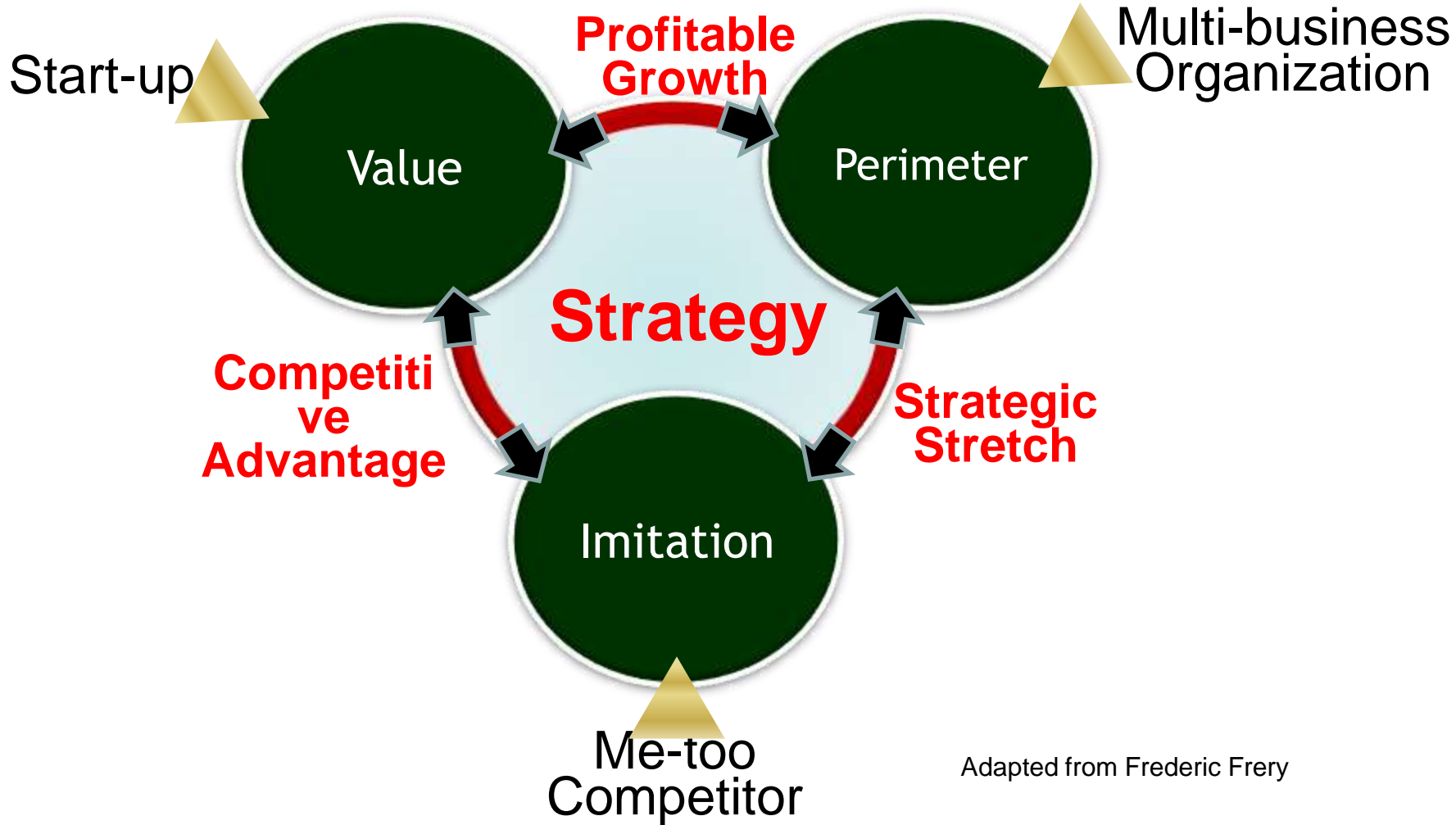




# Fundamental dimensions of strategy

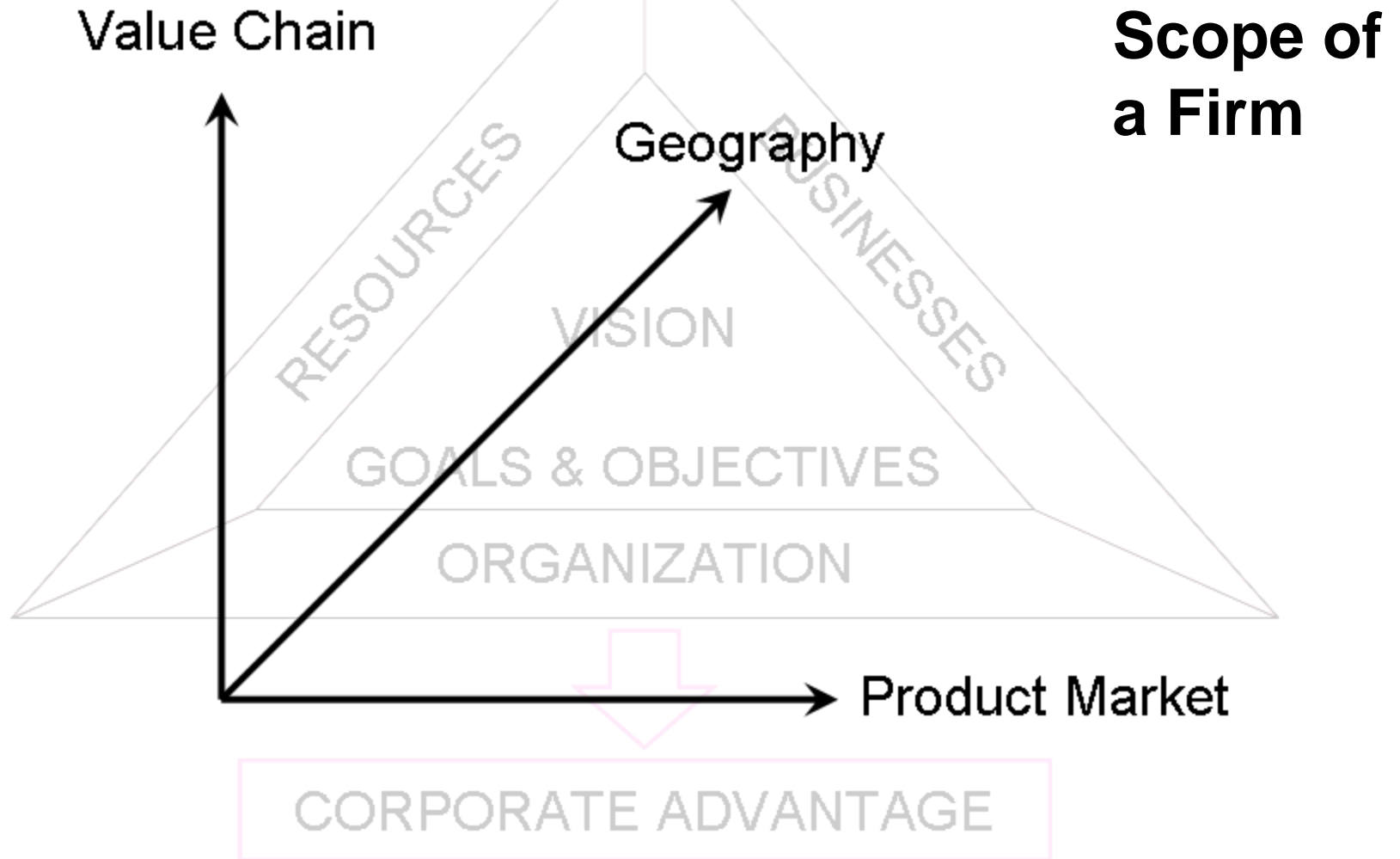
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Adapted from Frederic Frery



# Businesses Horizontal Boundaries of The Firm








# Corporate Strategy and Shareholder Value Creation

<b>M&amp;A Wave Era</b>	<b>Portfolio Management</b> (1960s, 1970s)	<b>Restructuring</b> (1980s)	<b>Transfer of Skills / Sharing Activities</b> (1990s...)
<b>Corporate Role</b>	<i>Passive:</i> Banker/Investor; Antitrust law	<i>Active:</i> Surgeon; Asset stripping	<i>Active:</i> Coach & Architect
<b>Focus of Strategy</b>	Business Portfolio; Conglomerates	Coordination of businesses; Divestitures	Sharing of knowledge; Relatedness hypothesis
<b>Operational Approach</b>	Lowering costs of capital, increasing financial cash flows; managerial synergies	Higher operating cash flows	Coordination of resources; Economies of scale and scope



# Corporate Strategy and Shareholder Value Creation

<b>M&amp;A Wave Era</b>	<b>Portfolio Management</b> (1960s, 1970s)	<b>Restructuring</b> (1980s)	<b>Transfer of Skills / Sharing Activities</b> (1990s...)
<b>Results</b>	Efficient markets; Conglomerate discounts: the whole less valuable than the sum of its parts    Many distressed businesses result in widespread divestiture	Dept financed M&A by raiders beneficial, full-blown M&A less beneficial    Partly beneficial, but “debtism” occurs, limiting ultimate success	Potential for creation of value high, post-M&A management crucial (implementation failures, excess bidding)    The brave new world of corporate synergy?



# The Three Tests

- The attractiveness test
- The cost of entry test
- The better off test



# Horizontal Boundaries of The Firm

## Session Outline

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- Economies of scale and scope.
- Where do economies of scale & scope come from?
- Special sources of economies of scale and scope.
- Sources of diseconomies of scale.
- The learning curve



# Think of...

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- Horizontal boundaries: How big a market does a firm serve?
- In some industries a few large firms dominate the market (Commercial aircraft manufacture)
- In others, smaller firms are the norm (Apparel design, Universities)
- There are several industries where large firms and small firms co-exist (Software, Beer, Banks, Insurance companies)
- What determines the horizontal boundaries of firms?
- How should a firm optimally choose its horizontal boundaries?



# Determinants of Horizontal Boundaries

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- Economies of scale
  - Declining average cost with volume
- Economies of scope
  - Cost savings when different goods/services are produced “under one roof”
- Learning curve
  - Cost advantage from accumulated expertise and knowledge



# Economies of Scale

- When the marginal cost is less than average cost, there are economies of scale
- Example: Computer software. The marginal cost of reproducing a CD is negligible compared with the huge fixed cost associated with software development



# U-Shaped Cost Curve

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- Average cost declines as fixed costs are spread over larger volumes
- Average cost eventually start increasing as capacity constraints kick in
- U-shape implies cost disadvantage for very small and very large firms
- Unique optimum size for a firm



# L-shaped Cost Curve

- In reality, cost curves are closer to L-shaped curves than to U-shaped curves
- A minimum efficient scale (MES) beyond which average costs are identical across firms



# Economies of Scope

- Firm 1 produces two products: A and B
- Firm 2 produces A only
- If the cost of producing A is smaller for Firm 1 than Firm 2, there are economies of scope



# Economies of Scope

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- $TC(Q_A, Q_B) < TC(Q_A, 0) + TC(0, Q_B)$
- $TC(Q_A, Q_B) - TC(0, Q_B) < TC(Q_A, 0) - TC(0, 0)$
- Production of B reduces the incremental cost of producing A



# Economies of Scope

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- Common expressions that describe strategies that exploit the economies of scope
  - “Leveraging core competences”
  - “Competing on capabilities”
  - “Mobilizing invisible assets”
  - Diversification into related products



# Economies of Scope

- The terms “Economies of Scale” and “Economies of Scope” are sometimes used interchangeably
- Managers may cite economies of scale and scope (even when they do not exist) to justify investment in growth



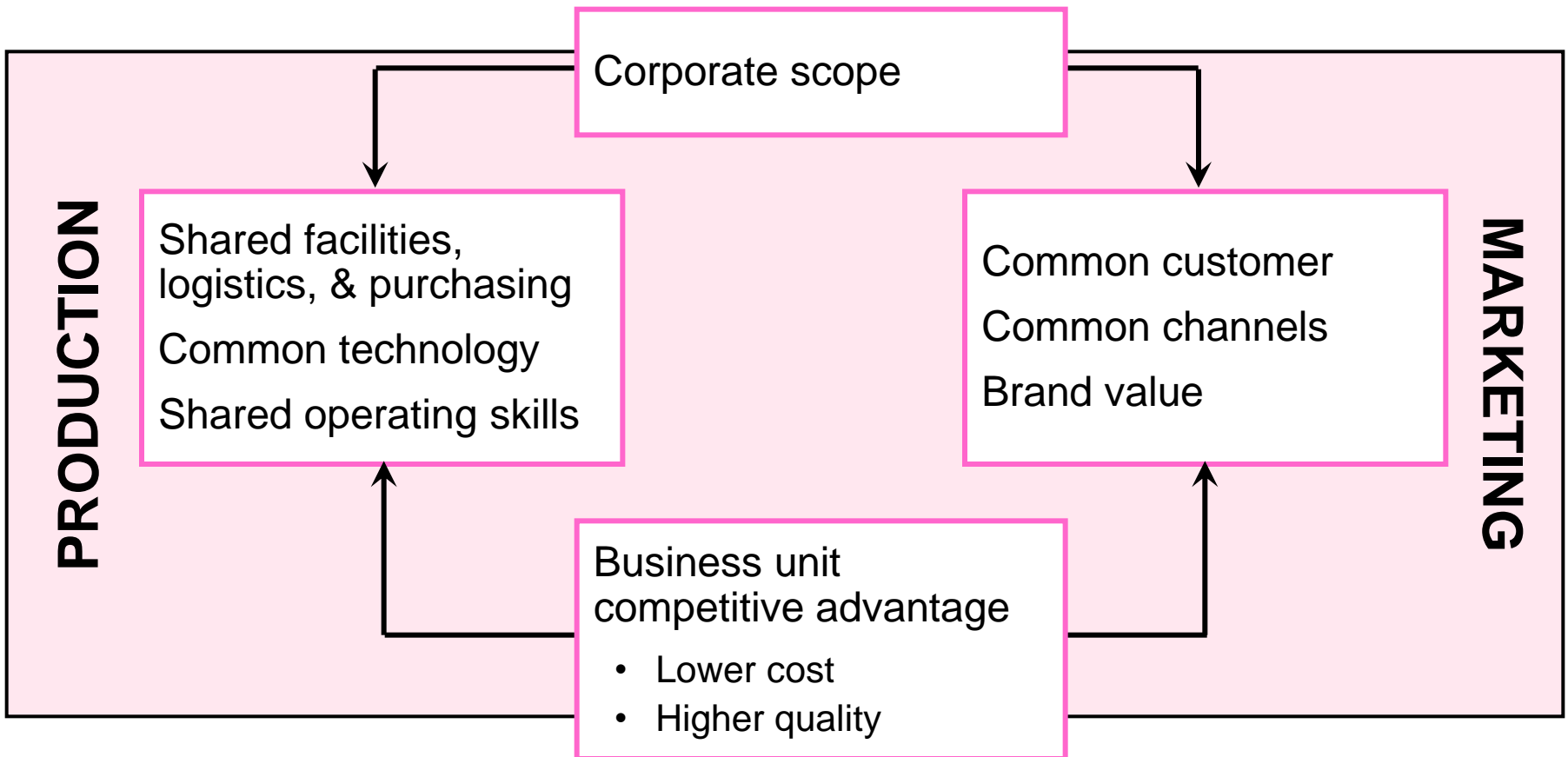
# Some Sources of Economies of Scale/Scope

1. Indivisibility & Spreading of fixed costs
  1. Product specific fixed cost
  2. Tradeoff among alternate technologies
  3. Capital intensive production processes
2. Increased productivity of variable inputs
3. Saving on inventories
4. The cube-square rule
5. Other sources: purchasing, advertising, R&D, complementarities & strategic fit



# Advantages of Economies of Scope

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# Diseconomies of Scale

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- Beyond a certain size, bigger may not always be better
- The sources of such diseconomies are
  - Increasing labor costs
  - Bureaucracy effects  
(AOL Time Warner Merger and Economies of Scope)
  - Scarcity of specialized resources
  - “Conflicting out”



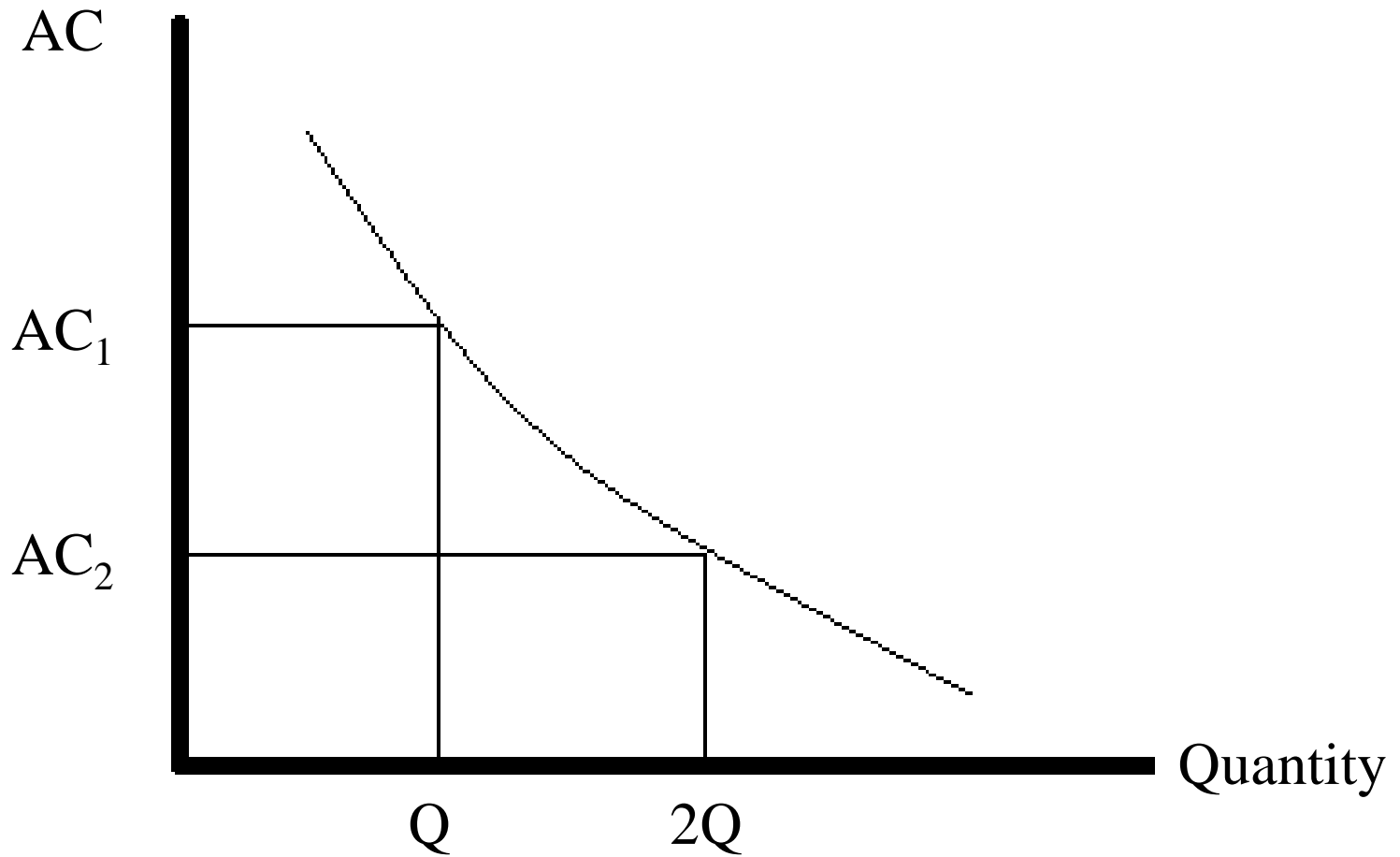
# The Learning Curve

- Learning economies are distinct from economies of scale
- Learning economies depend on cumulative output rather than the rate of output
- Learning leads to lower costs, higher quality and more effective pricing and marketing



# The Learning Curve

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# Slope of the Learning Curve

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- Slope of the learning curve is the relative size of the average cost when cumulative output doubles
- A slope of 0.9 indicates that the average cost will decline by 10% when the cumulative output doubles
- Learning flattens out over time and the slope eventually becomes 1.0



# Individual Learning and Organizational Learning

- Learning resides with individuals
- Organizational learning includes expertise that individuals have and the way they complement each other
- Worker mobility can lead to loss of expertise in the organization
- On the other hand, reducing job turnover may stifle creativity



# Learning Curve and Scale Economies

- Learning reduces unit cost through experience
- Capital intensive technologies can offer scale economies even if there is no learning
- Complex labor intensive processes may offer learning economies without scale economies