university of groningen

faculty of economics and business

Fight, Flight, Fit or Follow?

An evaluation of potential survival strategies for energy incumbents in a changing world

Dr. Killian J McCarthy
University of Groningen

k.j.mccarthy@rug.nl

Background

- Professor of Strategy, Faculty of Economics and Business
  - Economist by Training
  - Director of the MSc Strategy Programme (80 students)
  - Manager, Center for Energy Economics Research (CEER)
- Societal themes in Groningen
  - Healthy Ageing
  - Sustainable Society
  - Energy

ER GAAT NIETS BOVEN GRONINGEN

EFMD EQUIS ACCREDITED

AACSB ACCREDITED

Big Idea

- The climate is changing: 400 ppm
- Political and social pressures to change.
  - COP 21 Targets introduced to maintain 1.5c
  - Energy industry = 30% of emissions
- Energiewende as an example of what's to come
  - What was the impact on the firms?
  - E.On and RWE: -70% (between 2007 and 2014)
  - E.On: down from €92 billion to €53.5 billion
  - RWE: down from €25.6 billion to €15.5 billion

Big Idea

To consider which of the ‘big’ strategies in the strategy literature could be used to save the current energy incumbents.

Big Idea

Transaction Cost Theory

Theory of Competitive Advantage

Theory of First Mover Advantages

Theory of Non-Market Strategy

Theory of International Business Theory

Theory of Business Diversification

Resource-Based Theory of the Firm

Theory of Organisational Behaviour

Innovation Theory

Theory of Incumbency

Theory of Core Competencies

Big Idea

Grouped the theories.

Built a narrative on four options:

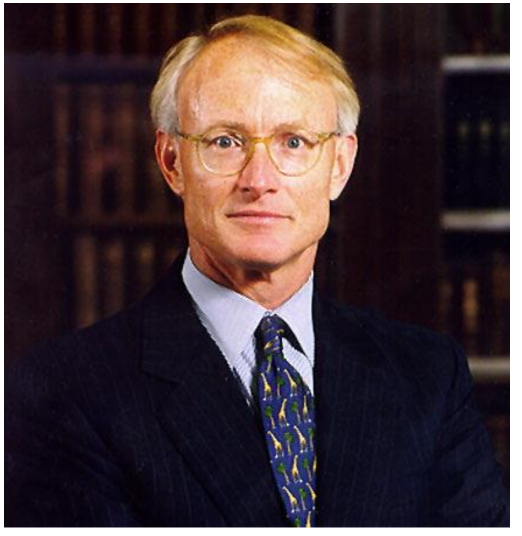
- Fight: resist the changes
- Flight: run from the changes
- Follow: match the changes
- Fit: refocus beyond the changes

Fight

Fight

Porter's (1980): firm performance depends on the way in which the firm positions itself against 5 forces:

- level of competitive rivalry
- the threat of entrants and substitutes
- level of buyer or supplier power



Fight

In 1994, Oster added government, as a ‘sixth force’.

Baron (1995) explains that are important differences between Porters 5 ‘market’ and Osters ‘non-market’ force.

Baron suggests that the firm must develop a market strategy, to deal with the 5 forces, and a non-market strategy, to positions itself against the regulatory environment.

He calls this an ‘integrated’ strategy.

Fight

Hillman and Hitt (1999)

Identify 3 non-market strategies:

- Information strategy
- Financial incentives
- Constituency building

Stratmann (1991) shows that, in 1985, a contribution of $3,000 to the US Congress led to the survival of a sugar subsidy, worth $465 million annually.

Fight

Oliver and Holzinger (2008) differentiate between:

- Value maintaining strategies: ‘defensive strategies’, aimed at preserving the firm’s position in the market.
- Value creating’ strategies’: ‘proactive’ strategies, aimed at creating new assets, competencies and new positions.

Fight

No research on the long term viability of these strategies.

Anecdotal evidence suggest value maintaining strategies do not work in the face of changing preferences.

Fight

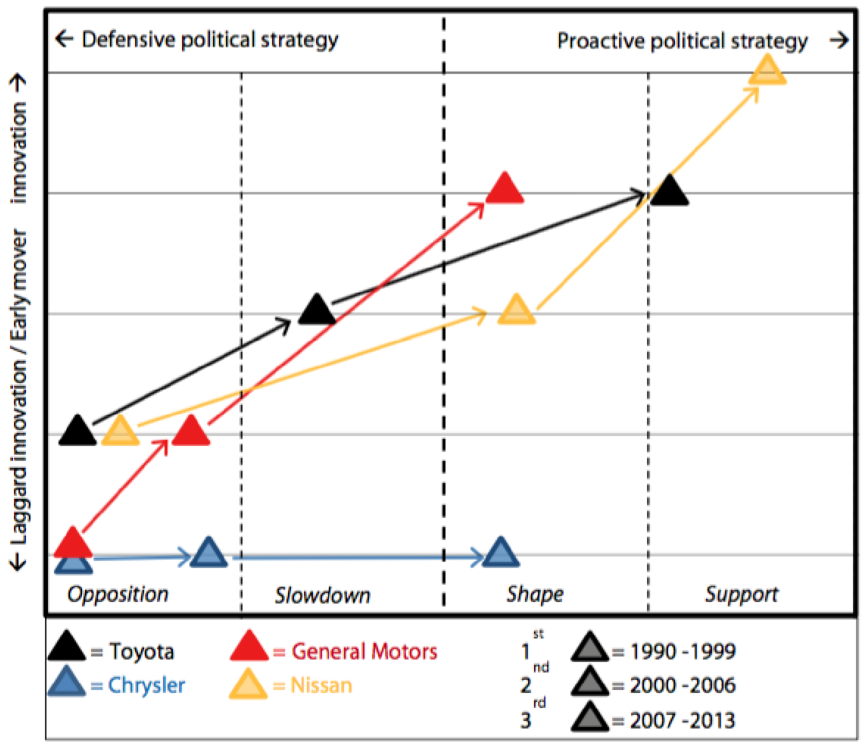
Palazzo and Richter, 2005:

The tobacco industry spends hundreds of millions on ‘massive lobbying and misinformation campaigns’. After 50 years of ‘denying [the] risks and manipulating [the] information’, they ‘lost all credibility’, and today they are ‘confronted with massive distrust from their relevant publics’ (p388).

So, value maintaining strategies only to delay the inevitable.

Fight

Wesseling et al (2015) hint that in the face of changing social preferences, a 'value creating' strategy may be more useful…



Fight

Concluding:

(1) the energy incumbents should have a non-market strategy;
(2) 'value maintaining' non- market strategies are only useful in delaying regulations that reflect social preferences;
(3) firms that work with the change, and adopt an active, and positive position, perform better, than those that fight.

Advice: work with the regulators, use the changes to shape the regulatory environonement, or risk becoming the new tabacco.

Flight

Flight

- ‘Flight’ = market exit.
- Two types of market exit:
  - ‘geographic market exit’
  - ‘product market diversification’

Flight

- Resource based scholars warn against both.

- Resource-based scholars suggest that competitive advantage originates not in the firms actions, but the ‘bundle of resources’ that it owns and controls (Barney, 1986).

Flight

- Resources can be tangible or tangible resources:

  - De Beers controlled 90% of diamond mines in 1902.
  - Coca-Cola derives 2/3rds of its value from its brand name.

- Also talk about capabilities (to deploy resources): owning Coca-Cola’s band name, and deploying it to create the same value that Coca-Cola does, are two different things.

Flight

- So what?
- Whether firms create value with their strategic choices (Porter), or with the value-adding resources (Barney) firms ‘shape’ themselves to the needs of their market / industry.

Flight

- Diversifying into new products implies a destruction in value.
- Resources that are highly valued in one market (Coco-Cola brand name) are worth less in other markets (diamonds).
- Finance scholars talk about 'diversification discount'.

Flight

- Internationalizing into new regions implies a destruction in value
- Resources that are highly valued in one market (Target in the US) are worth less in other markets (Target in Canada, -$2.1b in 4y).
- International business: ‘the liability of foreignness’.

Flight

- Of course there are successes:
  - Diversification: Virgin has 400 unrelated businesses
  - Internationalization: Primark – 35 in Ireland, and 290 outside

On average, however, the market punishes firms that announce internationalizations and diversifications.

Flight

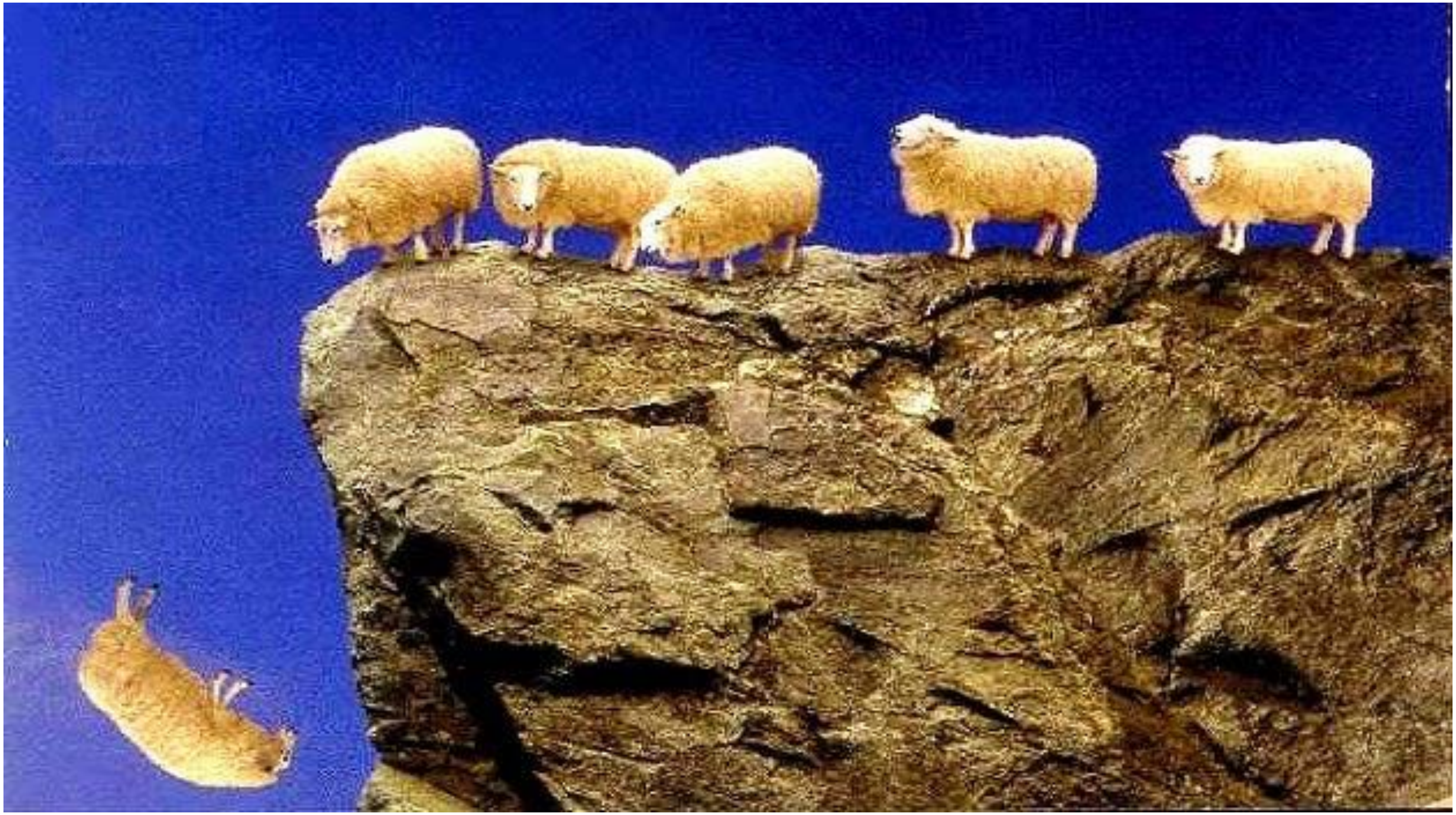
Concluding:

Exit makes sense if the incumbent :

(1) Is willing to incur significant losses in the value of their current market-specific resources and capabilities
(2) had the financial and managerial resources to acquire new resources and capabilities to compete in these new markets
(3) (if the regulations weren't going to follow them).

Advice: do not adopt a flight strategy, because doing so would significantly devalue your current resources.

Follow



Follow

‘Follow’ = follows the trends, mimics the new entrants and attempt to match it’s offering to the markets changing needs.

Two literatures raise questions about this strategy:

Follow

1. The innovation Literature

   Whether firms create value with their choices (Porter), or with the resources (Barney), firms ‘shape’ themselves their market. The market, however, is not stationary (Schumpeter, 1942). As the market changes, do too do the value of the firm’s advantages.

Follow

1. The innovation Literature

   Blockbuster employed 60,000, and operated 9,000 video rental stores in 2004. In the off-line era, location mattered.

   As the technology changed, so too did the value of those advantages. Netflix entered in 2007. By 2016, it operated in 190 countries, had revenues of $6,7 billion. Blockbuster has 51 stores

Follow

1. The innovation Literature

   The innovation literature talks about ‘creative destruction’
   So why did Blockbuster lose the innovation battle?

Follow

1. The innovation Literature

   – Lazy answer: smaller firms are smarter, faster
   – ‘Sunk cost’ argument: asymmetries between a firm that has already committed to a given technology and another that is planning a commitment (Kaplan et al, 2003).
   – ‘Replacement effort’ argument: assuming equal innovation capabilities, an entrant has higher incentives to invest in radical innovation than an incumbent (Arrow, 1962).

Follow

1. The innovation Literature

   Thus: the energy incumbents will likely lose any innovation race. By the time they re-orientating themselves, it will be too late.

Follow

2. First mover advantages

   First mover advantages are the advantages gained by the initial ("first-moving") firm to occupy a specific market segment (Lieberman and Montgomery, 1988).

Follow

2. First mover advantages

   It is likely the new entrants have:

   - ‘technological leadership in terms of market access
   - ‘preemption of asset’, in terms of product characteristics
   - ‘switching cost’ advantages, in terms of consumers that are unwilling to switch back to the incumbents

   Thus: any attempt to ‘mimic’ the entrants would relegate the incumbent to, at best, a second place position in the market.

Follow

Concluding:

1. The innovation literature isn't hopeful
2. The first-mover literature isn't much better

Advice: do not adopt a follow strategy. Doing so would relegate the incumbent to, at best, a second place position in the market.

Fit

Fit

Fit describes a strategy in which the firm accepts the trends, and look to its ‘core competencies’ to redefine its position.

Fit

The concept of ‘core competency’ was introduced in 1990.

Prahalad and Hamel (1990) observed :

- Western firms tended to conceive of themselves as ‘a portfolio of businesses’ -- they were built around ‘core businesses’ or ‘strategic business units’
- Japanese firms tended to conceive of themselves as ‘a portfolio of competencies’ -- they were build around skills.

Fit

This, seemingly moot distinction, meant that:

“many of the largest and best managed firms of the 1970s and early 1980s, such as IBM, General Motors, Caterpillar, Xerox, Sears and DEC lost the battle when pitted against their Japanese rivals in the mid- to late-1980s” (Prahalad and Hamel, 1994, p.6).

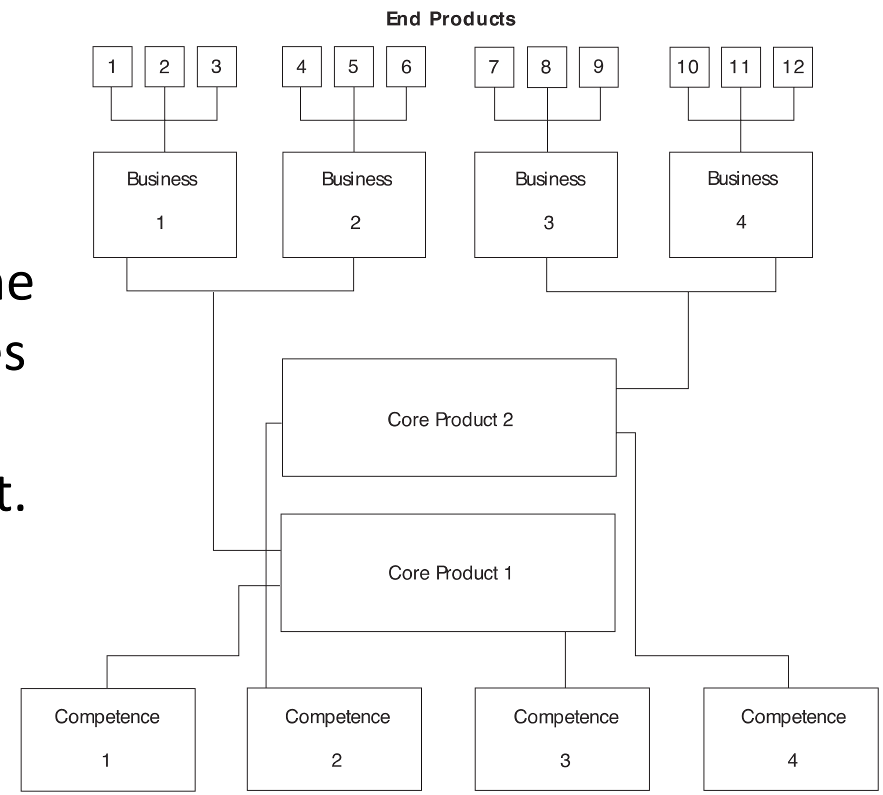
Fit

When the car market stalled, Chrysler, the ‘car company’, ran into problems, but Honda, the ‘engine company’, grew by 200%, by creating markets for its engines in motorbikes, off-road buggies, and boats. Chrysler focused on its ‘core business’, while Honda focused on its ‘core competency’.

Fit

So what is a core competency?

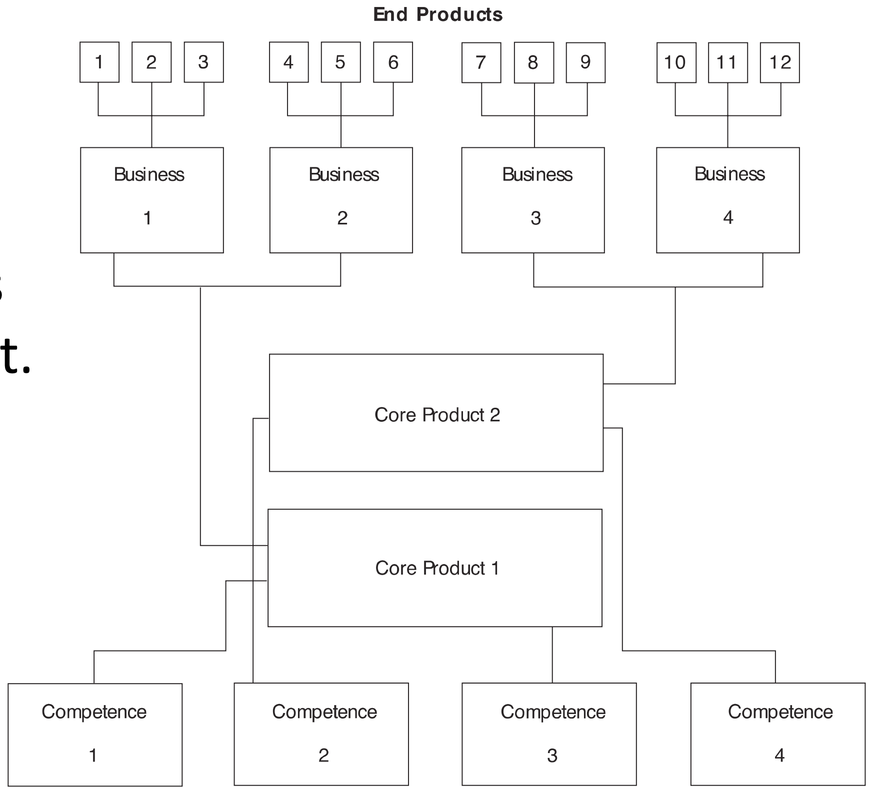
The metaphor of the firm as a tree: The trunk and the major limbs are the firms core products, smaller branches are the business units, the leaves, flowers and fruit are the end product.



Fit

So what is a core competency?

The strength of the tree is not in the flowers but in the roots that provides stability, sustenance and nourishment.



Fit

My favorite example: Wilkinson-Sword

– Founded in 1772, as a musket maker
– Added bayonets to its portfolio in the 1820s.

Fit

My favorite example: Wilkinson-Sword

- WWI: sales of 2 million bayonets
- WW2: sale of 10,000 bayonets
- Looked for new growth markets

Wilkinson Sword adopted a ‘core competency’ perspective. It had skills to produce blades. It did not take a ‘core business’ based perspective, defining itself as a producer of bayonets.

Fit

My favorite example: Wilkinson-Sword

When its ‘core business’ collapsed, Wilkinson Sword was able to redeploy its ‘core competency’ to create new growth markets.

In 2001, Wilkinson Sword was the world's number two in the razor market, with an 18 percent share, and sales of >$620 million.

Fit

Concluding:

Applying this logic, energy incumbents could change the way in which they view themselves, and in doing so create new possibilities for themselves (like Honda, and Wilkinson Sword).

<u>Advise: adopt a fit strategy, begin exploring what it is, at the most fundamental level, that each firm does, to look for new markets</u>

Conclusions

In sum, the answer to what the energy incumbents should do to deal with the transition is a simple recipe:

- 1 part a value-creating non-market strategy,
- 2 parts a reimagining of the firm in terms of ‘core competencies’.

The art, of course, and the challenge for the energy incumbents, is to turn this theory into practice.

Fight, Flight, Fit or Follow?

An evaluation of potential survival strategies for energy incumbents in a changing world

Dr. Killian J McCarthy
University of Groningen

k.j.mccarthy@rug.nl