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Strategy, Time, and Economic Performance

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" We don't have a desperate need to grow,
we have a desperate desire to grow."

—*Milton Friedman*

The United States and many other industrialized countries are currently experiencing an economic slowdown. While it is clear that economic slowdowns are difficult periods for most firms and those with interests in the firms, what is less clear is why some firms within the same industries seem to *weather the storm* better than others. From an economic perspective, these slowdowns present an opportunity for owners/managers (investors) to analyze decisions made both in terms of the reasons for the actions taken and also from an evaluation of the risk(s) the firm now faces for those actions.

Economists like to believe that economic reasoning is involved in most decision-making processes. This reasoning focuses on the *changes* in benefit and cost resulting from the action under consideration. Choices are often visible in the strategies and actions taken by firms. What makes reality significantly different from elementary blackboard economics is that these decisions are not made with perfect information, or perhaps to state it more clearly, decisions are made in a condition of uncertainty; hence, risk enters into the equation. Couple this with the fact that often these long-term or strategic decisions are critically analyzed within short-term periods given current economic conditions, and the decision may appear unfavorable.

Firms may find it difficult to separate short-term economic performance from long-term considerations. We often see that during periods of rapid growth most firms are anxious to expand capacity to take advantage of current higher demand. That capacity can be added internally or it could be sought in the market by purchasing inputs from suppliers. The option selected impacts the flexibility of the organization and, therefore, can have significantly different long-run outcomes.

We may see an application of economic reasoning leading to different short-term outcomes in local examples. I was recently interested in the financial results of two local firms in the same industry, Steelcase Inc. and Herman Miller Inc. Both firms manufacture office furniture, an industry that is quite cyclical and has been hit particularly hard by the current slowdown. What was interesting was that Herman Miller's financial results seemed to reflect that the worst might be over, while Steelcase's results were still quite disappointing. What can lay behind these seemingly opposing "pictures?" The answer may be past strategic choices, specifically decisions made regarding structure, and even more specifically, the decisions regarding the degree of vertical integration each selected. A glimpse at the balance sheet of both firms may reveal a much larger percentage of total assets in plant and equipment at Steelcase, possibly reflecting a decision to be more vertically integrated than Herman Miller.

I am also finding the recent financial results of Spartan Stores Inc. to be of interest. Spartan Stores was for most of its history a cooperatively owned (by member retailers) supplier of grocery products. Over the past few years, the firm has gone public and has been integrating into the ownership and management of retail stores. Their stock has not been performing well and one has to wonder if the stock price reflects the results and/or expectations of the fruits of this integration strategy.

Economic literature is quite clear in describing the advantages of vertical integration. These include lower transaction costs (negotiating, contracting, etc.); an assurance of a steady supply stream (this may be even more critical in economic slumps if suppliers leave the market); ability to correct for market externalities (assuring quality, etc.), market power gain or, if a victim of it, the elimination of market power; and the protection of proprietary information or processes. Any one of these or a combination can be good reasons to vertically integrate and must be considered in long-term decisions.

There are at least three possible costs of vertical integration. First the cost of supplying or distributing its own product may be higher for a firm that vertically integrates than for one that depends on competitive markets which serve those needs efficiently. This cost can be derived from the fact that a market supplier may be able to better exploit economies of scale (greater gains from a specialized resource due to longer production runs) than an in-house supplier.

Second, as a firm gets larger, the difficulty and cost of managing it increases. These costs can be quite substantial, especially when viewed in traditional economic terms of opportunity cost (the alternatives sacrificed). In addition to the costs we normally associate with managing resources, a firm that seeks to allocate scarce resources across many different departments or subsidiaries may find managers using precious time lobbying for those resources. Also, in all likelihood, a manager of an internal division or department will perform differently than an owner/manager of his or her own company. They are insulated from the market, and inefficiencies can be spread (hidden?) by other divisions/departments. The advantage of dealing with a competitive market is that someone else supervises production, and the market disciplines the inefficient producer while rewarding the efficient one. You would certainly have to wonder where the *lower costs* for Spartan would be in managing stores versus the market discipline that an on-site owner would be faced with. Who is going to be more efficient?

Third, the firm may face substantial legal fees to arrange to merge with another or to structure the integrated firm.

When we consider these benefits/costs of vertical integration what could we expect? We may expect an integrated firm to perform well during industry expansions but have weaker overall results during slowdowns. The integrated firm may perform close to ideal economic scale during growth cycles as it supplies itself with inputs. A less integrated firm may be more flexible, may be able to exploit the capacity of suppliers, and may take advantage of lower market prices during slowdowns, but it may find itself struggling for inputs when the economy is doing well.

What can we learn?

Strategic decisions are long-term and, as a result, are made under a high degree of uncertainty. Toward the end of the 1990s and into 2000, financial and business articles were reminding us that there is a *new economy* and there may be an end to business cycles, as we knew them. We have seen that business cycles remain and if there is a *new* (whatever that means) economy, it cycles like the *old* one. Maybe we should develop a rule-of-thumb that as the numbers of pundits that begin to espouse the end of the business cycle increase, the closer we are to the next downturn.

We also need to be reminded that uncertainty is constant. No one knows what the future looks like, and if you should ever find yourself listening to individuals who contend they do, ask yourself why they are sharing this information with you. Be assured that they would not share that knowledge with anyone, but would seek to keep this information to themselves and profit from it.

Strategic choices which require a long-term or *forward* view are by definition risky and will not always work out as we'd like. Trying to estimate the discounted present value of a decision with long-term implications is difficult under ideal conditions. It is perhaps one step removed from a *guess* in an economy subject to cycles.

We hear often, but perhaps not often enough, that short-term economic conditions can make long-term strategic decisions look *bad.* As it could be with the case of vertical integration, a highly integrated firm will find it a challenge to steer through a slowdown while a less integrated firm will move a little easier. This does not imply that one structure is right or the other is wrong. They will perform differently under different conditions. The highly integrated firms may lay off many workers when the economy slows; the less integrated firm may find that suppliers lay off many workers. It may be that in either case similar numbers are out of work, or the market supplier was able to diversify across different buyers or industries, reducing risk, and does not have to lay off as many.

Perhaps we should be reminded that markets often work. The idea that we can always do it better than someone else is something we should continually question. It may be that a company will find that by integrating into a process may be profit enhancing in the short-run, but the discipline of the market is a powerful tool that more often than not brings about efficient outcomes. That efficiency can be lost when a firm is insulated from the market.

Finally, for the following reasons and more, we learn that as investors we need to consider the strategies that managers formulate:

- By definition strategies are formulated under uncertainty.
- Strategic decisions cover a long time span. Decisions made ex ante with less than perfect information (uncertainty) could be the best decisions given the available data. These same choices, however, can lead to ex post bad outcomes over the business cycle.
- When it comes to organizational structure, one size does not fit all. Industries face different risks to varying degrees. The structure that fits the furniture industry may not be the best for grocery retailing. We also see that as technology continues to improve and our knowledge grows, structures will evolve, but again at different rates and in different ways, across industries.