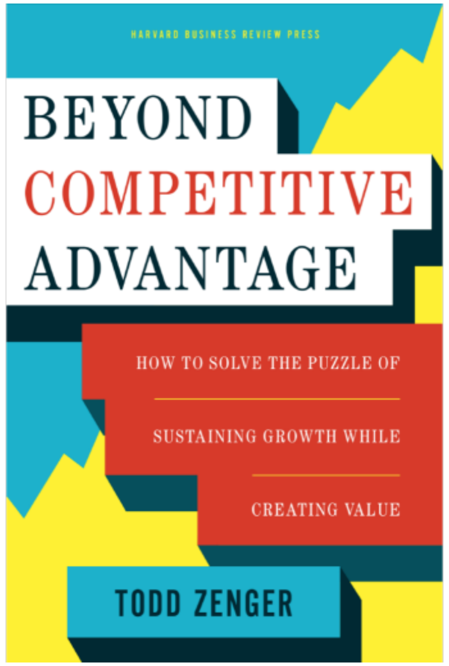
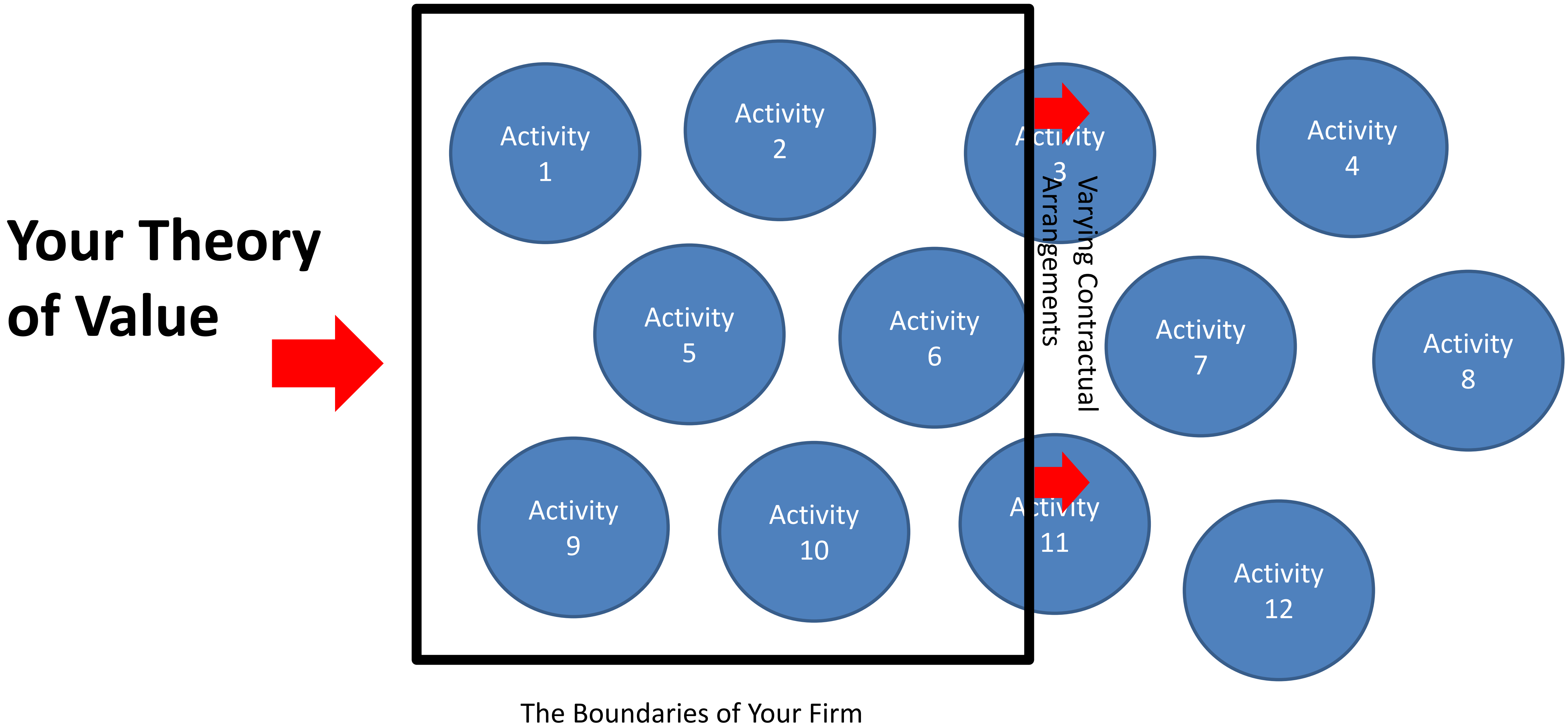
The Make or Buy Decision

(Chapters 4-5)



MAKE OR BUY


Your Theory
of Value
Activity 1
Activity 2
Activity 3
Activity 4
Activity 5
Activity 6
Activity 7
Activity 8
Activity 9
Activity 10
Activity 11
Activity 12
Varying Contractual Arrangements
The Boundaries of Your Firm

COMPETING VOICES

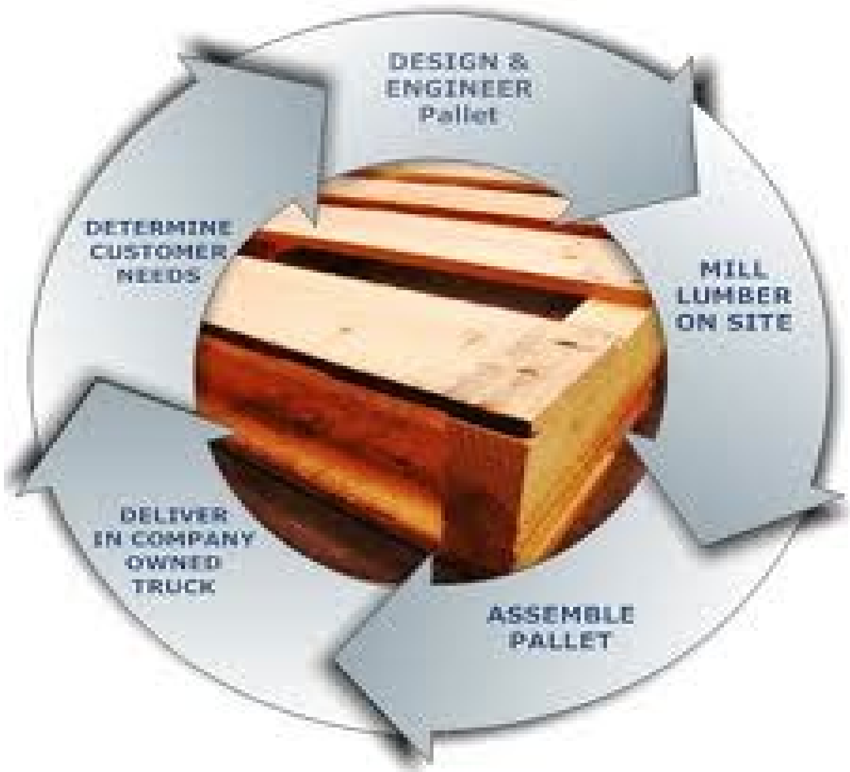
- Integrate and expand the firm

vs.

- Disintegrate and outsource

OUR LOVE OF INTEGRATION

- We generally have really bad intuition about when to make and when to buy.




THE SATURDAY EVENING
POST
SEPTEMBER 4, 1943 10¢
THE
NEBRASKA STORY
By Governor Dwight Griswold
WE SKIP-BOMB THE JAPS
By Charles A. Rawlings
Norman Rockwell


THE SATURDAY EVENING POST
5cts.
JANUARY 22, 1927
Richard Washburn Child—Joseph Hergesheimer—R. G. Kirk—Thomas Beer
Charles Brackett—Kenneth L. Roberts—Gilbert Seldes—Frederic R. Gruger

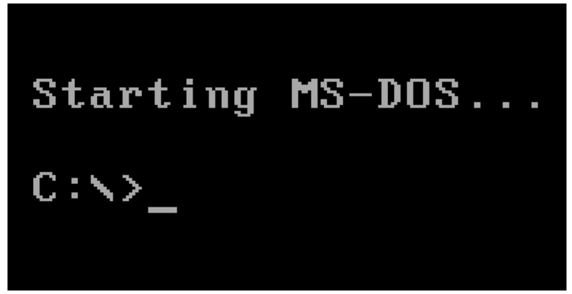
SATURDAY EVENING POST






Trees → Logging → Paper Production → Printing → Magazine Publishing → Distribution

OUR LOVE OF THE MARKET



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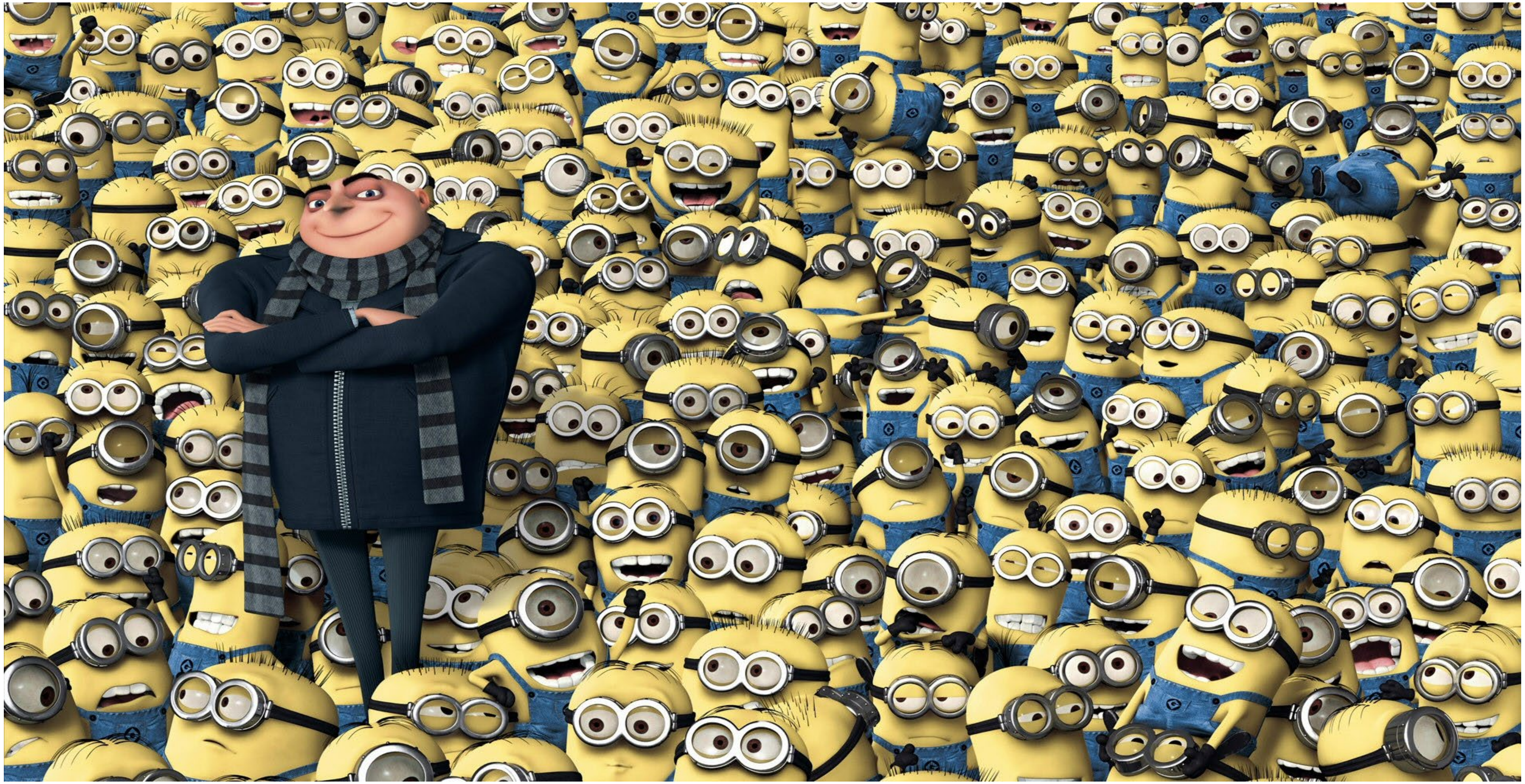
BEWARE OF SIMPLISTIC LOGIC

- Outsource what you do poorly and integrate what you do well
- Not that simple

TWO CENTRAL QUESTIONS

1. What composition of assets and activities do you propose to create? What assets and activities do you seek to combine or orchestrate and how must they be transformed? [What is your theory of value creation?]
2. What is the lowest cost approach (market or hierarchy) to organizing access to these assets and activities? Or, what are the right incentives required to organize access?

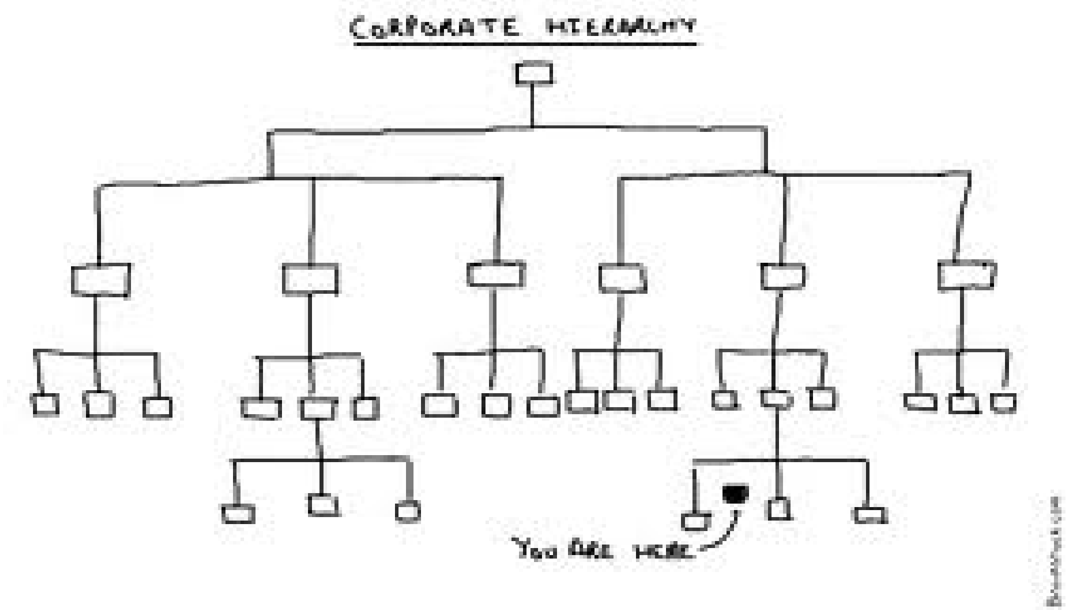
DECIDING HOW TO ORGANIZE ACCESS TO THE ABUNDANCE OF REQ. ACTIVITIES



NOT ABOUT "CONTROL" ALONE…

- Rather, deciding what type of control you need:

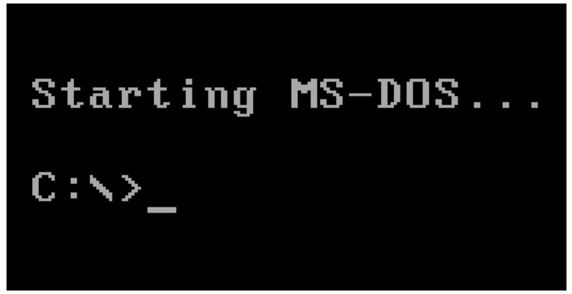
Markets



Hierarchy

Markets induce "individuals to do…desirable things without having anyone tell them what to do." Hayek

THEORIES REVEAL DESIRED FUTURE STATE OF ASSETS AND ACTIVITIES



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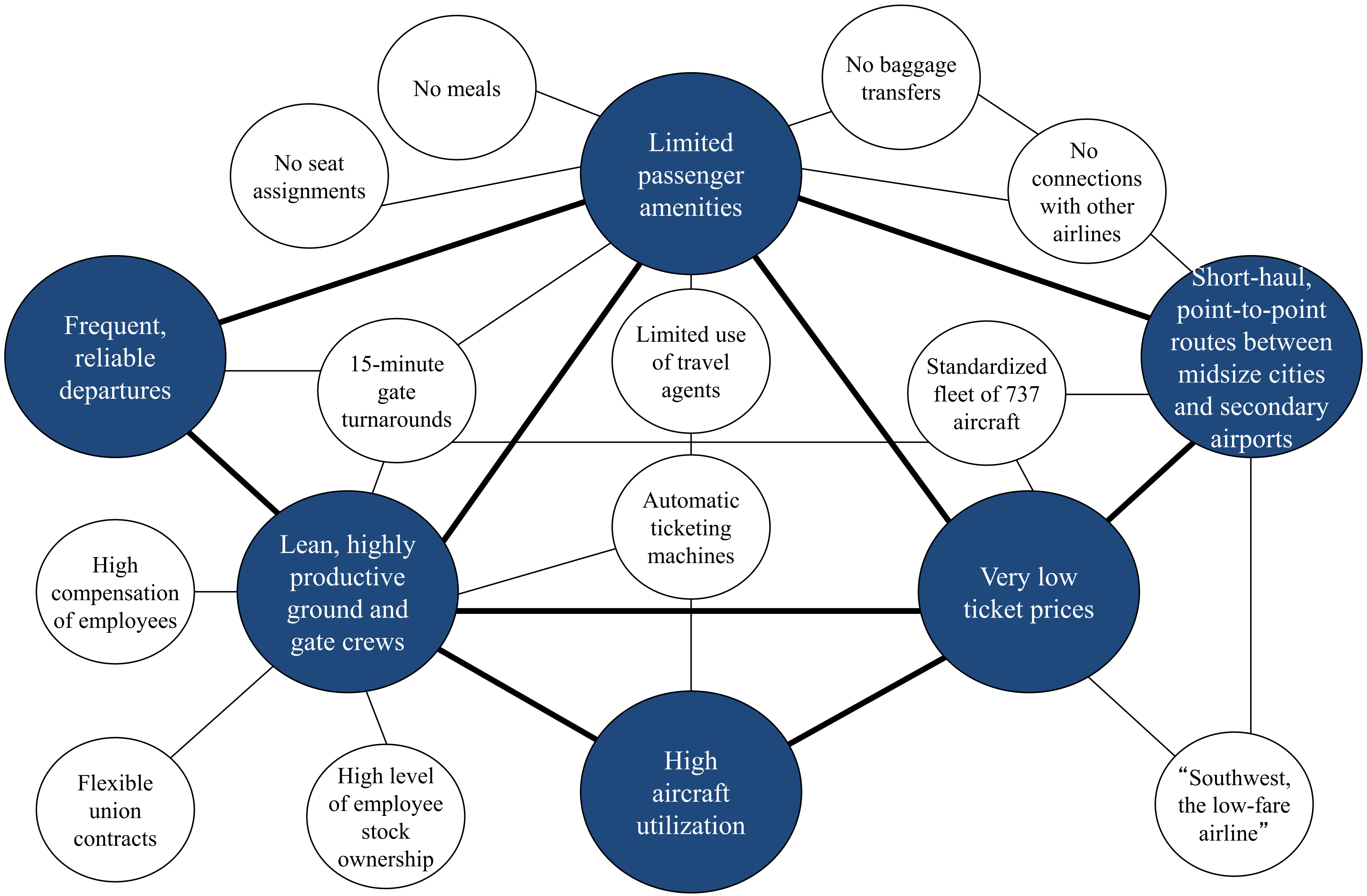
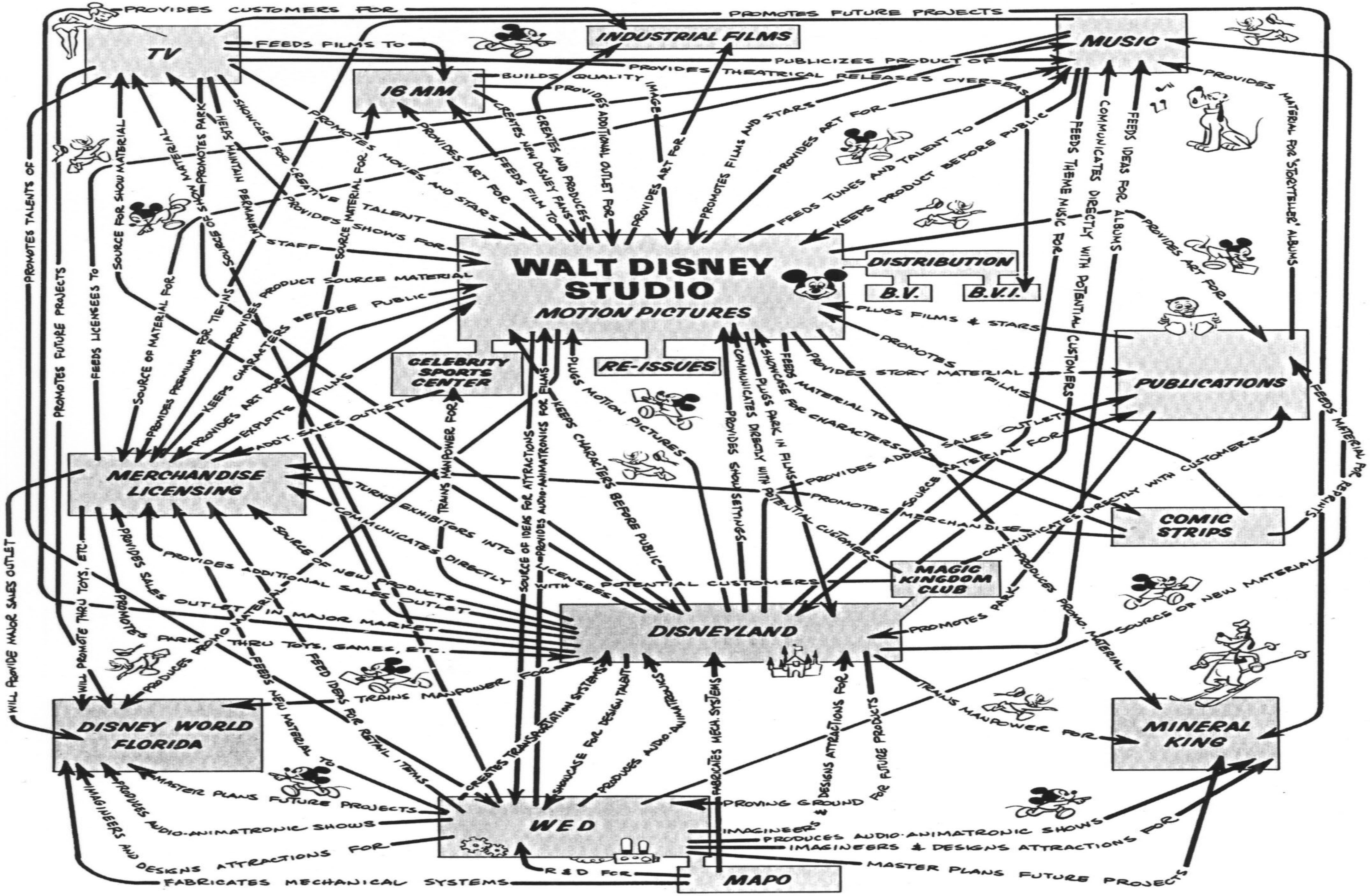
HOW DO I CREATE INCENTIVES TO COMPOSE THIS?



Source: Michael E. Porter "What is Strategy" *Harvard Business Review*, Nov-Dec 1966

How do I create incentives to compose this?

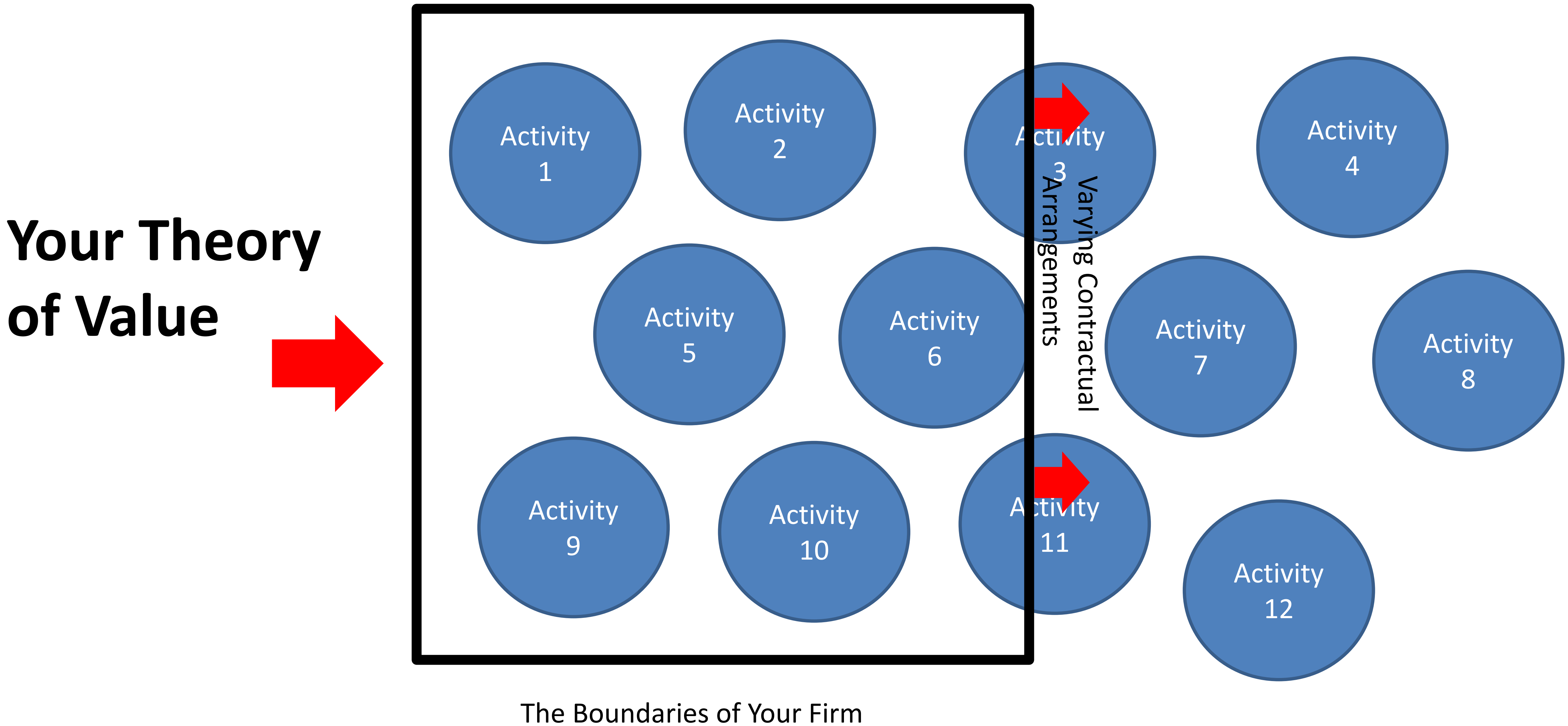


MARKET’S VIRTUES

- Motivate a host of actors (with abundant skills and talent) to generate products and services that enhance value of what you do.
- Bill Joy, Sun Microsystems: “Most of the smartest people don’t work for you”

- Decision to outsource reflects confidence in the wisdom and creativity of market actors strongly motivated will compose solutions superior in cost and quality to those you can compose

MAKE OR BUY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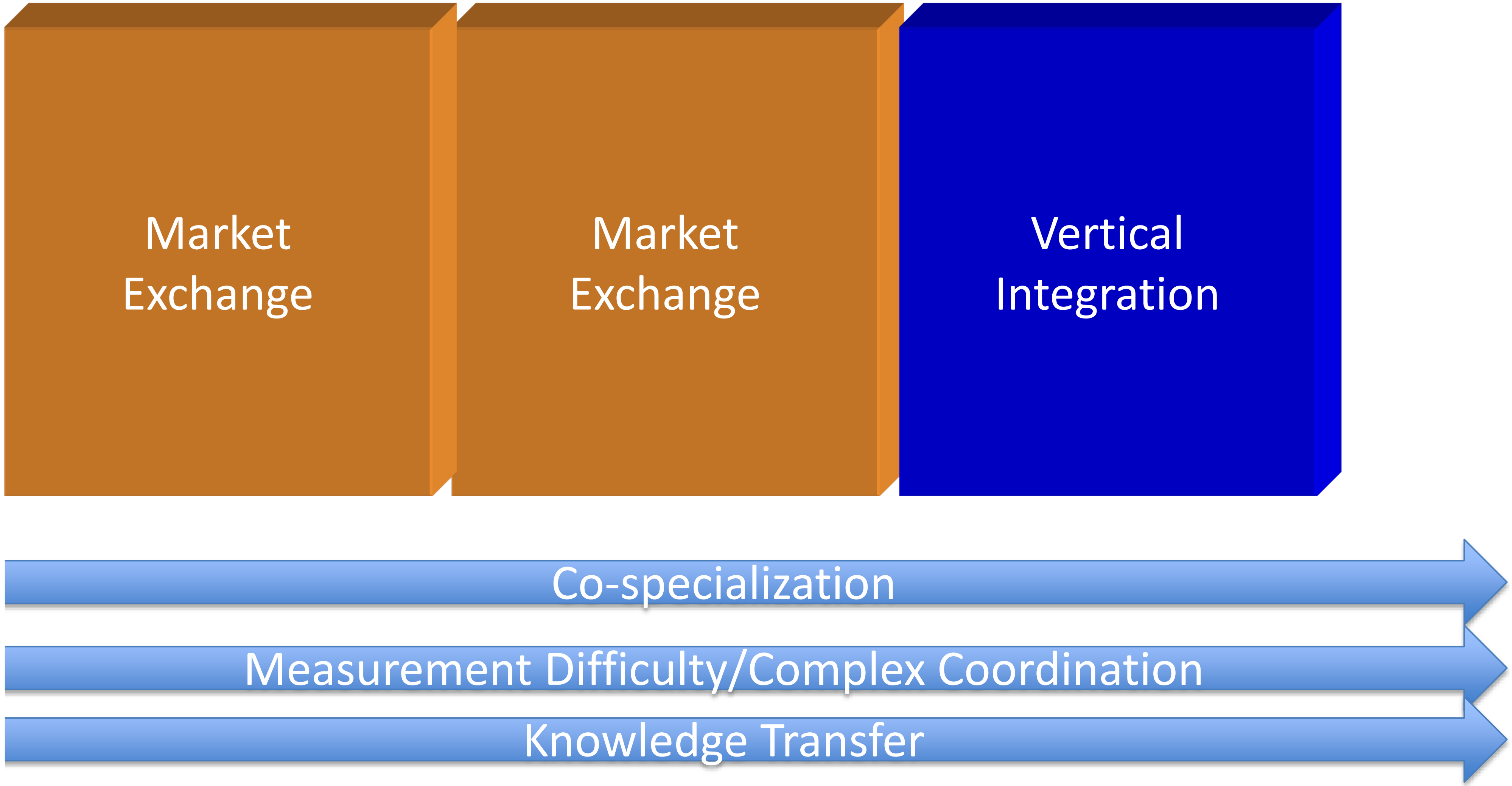
WHAT CAUSES MARKETS TO FAIL IN EFFECTIVELY MANAGING TRANSACTIONS?

1. When desired exchanges require co-specialized investments.
2. When exchanges require complex coordination.
3. When exchanges require the transfer of subtle, tacit forms of knowledge.

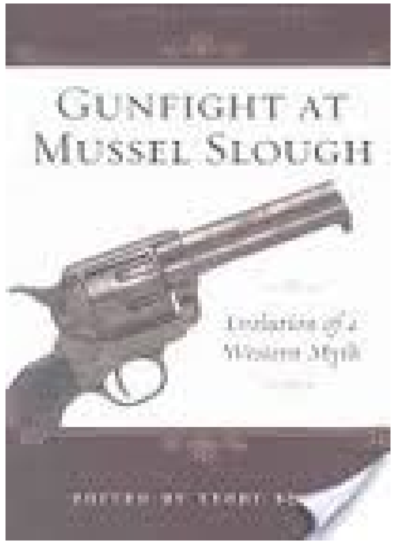
THE DRIVERS OF TRANSACTION DIFFICULTY



CO-SPECIALIZATION

- The need for co-specialized investments (with uncertainty) elevates cost of using the market, and is thus the primary driver toward greater vertical integration.

THE HOLD-UP PROBLEM



“$2.50 per acre and up”

After homes built, asked for $35/ acre.

POOR INCENTIVES TO GENERATE DESIRED INVESTMENTS

EXAMPLE: GM-FISHER BODY

- GM wants Fisher Body to make large investment in metal stamping equipment
- GM also wants Fisher to co-locate its facilities
- Fisher had no incentives to invest in specific capital absent guaranteed price and volume
- GM unwilling to guarantee price and volume due to uncertainty about demand
- GM buys Fisher to reshape incentives – to induce and protect specific asset investments

CO-SPECIALIZATION

Firm 1: Manufacturing

Firm 2: Consumer Electronics

$100 million
Hold-up potential

$200 million

½ is specific

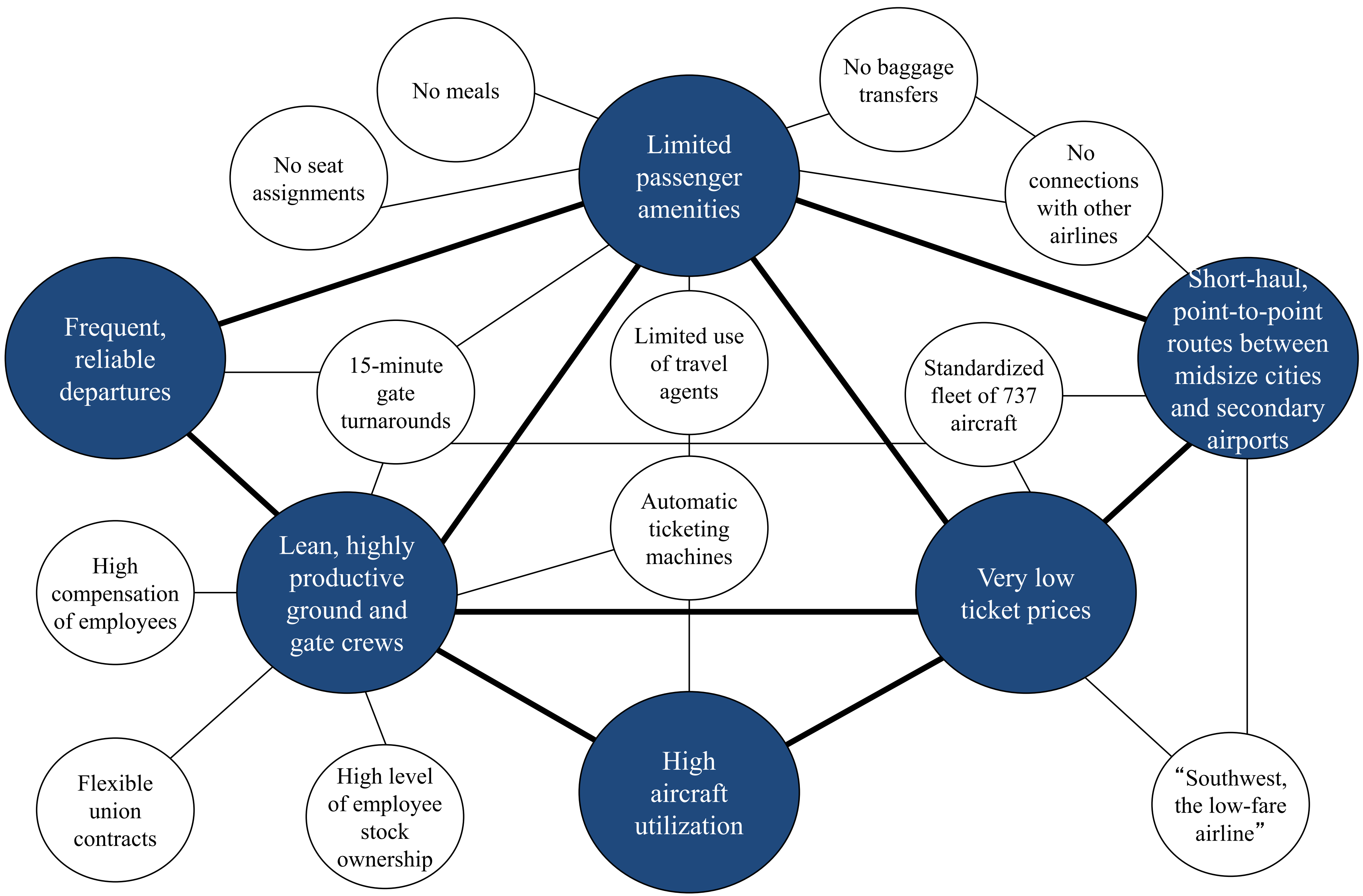
FORMS OF CO-SPECIALIZATION

- Physical asset specificity:
  - I need this vendor to create and install highly customized equipment.
- Site specificity:
  - I need this vendor to invest in assets at a rather remote location.
- Human asset specificity:
  - I need this vendor to develop deep knowledge about my organization and customized skills with little application elsewhere.
- Temporal specificity:
  - I need this vendor to provide a service for me at particular point in time.

MANAGING COMPLEX COORDINATION WITH POOR MEASUREMENT

- How easily is output measured?
  - Quality
  - Quantity
  - Reliability
- How easy are inputs measured?
  - Effort
- Can you easily draft a contract to support the exchange? Can you easily specify and measure the output?

CAN I COMPOSE THIS COORDINATION USING MARKET INCENTIVES?



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CONTRACTING FOR KNOWLEDGE

- Is knowledge the primary asset to be exchanged?
  - Technology, skills, expertise
- Can you draft a contract to protect the exchange?
- Basic Hazard:
  - The value of knowledge is not known until after it is revealed. Once revealed the recipient has no incentive to pay for it.
  - Efficient knowledge transfer requires shared language to facilitate

ADVANTAGES OF INTEGRATION

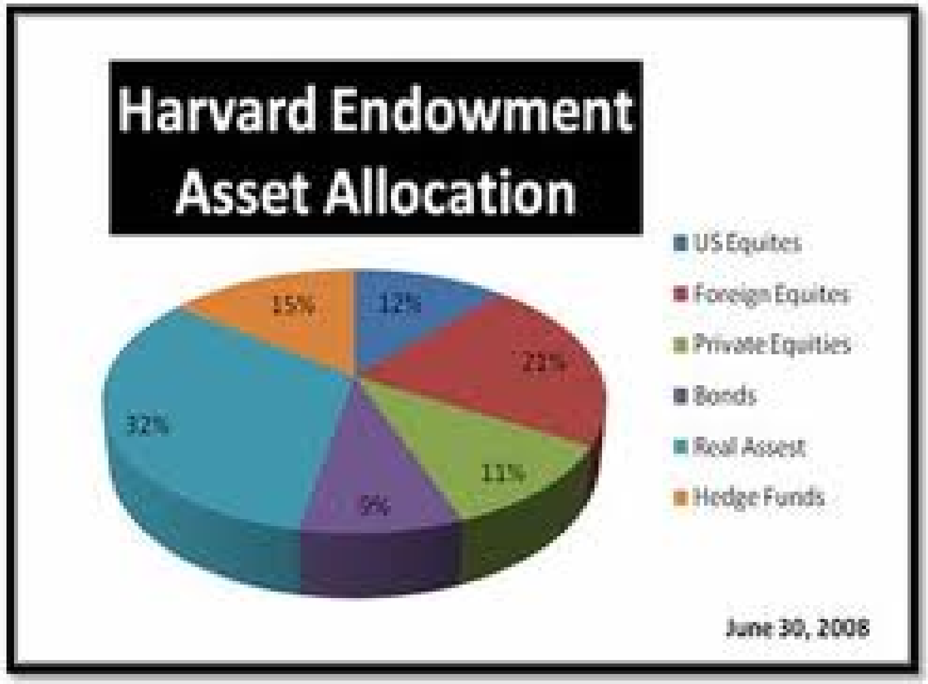
1. An ability to wield authority-—direct co-specialized investments and flexibly direct coordination.
2. An enhanced ability to build a cooperative community imbued with a sense of purpose and fairness that inspires cooperation in making investments, sharing knowledge, and coordinating.

WHEN INTEGRATION FAILS…

- The cost of integration's control is the loss of the market's motivation!

WHAT CAUSES THE LOSS OF INCENTIVES WITHIN FIRMS?

- Social comparison costs
- Knowledge atrophy costs
- Social attachment costs


Harvard Endowment
Asset Allocation
US Equites
Foreign Equites
Private Equities
Bonds
Real Assest
Hedge Funds
15%
12%
21%
32%
11%
9%
June 30, 2008


2002-2003 HMC FUND MANAGER PAYOUTS
Payouts in Millions of Dollars
40
35
30
25
20
15
10
5
0
2002 Fiscal Year
2003 Fiscal Year
David Mittelman
Jeffrey Larson
Maurice Samuels
Steve Alperin
Tony Morgan
Jack Meyer
Elizabeth Randall
Shawn Martin
Fund Managers

- $27 billion endowment, internally managed
- Internal managers outperformed comparable funds by 50%, worth billions in increased endowment
- Top fund managers each earned $25-30 million per year
- Student, alumni, faculty outraged
- Harvard President insisted that payments would be greater if the activity was outsourced.
- University Treasurer publicly notes that if activity was outsourced, people would not care.
- Pay is cut, fund managers leave.

PAYOUTS

Manager	’04 Payout	’04 Performance	’03 Payout	’03 Performance
David R.Mittelman	$25.4	9.2% vs.(3.4%)	$34.13	31.1% vs.17.3%(Domestic bonds)
Maurice Samuels	$25.3	17.5% vs.7.6%	$35.1	52.4% vs.18.0%(Foreign bonds)
Jeffrey B.Larson	$8.1	40.6% vs.32.6%	$17.3	(2.8%) vs.(6.2%)(Foreign equity)
Jack R.Meyer	$7.2	21.1% vs.16.4%	$6.9	12.5% vs.8.3%

SUMMERS REACTION

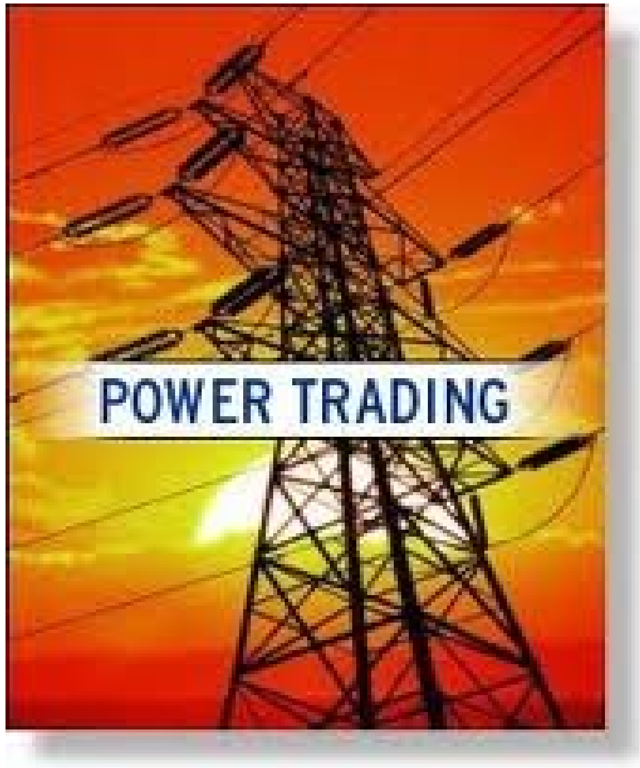
- “Most universities hire hedge funds, which pay huge salaries to their best traders. We hire our own traders and therefore pay them huge salaries, and people sometimes get upset. The easy thing would be to say we weren’t going to do it anymore and hire external managers, like everybody else does. [But] we would then be spending $50-$100 million a year more getting our endowment managed. It would be easier to do the inefficient thing and avoid bad publicity, but I don’t think it would be the right thing to do.”

ANOTHER ILLUSTRATION

- In 1980 Tenneco Inc.'s acquired a relatively small company, Houston Oil and Minerals Corporation (HOMC). To encourage the retention of Houston Oil's exploration talent, Tenneco initially offered special salary, bonuses, and benefits to Houston Oil employees -- payments that were not offered to others at Tenneco. Tenneco also "agreed to keep [HOMC] intact and operate it as an independent subsidiary" rather than consolidate the acquisition. Despite initial enthusiasm, [HOMC's] managers and its geologists, geophysicists, engineers, and landsmen left in droves during the following year. The implementation of the customized compensation package was delayed, because, as Tenneco's vice president for administration observed, "We have to ensure internal equity and apply the same standard of compensation to everyone."

LARGE PHARMA COMPANY BUYS BIOTECH STARTUP

xceed
biotechnology ltd


POWER TRADING

WHAT DO THE ILLUSTRATIONS TELL US?

- In each illustration, managers attempted to create high-powered, market-like incentives within the firm.
- Plans, where implemented, were successful in delivering desired performance, …
- …but the comparison processes of those not part of the plan imposed overwhelming costs.
- The trade-off was:
  - incentive/selection benefits (those within plan)
  - comparison costs (from those not attached to the plan)
- Firms must maintain fairness norms to generate the collaboration vital to their advantage over markets.

SOCIAL COMPARISON PROCESSES

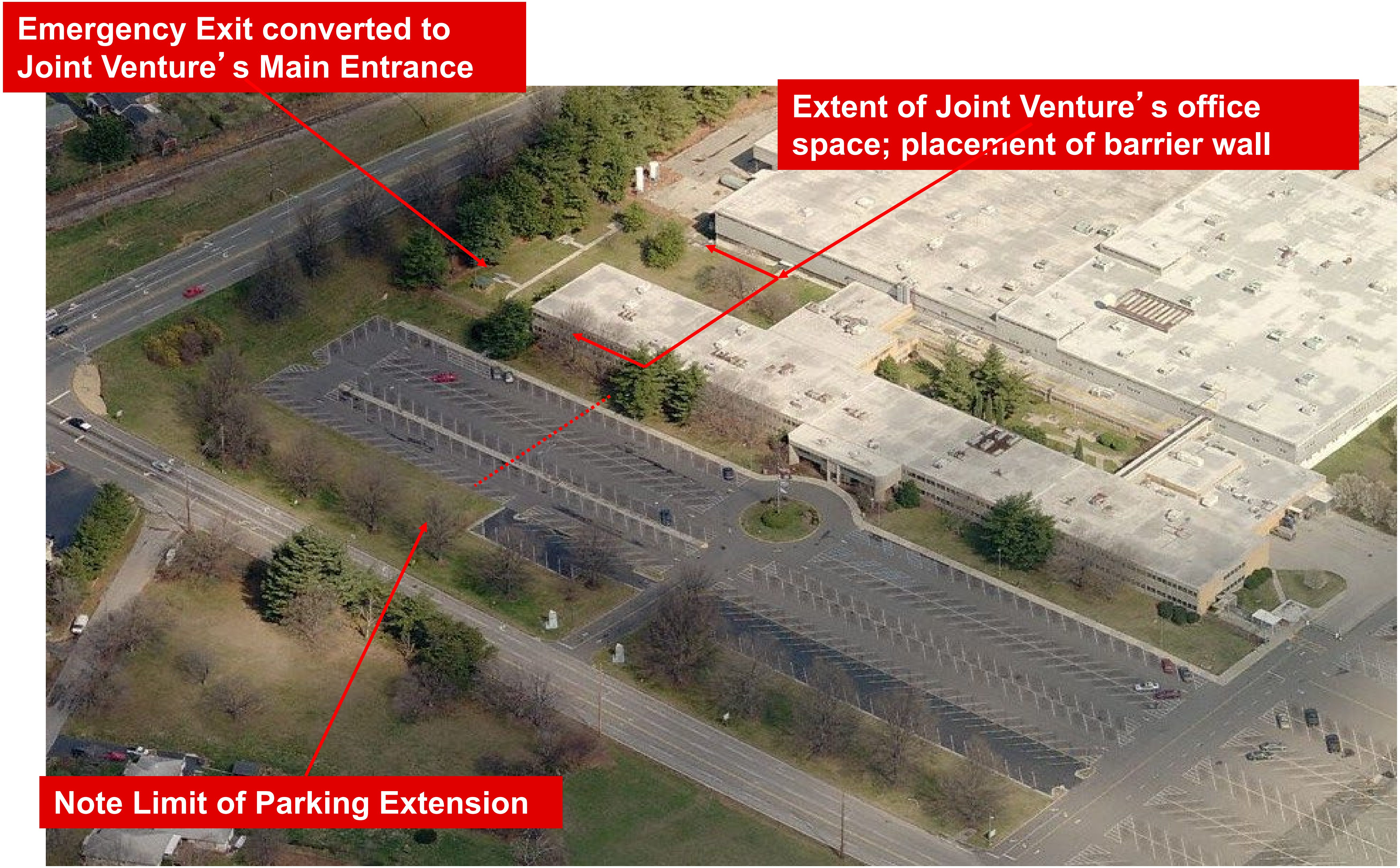
- Income differences trigger emotions of envy or inequity.
- Heightened by propensity to exaggerate self-ratings
- Perception of inequity causes employees to act to reduce it in ways that impose costs on the firm:
  - Departure
  - Reduced effort
  - Costly politicking

WHAT TRIGGERS SOCIAL COMPARISON?

	Company A N=268	Company B N=445
Top 1%	8.0%	11.9%
Top 5%	32.8%	42.0%
Top 10%	61.8%	73.3%
Top 25%	89.7%	92.5%
Top 50%	99.6%	100.0%

WITHIN FIRMS…

- Comparison costs: cost imposed on the firm as a response to perceived inequity in the distribution of rewards (reduced effort; turnover; politicking)
- General propositions:
  - In choosing what to integrate and the structure of compensation for that which is integrated, managers must take into account social comparison costs—costs associated with failing to generate perceived fairness.

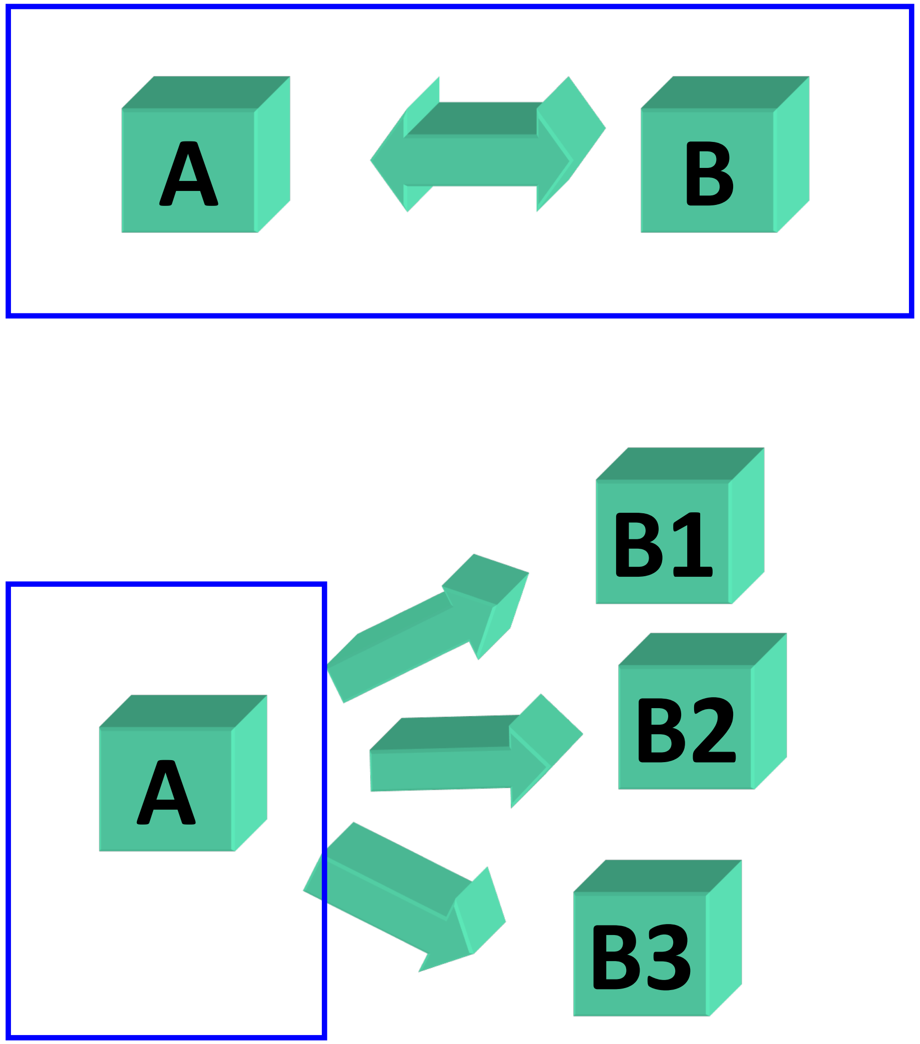

Emergency Exit converted to Joint Venture's Main Entrance
Extent of Joint Venture's office space; placement of barrier wall
Note Limit of Parking Extension

OPTIONS IN REDUCING SOCIAL COMPARISON COSTS

- Change the boundaries of the firm
- Isolate individuals with differing pay (restrict social comparison) – involves compromising optimal production design
- Restrict variance in pay

INTEGRATION AND COMPETENCE ATROPHY

Internal units focus on satisfying internal customers rather than establishing levels of competence required to compete externally



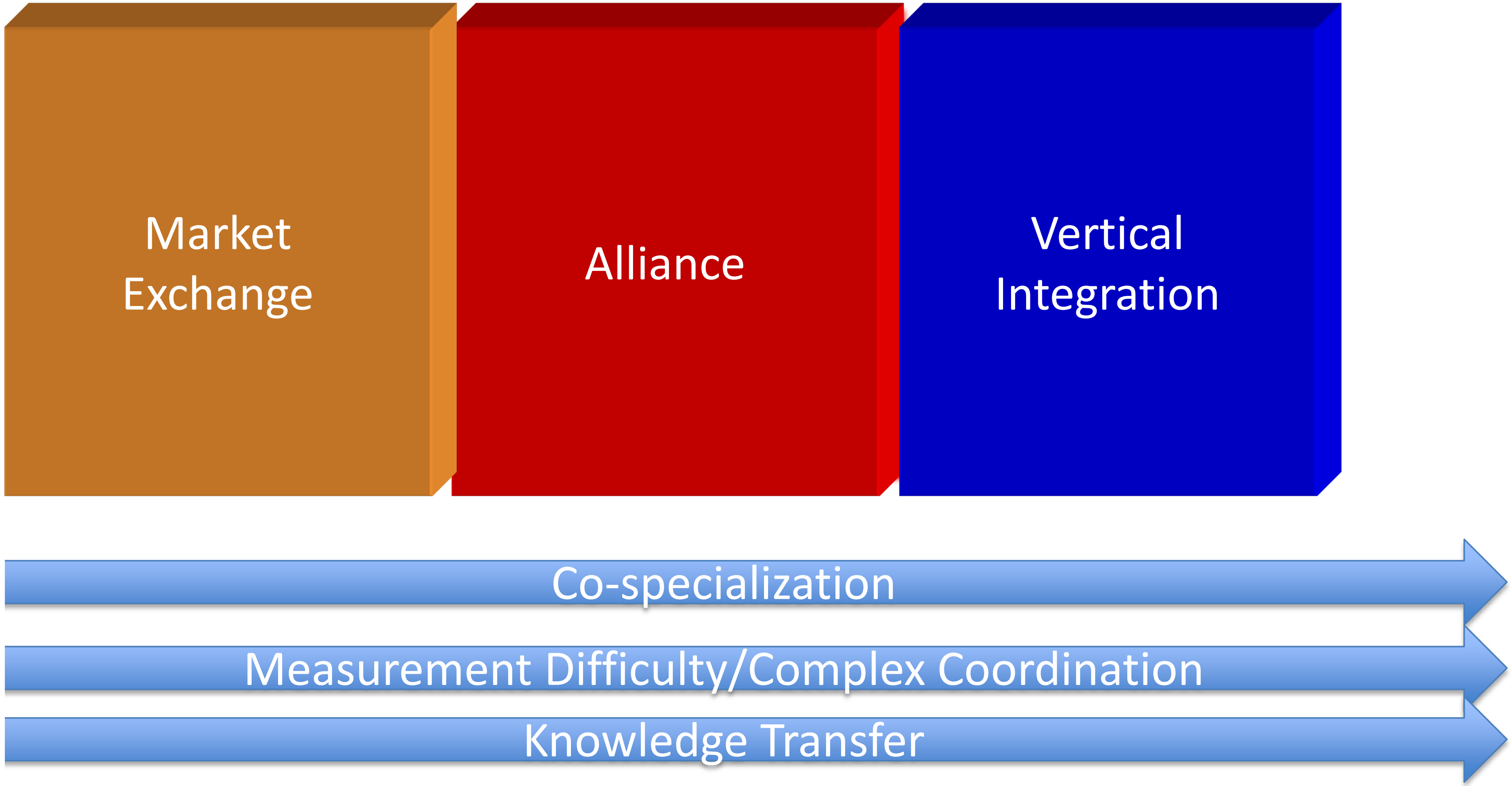
INTEGRATION PROMOTES SOCIAL ATTACHMENTS

- While social attachments…
- Facilitate better communication
- Perhaps enhance effort
- But,
- May cloud investment decisions
- May cloud strategic decision making
- Reduce flexibility

MAKE VS. BUY

- Market Benefits
  - Motivating the minions who are collectively smarter
- Market's Failure
  - Inability to effectively support co-specialization, complex coordination and tacit knowledge transfer.
- Hierarchy's Benefits
  - Command and control
  - Creating collaborative culture
- Hierarchy's Failure
  - The cost of control is the loss of motivation
  - Knowledge atrophy
  - Over-socialization

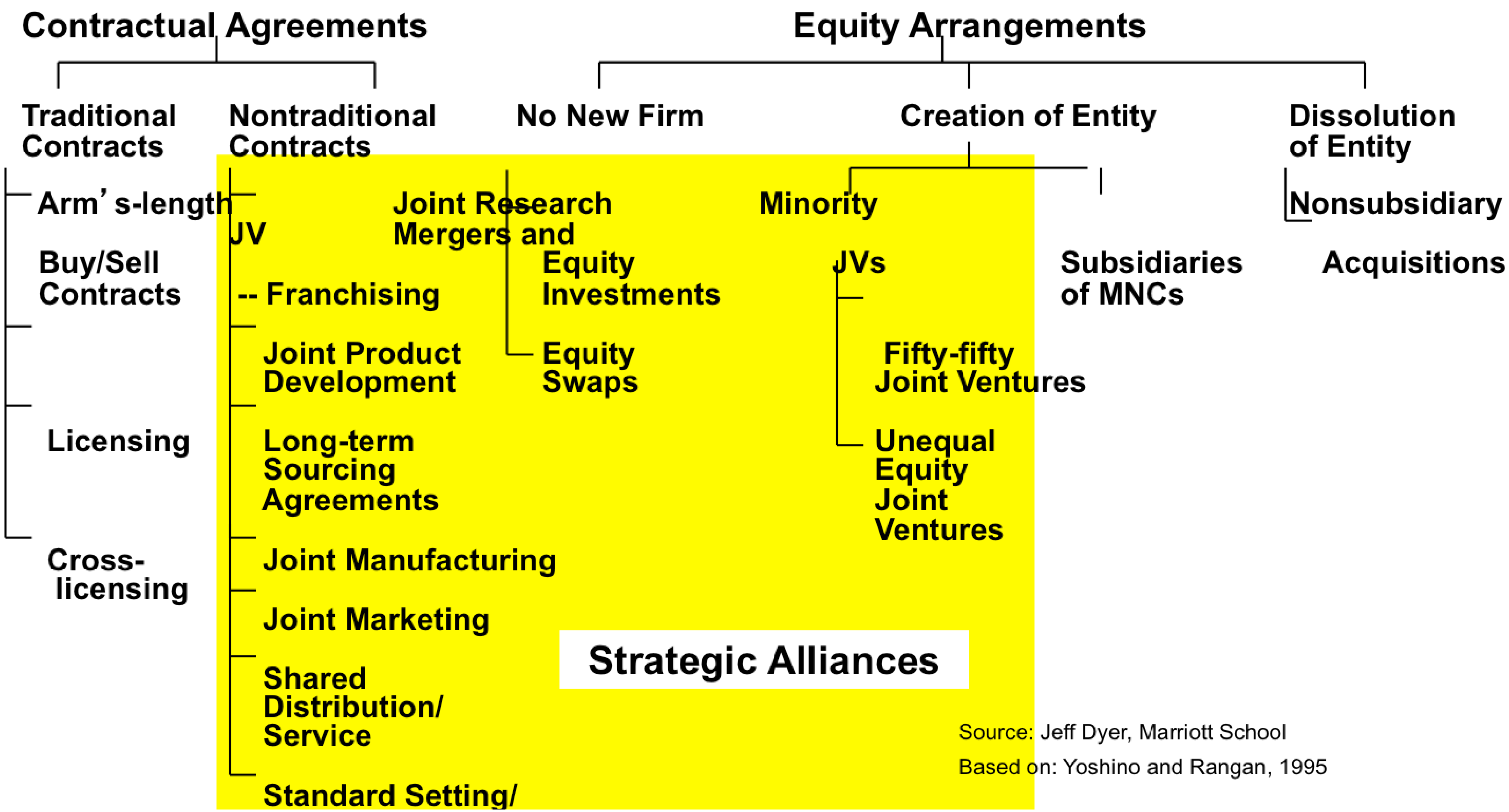
AN INTERMEDIATE OPTION



ALLIANCES: AN INTERMEDIATE ALTERNATIVE

- Collaborative partnerships and alliances are frequently a compelling intermediate governance choice (between market control and integration).

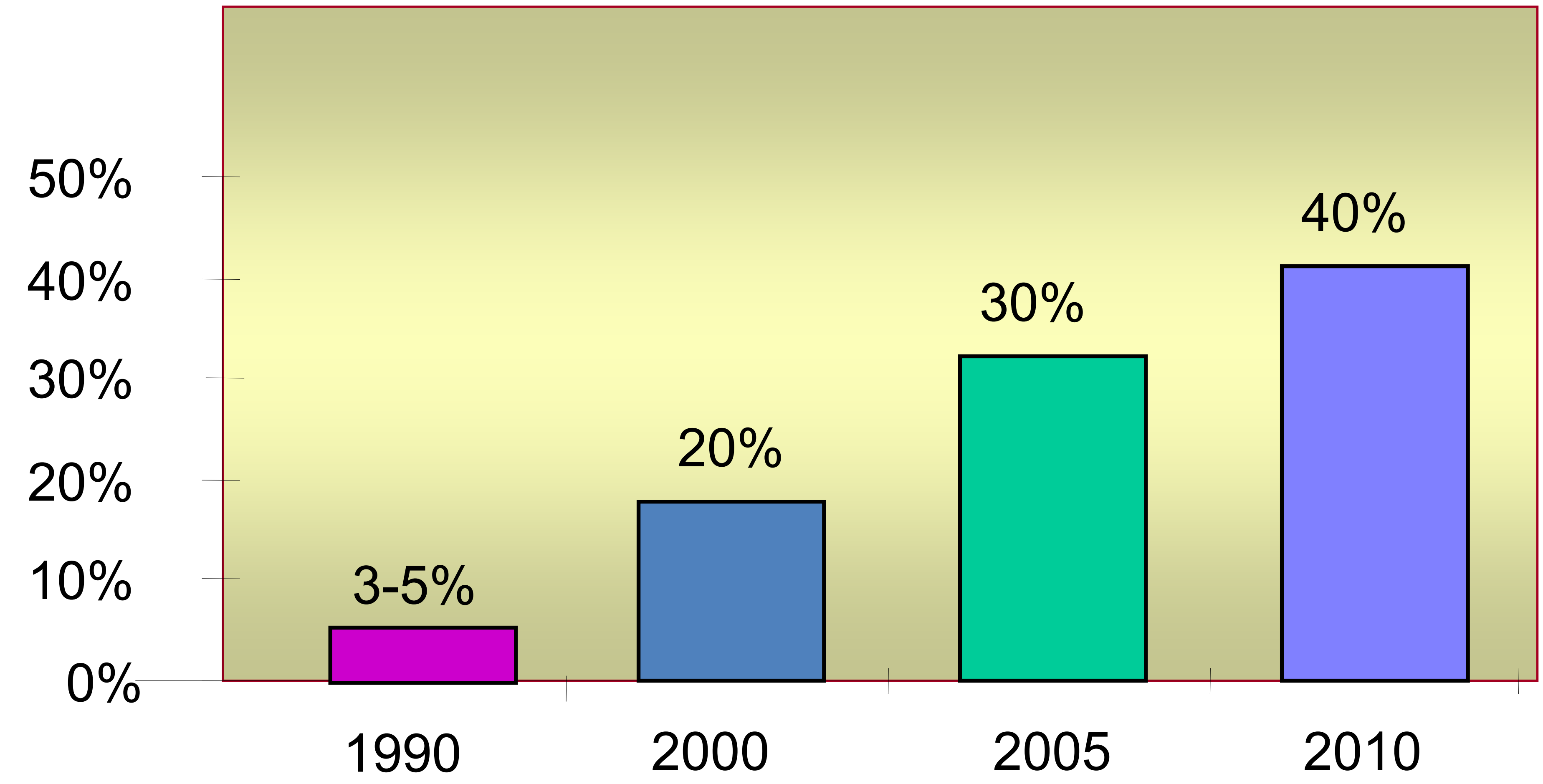
THE SCOPE OF INTER-FIRM RELATIONS



Source: Jeff Dyer, Marriott School

Based on: Yoshino and Rangan, 1995

Total business conducted through alliances

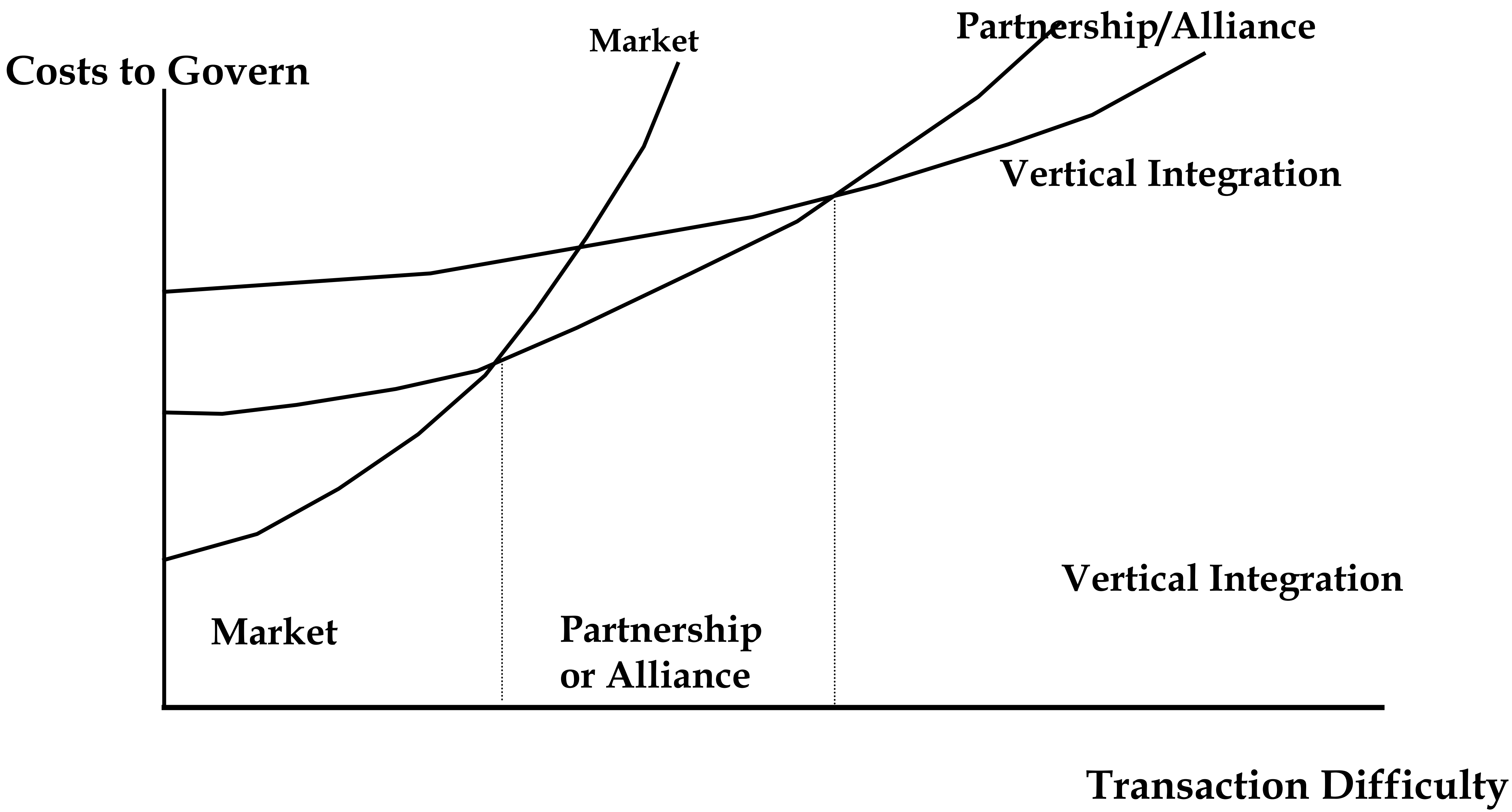


Cited by: Jeff Dyer, Marriott School, BYU

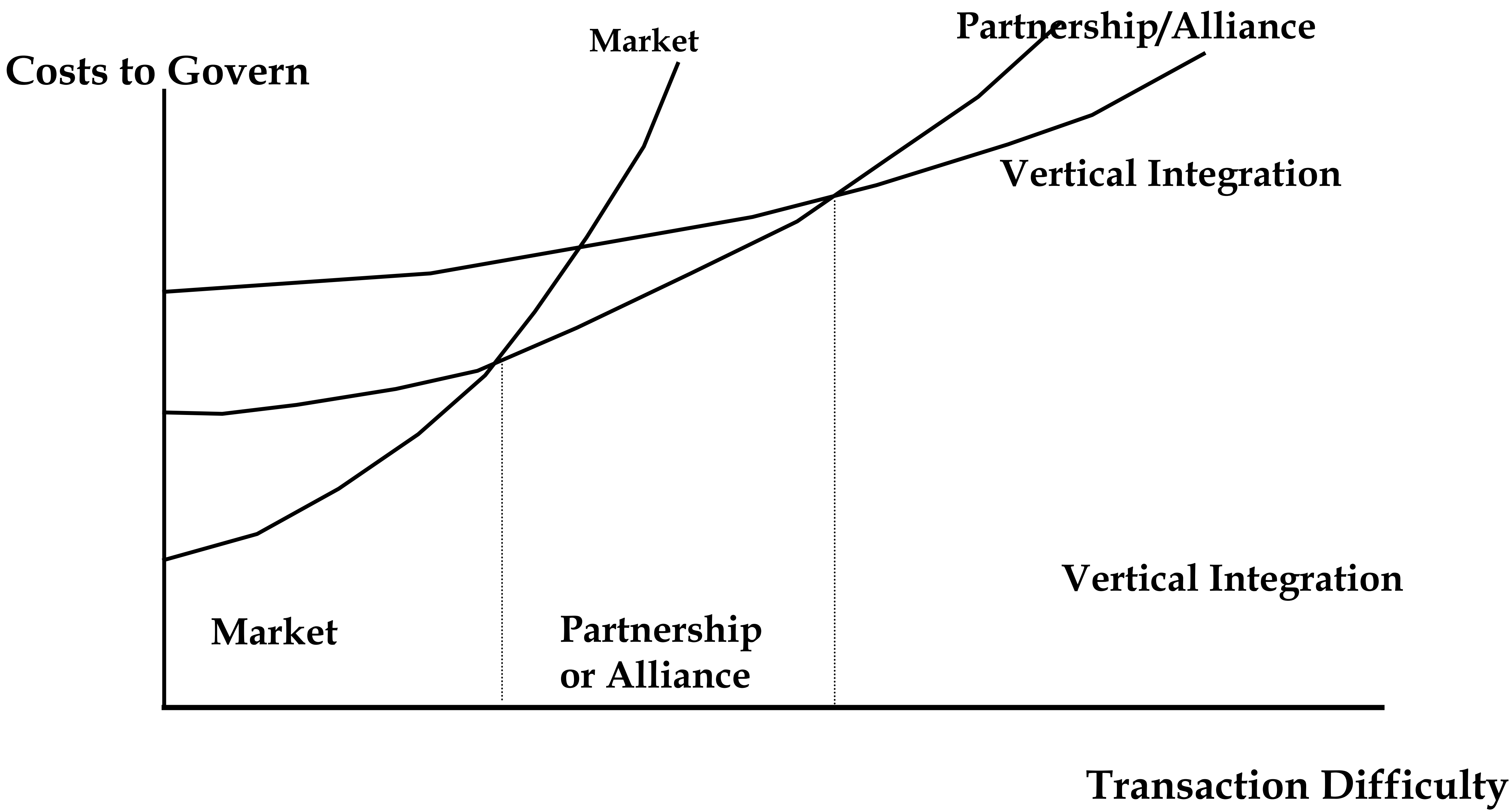
CHOOSING PROPER GOVERNANCE

- Firms that learn to more efficiently govern markets, alliances, or hierarchy improve their performance and shift their governance mix (contracts, alliances, integration).

COSTS AND DISTRIBUTION OF GOVERNANCE



LEARNING TO DO ALLIANCES



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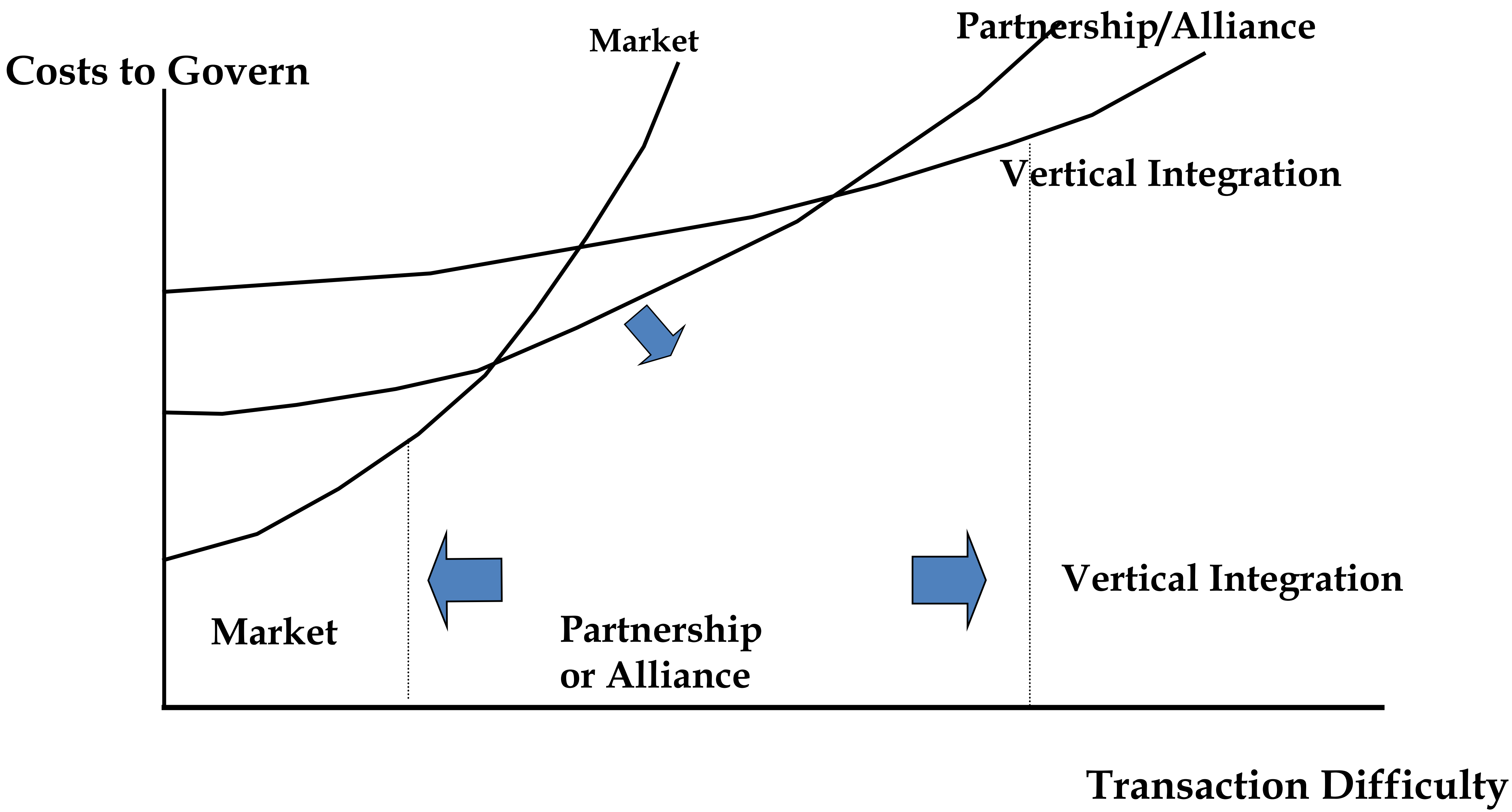

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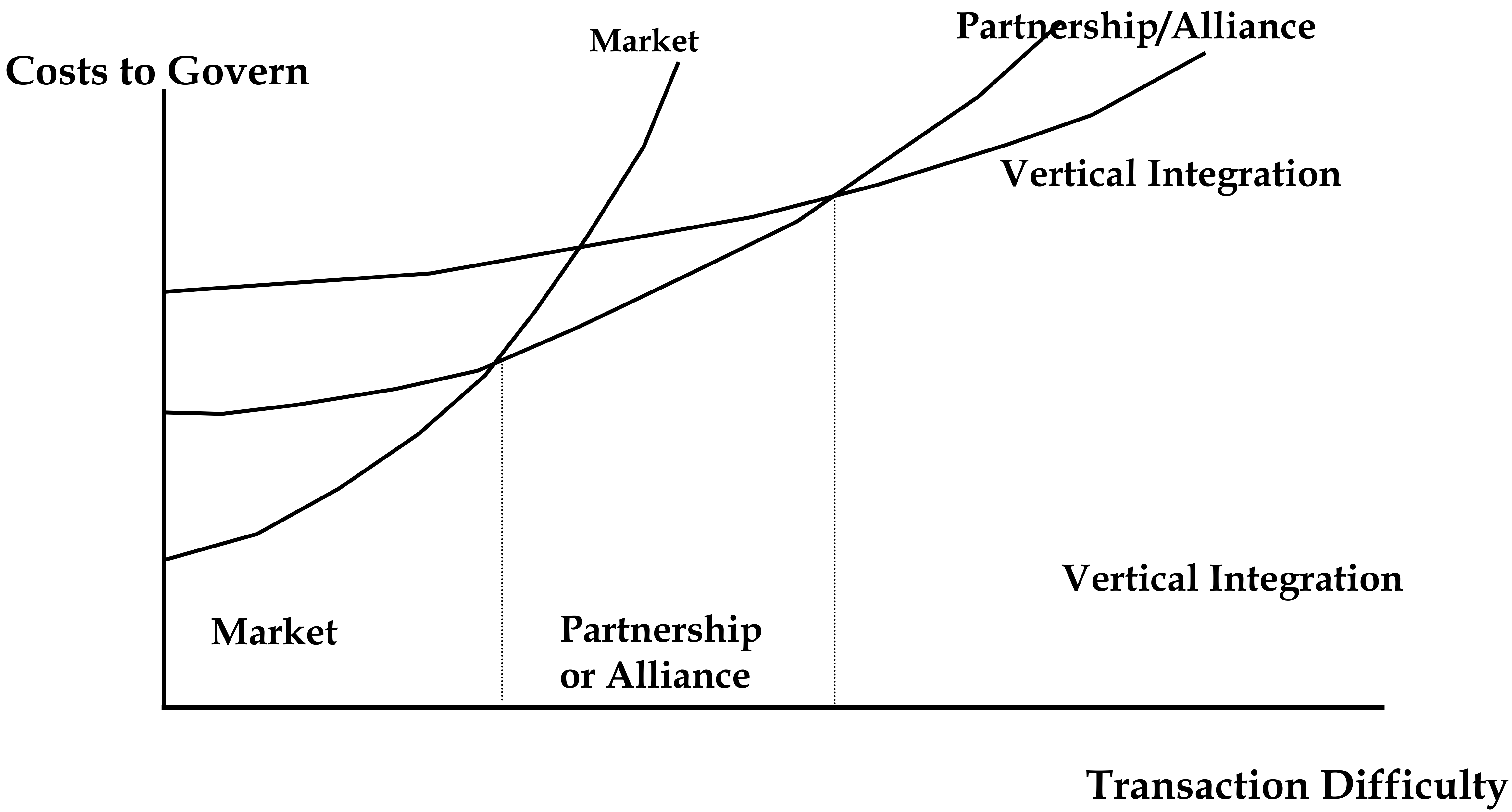
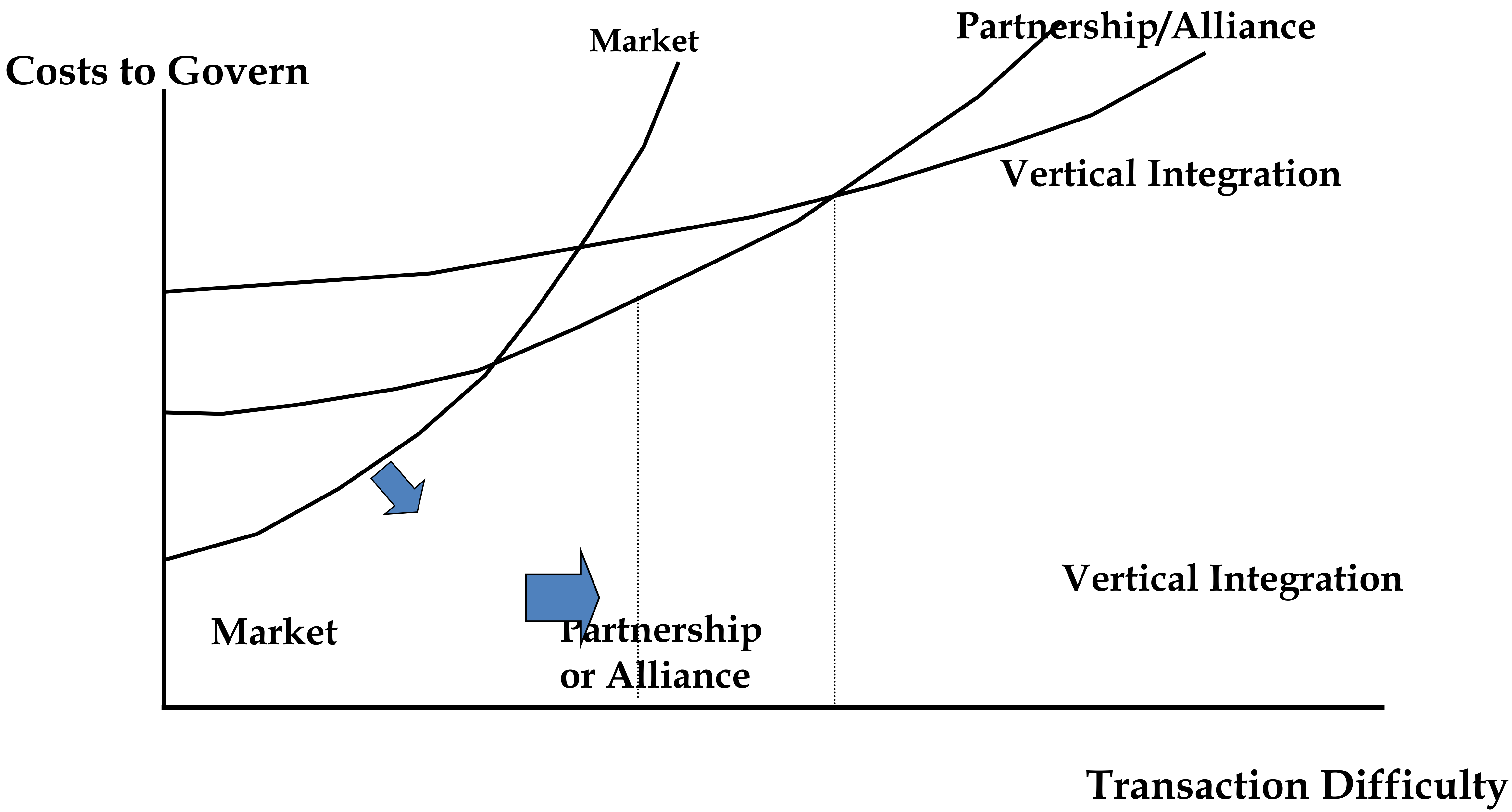
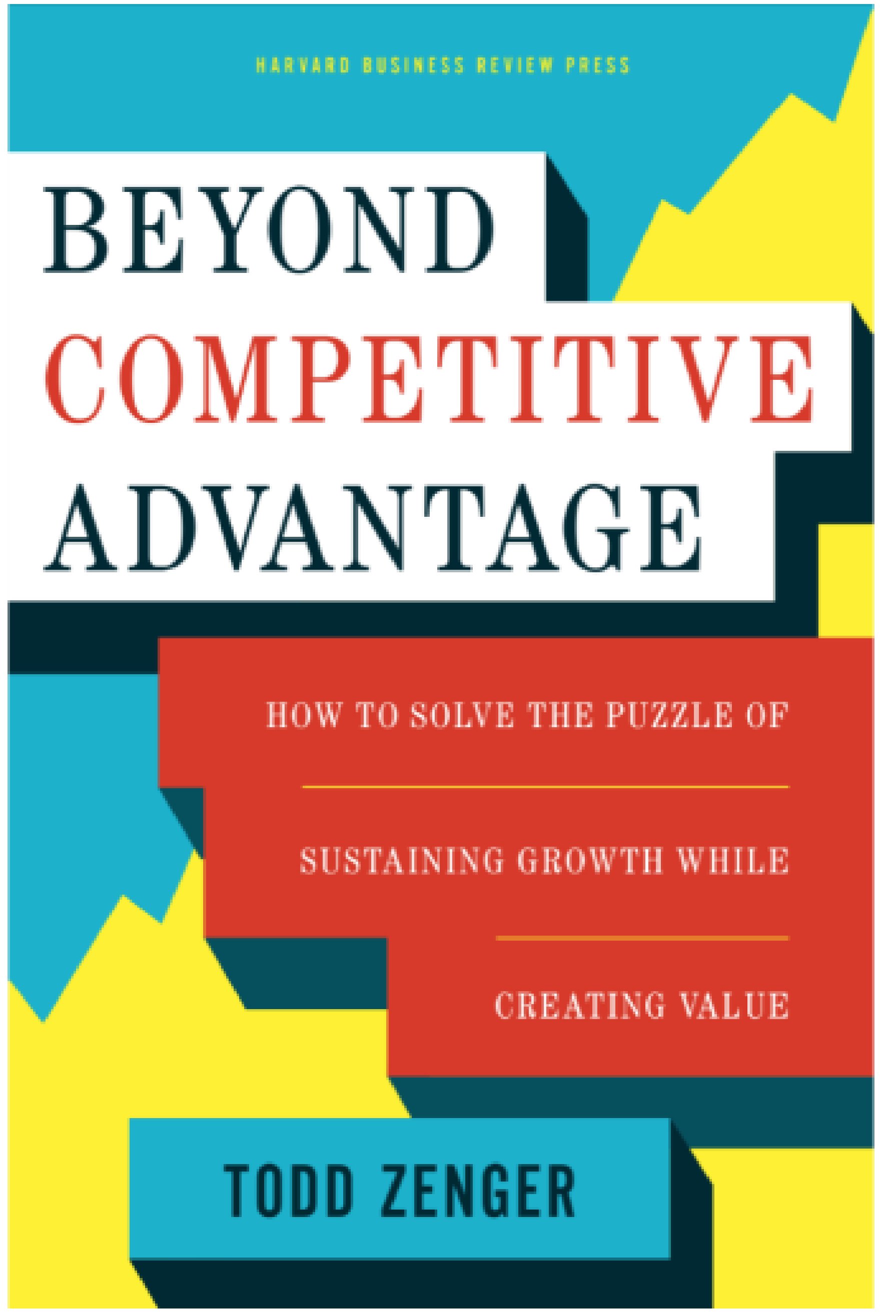


LEARNING TO USE MARKETS



SUMMARY

- Object is to compose the activities and assets that your theory reveals
- Organizing the transactions that access these activities and assets is critical to value creation and value capture
- Beware of your intuition to seek greater control.
- Understand the central role of co-specialization
- Manage the dynamics of governance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