

Organizational Economics

Competitive Strategy, Lecture 8

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Spring 2021

Overview of Today

- Between Firms
 - Mergers & Acquisitions
- Within Firms
 - Organizational Structure

Between Firms: Mergers & Acquisitions

- Interchangeable phrases
 - Make vs buy
 - Integration vs arm's length transactions
 - In-house vs outsource
- If markets work, we should isolate our competency and focus
 - ... but it turns out there are problems with this approach
 - ... and you will face them when you leave the classroom

Types of Integration

- Horizontal

- Different business units at the same level in the supply chain
- e.g. Facebook & Instagram, Facebook & WhatsApp
- Antitrust implications are questionable

- Vertical

- Business units at different levels of the supply chain
- i.e. suppliers and buyers
- e.g. AT&T and Time Warner
- Almost always OK for antitrust

Key Idea: Pass the Three Tests

- When Should You Integrate?
- Three Test Framework
 - ① Synergies Test: Does it create value in the corporation?
 - ② Costs Test: Are benefits greater than the cost of corporate overhead?
 - ③ Price Test: Do we create more value than other possible parents?

Synergies Test

- Scale synergies
 - Overhead costs with all businesses
 - Management and managerial practices
- Revenue synergies
 - Customer base (e.g. cross-selling)
 - Brand capital
- Knowledge Synergies
 - Marketing and customer data
 - Technical know-how

Costs Test: The Setup

- Principal-Agent problems!
- Explained by Example: Management Consulting
 - Firm owns brand, you work for firm
 - Quality of their advice depends on number of your insights
 - Insightful analysis requires effort
 - They keep revenue, and you receive a wage

Costs Test: The Problem

- Consulting firm does not know...
 - Type of worker
 - Brilliant and boneheaded people both apply
 - Brains of employee hidden from employer
 - In jargon, adverse selection
 - Actions of worker
 - Regardless of type, everyone shirks
 - Effort of employee hidden from employer
 - In jargon, moral hazard

Price Test

- Scope and diversification
 - Diversification does not create value on average
 - But important to recognize exceptions!
- “The price is right” principle
 - Why would it be different for you?
- How valuable would the business unit be on its own?

Within Firms: Organizational Structure

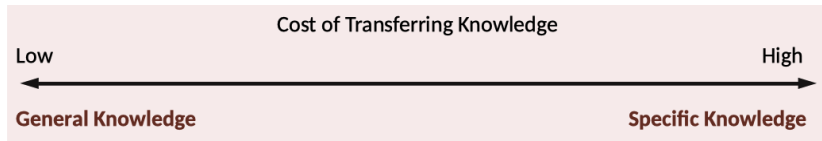
- “How can... fragments of knowledge existing in different minds bring about results which... to be brought about deliberately, would require a knowledge on the part of the directing mind which no single person can possess?”
- Key problem: knowledge (information, skills, ideas) is dispersed

Key Idea: Pair Decisions with Knowledge

- Benefit 1: Decisions are more efficient!
- Benefit 2: Bigger incentive to acquire knowledge!
- How do we implement this pairing?
 - Centralization: Move Knowledge to Decisions
 - Decentralization: Move Decisions to Knowledge

Consideration 1: General vs Specific Knowledge

- How costly is transmission?
 - General knowledge is cheap \Rightarrow Centralize
 - Specific knowledge is expensive \Rightarrow Decentralize



What Makes Knowledge General vs Specific?

- Characteristics (No = General, Yes = Specific)
 - Perishable? - must be acted on quickly or loses value
 - Complex? - many dimensions, interdependencies
 - Technical? - requires specialized skills to understand
 - Unforseeable? - environment is changing, random
 - Subjective? - hard to describe rigorously

Consideration 2: Decision Maker Quality

- How good are the decision makers?
 - Make sure the decision maker can use the knowledge!
- Centralization is better when...
 - More certain environments
 - Known best practices
 - Concentrated managerial skills
 - Coordination is more important
- Vice versa for decentralization

Visualizing the Centralization Tradeoffs

