: “Wish I knew more about organizations.”
   b. Reed lectures: 1/4 strategy, 3/4 management
   c. Tech. Strat. = 1/2 delivering value
2. Organizational capabilities (especially management processes) are important for strategy, even for BUs and stand-alone firms:
   a. implementation: need org to execute strat
   b. constraint: can’t do strat b/c can’t do org
   c. inspiration: invent strat to utilize org

3. Corporate strategy is largely organizational:
   a. What corporate value will we create, & for what BUs?
   b. How will we deliver this value?
   c. Why will this be profitable?

4. Cutting edge of strategy research and practice:
   a. 1980s: industry analysis (Porter)
   b. 1990s: core competencies (Prahalad & Hamel)
   c. 2000s: ??

What figure will go here?
1b. How does it fit at Sloan (and why)?

1. First-year fall core courses don’t have time:
   a. 010 hasn’t time for organizations
   b. 311 hasn’t time for economics
   c. 900 hasn’t time for corporate strategy

2. Second-year electives (e.g., tech strat and e-bus) shouldn’t reinvent the wheel:
   a. Don’t haven’t time to develop much basic theory
   b. Duplication of basic theory in each elective would be inefficient

3. As quasi-core course between fall core and second-year electives, this course is more abstract than hands-on:
   a. Reed: “Sloan saved me 15 years.”
   b. We developed models that are simple enough to be useful.
2a. Incentives

Framework: \[ w = s + bp + B(y) \]

Issues / Lessons:

1. Alignment / Get what you pay for (LN 2)
2. Good performance measure induces valuable actions; not necessarily highly correlated with total contribution. (LN 2)
3. There are lots of sources of incentives, even if relatively few incentive contracts: hold-up, relationships, fear of firing, career concerns, and intrinsic motivation.
4. If successful incentives can be created by just a formula, then consider outsourcing. (Free Lunch Challenge)
5. Importance of and difficulties in managing relationships (LN 3; CSFB)
   a. manage the extremes
   b. grow the value of the relationship
   c. know when to stop (and when to start)
   d. conceive, communicate, implement, change
6. When is an incentive problem just an incentive problem? Incentives → HR → orgzn → strat. (At BBF law firm, comp pbm = strat pbm)

7. Fit / complementarities → core comp → rigidity. (Lincoln’s system will not work everywhere, and is hard to change at Lincoln.)

Central cases:

Lincoln Electric: They understand formula vs. relationship, and also that incentives are part of a larger system, but it’s tough to change their system or spread it to new BUs.

CSFB: Miscommunication can kill relationships. But when the world changes, it’s sometimes optimal to renege. Perhaps CS corporate strategy drove reneging.

BBF law firm: Not about finding a better formula. Instead, should jointly optimize incentives, organization, and strategy.
2b. Structure

Framework: function-product-geography
meets
formal-informal

Issues / Lessons:

1. Structure should implement strategy, usually with grouping on dimension of greatest importance. (Rubbermaid)

2. There is no perfect structure, because grouping on one dimension short-changes another. Even “bureaucracy has its purposes.” (Appex, Citi Euro)

3. Linking mechanisms can and should have different weights: lightweight team, heavyweight team, autonomous team. (Rubbermaid vs. Oticon)

4. Reasons to change structure (Citi Euro, Appex):
   a. change in strategy
   b. change in firm (capabilities, personnel)
   c. change in environment

5. Reasons to change in steps (Citi Euro, Appex):
   a. hedge and/or experiment
   b. build skills
   c. gain buy-in / avoid reneging
6. Decision rights within organizations are (mostly) held at the top. (J&J, Oticon)

7. Therefore, “confidence can only be rented, never owned.” (Rubbermaid, LN 4.5)

8. Irrevocable empowerment / autonomy comes from spin-off. (Oticon, LN 4.5)

9. Informal structure (network, water cooler) often at least as important as formal structure. (ABB)

10. Structure can be rhetorical device to communicate strategy. (Appex?)

Central cases:

Citi Euro: Restructuring is hard, even after competitive environment changes.

ABB: Matrix is key to strategy (3 contradictions), but requires enormous management effort and capability on informal side.

Appex: Reasons to change in steps. Structure as communication device?

J&J: Empowerment is a promise, and not a blank check.

Oticon: Structure “was the strategy,” but (most) decision rights still at the top. Possible reneging by CEO, project leaders.
2c. Culture

Framework: artifacts-espoused values-unconscious assumptions meets clarity-credibility

Issues / Lessons:

1. Culture should implement strategy. (Guarantee Trust, Saturn, Oticon)

2. Culture has both normative and cognitive aspects: should do vs. taken for granted.

3. Clarity (“What does this mean?”) and credibility (“Should I believe it?”) are crucial. (Saturn, Oticon)

4. Stories and actions for clarity; actions for credibility. (Guarantee Trust, Saturn)

5. Update culture to reflect new strategy, organization, or environment; challenge culture to reaffirm clarity and credibility. (J&J)
Central cases:

Guarantee Trust: Culture (in opposition to field) “was the strategy,” but failed to update.

Saturn: Stories and actions for clarity and credibility.

J&J (& Lincoln): Role of “founder” in achieving clarity and credibility of culture.

Novartis: Difficulties with clarity and credibility of new culture in merged firm.
2d. Boundaries

Framework:

![Diagram showing upstream and downstream parties, asset partitioning, and alternative use](image)

(Note: “contractible component” from Appendix of LN 5.)

Issues / Lessons:

1. Causes of integration:
   a. reduce rivalry
   b. efficiencies
   c. agency problems
   d. fashion in capital market
2. Porter’s reasons to diversify:
   a. portfolio
   b. restructuring (→ sell)
   c. share activities
   d. transfer skills

3. Modern corporate strategy: Porter meets Lewent
   a. purpose?
   b. alternative governance structures?
   c. control rights?
   d. relational contracts?

4. Hold-up (= opportunistic renegotiation) may be your friend: \( Q = a + \varepsilon, P = a + \phi \) vs. \( Q = a_1, P = a_2 \). (Schmalensee: “Problems we like to have.”)

5. Formal method (e.g., contract) for solving one hold-up problem often creates another. (GM-Fisher)

6. There are (formal and relational) incentive contracts between as well as within firms, and “Get what you pay for” problems, too. (Chrysler, Crown Equip.)

7. Integration (or formal contract) often provides control but destroys good incentives along with bad. Under non-integration, \( U \) gets \( P + \alpha(Q-P) \). (HGA, LN 5)

8. How to recreate non-integration’s good incentives for divisions within the firm? (BMGI, GE, LN 6)
Central cases:

<table>
<thead>
<tr>
<th>Company</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Crown Equip.</td>
<td>Relational contracts between firms as well as within. Core comp is relationship management, not design.</td>
</tr>
<tr>
<td>Chrysler</td>
<td>Interaction between formal and relational contracts: SCORE + “We want your ideas, not your margins.”</td>
</tr>
<tr>
<td>GM-Fisher</td>
<td>Contracts and ownership as responses to hold-up, but how to create incentives for Fisher division?</td>
</tr>
<tr>
<td>HGA</td>
<td>Non-compete and golden handcuffs could lock in Alexander, but at what cost?</td>
</tr>
<tr>
<td>Kraft</td>
<td>PM acquisition of GF shows efficiencies, agency problem, or valuation? Kraft-GF merger shows efficiencies, but stages of merger like stages of structure?</td>
</tr>
<tr>
<td>GE</td>
<td>Sharing activities and transferring skills (individual and organizational), but if Welch is decisive factor and/or restructurings are complete, then consider break-up(s)?</td>
</tr>
</tbody>
</table>
2e. Hybrids

Framework: make-or-buy meets relationships

→ improved tradeoff between incentives and control

(see figures)

Issues / Lessons:

1. 4Qs of modern corporate strategy (XTV, Crown Equip., LoJack):
   a. purpose?
   b. governance structure?
   c. control rights?
   d. relational contracts?

2. 3Qs of (slightly dated?!) corporate strategy (GE):
   a. what corporate value for what BUs? = 1a
   b. how to deliver? = 1b, 1c, 1d
   c. why profitable? Often = 1d. (Lincoln, J&J, Crown Equip.)
3. Diagnosing failed relationships (CSFB, Chrysler, XTV, Oticon; Novartis?)
   a. promisor didn’t get it?
   b. promisor didn’t explain it?
   c. extreme fluctuation or permanent change → optimal to renege (LN 3)

Classic cases:

XTV: Xerox exercised right to repurchase!
LoJack: Lives of a deal: different purpose, different capabilities, different control rights.
Lewent: See below
Crown Equip.: See above
Oticon: Irrevocable autonomy comes from spin-off.
3a. Judy Lewent: The Real B2B

1. Purposes:
   a. expand product set
   b. access complementary R&D
   c. drive new growth complementing core businesses

2. Alternative governance structures:
   a. acquisition
   b. contract
   c. JV

3. Control rights:
   a. Acquisition: unilateral management control, but pay premium and may lose key employees
   b. Contract: use for straightforward transactions, where contract can give sufficiently high control over relevant assets – V(a,b)
   c. JV: leverage partner’s expertise – V(a, A, b, B)

4. Relational contracts (and their management):
   a. JV has management costs: V(a, A, b, B) – c
   b. Lives within a deal: restructure the relationship
   c. “…listening, paying attention, spending time, and having the right chemistry on a personal level.”
3b. John Reed: The Architecture of Management

1. Leadership (drawing from Schein):
   a. capture attention
   b. motivate action
   c. establish values, style, culture

2. Language (from Processes):
   a. “most important tool; worth investing the time”
   b. numbers are a language, but horribly incomplete (The Fallacy; “a number is an adjective”)
   c. balanced scorecard = “framework to excite discussion” (≠ formula)

3. People:
   a. Evaluate: what was done, under what circumstances, what was not done, and how was it done. (Judgment, subjectivity.)
   b. Invest in evaluation (and coaching and communication and culture-building).
   c. The contract: what is expected of me and what can I expect of the organization?
4a. Organizations are a mess but not a mystery.

Coase (paper = 1937; Nobel = 1991):

If markets were perfect, why would we need firms?

$\rightarrow$ Some markets must entail “transaction costs.”

![Diagram showing Social Surplus, Transaction Difficulty, Firm, and Market]

Heckman (paper = 1976; Nobel = 2000)

If two actors make different choices, they may be solving different problems.

$\rightarrow$ Be careful drawing inferences about the true effects of the choices.

Example: Observed markets may be more efficient than observed firms because firms exist to solve hard problems.
4b. What you might do about it.

Coase meets Porter, Lewent, Reed, and Welch:

Porter: do not integrate without very good reason (share activities, transfer skills)

Lewent: manage relationships in JVs and in contracts between firms, but note that \( \pi = V(a,b) - c \)

Reed, Welch: formal rules, procedures, and formulas are only limited help; management capabilities requiring judgment, subjectivity, and discretion are key

\[ \Rightarrow \text{build and manage relationships within and between firms} \]
4c. Next step

You are now at the frontier in MBA teaching and near the frontier in management practice and research.

Teaching: rough edges, guinea pigs, feedback  
but first leading b-school to bring econ to org (to strat) in core course (and hence in electives)

Practice: 4Qs & XTV @ Merck

Research: LN 4.5 is 1999 paper  
LN 6 is 2001 paper (see e-mail)  
Appendix of LN 5 is 2001 paper

Sloan’s mission states that we will:

“Conduct rigorous and creative research that advances management theory and drives innovation in management practice.”

“Continuously improve our educational programs to reflect advances in management theory and practice.”

Next step: impress Rebecca in Tech Strat!