MASTER'S THESIS

A Roadmap for Unbundling the Corporation

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LULEÅ UNIVERSITY OF TECHNOLOGY — TARBIAT MODARRES UNIVERSITY

۱۳۸۸/۴/۱۶ 2009

دوره مشترک کارشناسی ارشد بازاریابی و تجارت الکترونیک دانشگاه تربیت مدرس و دانشگاه تکنولوژی Lulea

عنوان :

ارایه مسیر راه برای گسست سازمانی و تمرکز بر فرآیندهای محوری

نام دانشجو :
مهرداد معینی جزنی

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سال ۱۳۸۸

۱۱۶۳۵۷

TARBIAT MODARES UNIVERSITY
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Abstract

Growth of the many organizations is still limited mostly due to the fact that they are an amalgamation of three core yet conflicting business processes: infrastructure management business, product innovation business and customer relationship business. Leading companies have focused on their core capabilities and leveraging their growth by participating in networks of specialist companies.

Unbundling the corporation, introduced by Hagel and Singer (1999), explains why the traditional corporations are not able to achieve the desired level of growth by doing every aspects of value chain themselves. However, rapid technological improvements in internet and networking have reduced the interaction costs which have made it possible for managers to focus on their organizational core capability and unbundle the rest to the specialized partners.

Unbundling the corporation should be considered as a growth strategy. To be applied by practitioners, developing a roadmap for unbundling is essential. Considering the increasing trends in outsourcing specifically in the time of economic turmoil signify the necessity and importance of such a roadmap.

In this research, we propose a roadmap for unbundling the corporation. Our roadmap has been derived from extensive case studies in order to increase its generalisability. The roadmap consists of two frameworks. The first framework assists practitioners to map their organizational capabilities and decided in which they should invest. Finally, the second framework indicates the relationship between core capabilities and network capabilities of an unbundled organization. Together the two frameworks help managers to devise their strategic approach toward unbundling and growth.

Keywords

Unbundling, Capability, Process, Networks, Leveraged Growth, Uncertainty, Specialization, Growth, Orchestration, Shaping and Adaptation

Acknowledgement

Although writing a thesis is compulsory, to me it was a two-year journey of induction and deduction of contemporary theories and ideas. As one of the most memorable journeys I ever had, I learnt a lot from theories and I got familiar with renowned scholars. The most important achievement of this thesis to me is learning to conduct a piece of research in a timely and effective manner.

As a master student of Marketing & e-Commerce who is still at the beginning of discovery, I should confess that this journey would not lead to the destination without the Almighty God generous supports and if the kind support and encouragements of many people did not exist.

First of all, I would like to express my sincere gratitude to my local supervisor, Dr. Amir Albadvi whose deep insights, knowledge and kind support have always enlightened my way though the research. I learnt a lot from him during the almost two years of our regular weekly meetings at his office on Monday mornings. Secondly, I would like to thank my LTU supervisor, Dr. Deon Nel whose valuable comments had a great impact on the quality of the thesis at hand.

I would also like to show my sincere appreciation to Professor Peter Naude' from Manchester Business School to whom I owe a lot. I am grateful for all his encouragements and patient supervision on some pieces of my work published as conference papers. The most important gifts he gave me were hope and endeavor.

Special thanks to Professor Salehi the head of division of Industrial Marketing & e-Commerce at Lulea University. for all his attempts in holding such a worthwhile joint master program. Moreover, many thanks to Professor Anne Engström for her kind hospitality in Sweden, in addition to her patient and considerate replies to my numerous emails. I wish her the best.

Finally, I would like to assert my warmest gratitude to my dear parents for the love, affection and support they provided me on every step of my life specially my educations.

Mehrad Moeini Jazani,
Tehran, April 2009

Table of Content

List of Tables

List of Figures

Chapter One

Unbundling the Corporation: the New Growth Strategy for the New Era

1. Unbundling the Corporation: the New Growth Strategy for the New Era

Some companies simply specialize in a limited part of the value chain and outsource the rest. That is how Bharti Airtel has built up the largest mobile services in India – and the fastest growing one in the world in terms of subscribers – despite initially trailing better funded competitors. Outsourcing of IT services to IBM and of the development and management of its telecom network to Ericsson, Nokia and Siemens. These changes freed up Bharti's capital, made its cost structure much more variable, and *allowed the company to target pricing levels of 1.5 to 2 cents per minute in advanced markets, all of which fueled rapid market growth and penetration. Bharti's has focused on its capabilities to concentrate on customer care and regulatory interface (Ghemawat & Hout, 2008).*

Specialized companies are emerging and new business models and strategies are born. More and more companies are concentrating on their core competencies and develop their capabilities in those areas and unbundle the rest part of their value chain in which other specialized companies are able to do the processes with higher quality and less costs. Traditional models no longer guarantee the growth and profitability of the organizations. Managers should ask themselves a very fundamental question "What business are we really in?" Their answers will determine their fate in an increasingly frictionless economy.

One of the recent theories, explaining these great transformations in business models, is unbundling the corporation presented in 1999 by Hagel and Singer in Harvard Business Review. The aim of this chapter is reviewing the unbundling theory and its origins at first. Then the importance of research on this topic has been clarified. After explaining the motivations of this research, the goals of the research or research questions in addition to the layout of the research have been presented. Finally, the conclusion section of this chapter has provided an appropriate guideline for surfing through different parts of this research.

1.1 Unbundling: The Origins

In order to better understanding of unbundling theory, one might pay attention to its underlying principles. One of the influential building blocks of unbundling theory is *transaction cost economics (TCE)*, created by Coase (1937) and further developed by Williamson (1971). This theory is one of the most popular theories in explaining the boundaries of the firm. According to this theory, all integration or disintegration decisions are driven by the goal to minimize the transaction costs, which are the coordinating costs for governing a relation (Williamson O. , 1971).

To elaborate more on TCE[1], definitions of *"Interaction"* and *"Interaction Costs"* has been provided. *Interactions* are defined as searching, coordinating, and monitoring that people and firms do when they exchange goods, services, or ideas - encompass all economies, particularly those of modern developed nations (Butler, et al., 1997). These interactions occur within firms, between firms, and all the way through markets to the end consumer. They take many everyday forms - management meetings, conferences, and phone conversations, sales calls, problem solving, reports, memos - but their underlying economic purpose is always to enable the exchange of goods, services, or ideas (Butler, et al., 1997). Accordingly, *"Interaction costs"* represent the money and time that are expended whenever people and companies exchange goods, services, or ideas (Hagel & Singer, 1999)

Interactions and their relative costs are important determinants of how firms and industries are structured and how customers behave. Firms do trade off the value of specialization against the interaction costs associated with external suppliers when they set their boundaries and choose their focus. To be more specific, companies trade off the effectiveness of alternative organizational forms against the interaction costs involved in managing them. That is, they always think about being larger and form a big corporate by doing the worked themselves which in turn form a new organizational form. Are departments the natural way to configure a modern corporation, for example? Do they have to be co-located? Is a central structure needed to monitor them? Are ad hoc teams more effective than permanent structures? Are flat or hierarchical structures easier to manage? (Butler, et al., 1997)

When the interaction costs of performing an activity internally are lower than the costs of performing it externally, a company will tend to incorporate that activity into its own organization rather than contract with an outside party to perform it. All else being

[1]Transaction costs, as economists have defined them, include the costs related to the formal exchange of goods and services between companies or between companies and customers. Interaction costs include not only those costs but also the costs for exchanging ideas and information. They thus cover the full range of costs involved in economic interactions (Hagel & Singer, 1999)

equal, a company will organize in whatever way minimizes overall interaction costs (Hagel & Singer, 1999). In addition to affecting the boundaries of the firm and industry, interaction costs will affect customers too. Customers choose products and providers by trading off the interaction costs of additional search against the marginal value expected from it. In the world where searching costs nothing, consumers would search exhaustively until they found the exact product of their choice at the lowest price available.

In the theory, if interaction costs were negligible, an organization could be atomized into a collection of individuals, geographically dispersed but connected by a communications network. In reality, however, substantial interaction costs and the human aspects of effective interaction limit the range of such configurations (Butler, et al., 1997).

John Hagel III and Marc Singer (1999) proposed that the rapid change in technology specifically the networking and communications has facilitated the interactions and reduced their respective costs. In result, companies will be able to outsource non-core processes to other specialized companies with minute transaction costs and concentrate in their core businesses and capabilities. Such transformations in organizational structure and boundaries have been possible due to the great development in communication and networking technologies. That is why, increasing number of firms are exploring various sourcing mechanisms for their business processes for cost and strategic advantages. Once tightly coupled business processes in the firm's value chain are being *unbundled* to exploit global sourcing opportunities around the world (Ge, Konana, & Tanriverdi, 2004). To demonstrate the undeniable impacts of emerging technologies on interaction costs, we will discuss their effect in the next section.

1.2 Role of Technology in Revolutionizing Interactions

All modern forms of interaction - whether they are as simple as writing a letter or as complex as solving a problem in a team - are being shaped by computing and communications technologies.

New networking capabilities, technologies that enhance connectivity and bandwidth, and standards that drive new applications have come together to strengthen processing power and to deepen technological penetration. This potent combination heralds a new age of abundant interactive capability (Butler, et al., 1997).

The growing use of networks has created an explosion in the ability to interact. The emergence of a new set of standards has boosted network usage and applications development. In the face of a massive increase in interactive capability, many of our traditional assumptions about the natural forms of economic activity will fall by the wayside. The tradeoffs that shape economic activity – firms trading off specialization against interaction costs, customers weighing current selections against further search costs, organizations considering alternative configurations - will each find a new point of balance as one side of the scale tips down. New ways to configure businesses, serve customers, and organize companies are emerging. The new achievements for firms and industries are as follow (Butler, et al., 1997):

- ***Productivity Enhancement:*** The most straightforward interpretation of the increase in interactive capability is that workers could do their jobs in less than half of the time they currently spend. This means that a salesman will be able to spend much more time with customers, for instance, while R&D staff will have to spend much less time collecting data and waiting for test results. For the US economy alone, such savings could translate into productivity gains worth at least $1 trillion, or a third of GDP.
- ***Business Re-configuration:*** *Vertical integration*[2] will become less valuable and disaggregation, outsourcing, and the use of external markets will increase. Whether a company makes or buys depends on the comparative costs of transformation (production and transportation) and interaction. While outsourcing or purchasing from a market allows buyers to benefit from the superior economics of specialized suppliers, it tends to involve substantial interaction costs.

[2] Vertical integration is the degree to which a firm owns its upstream suppliers and its downstream buyers. Contrary to horizontal integration, which is a consolidation of many firms that handle the same part of the production process, vertical integration is typified by one firm engaged in different aspects of production (e.g. growing raw materials, manufacturing, transporting, marketing, and/or retailing) (Perry, 1988).

As these costs fall, the relative attractiveness of arm's-length purchases will rise. Integrated business systems will give way to more specialized ones, and disaggregation and outsourcing will burgeon. In contrast, *horizontal integration* and cooperation will become more economically attractive. Horizontal integration brings benefits when carrying out a set of activities jointly rather than separately yields economies of scope in the form of higher returns or lower costs. As falling interaction costs allow companies better to coordinate the marketing and distribution of a wider variety of products and services, the value of horizontal integration should increase.

Another important aspect in business re-shaping is that the strategic value of scale is likely to decline in many industries, although it will rise for networked businesses. In businesses where distribution or logistics originally made scale essential, falling interaction costs will reduce its importance. Outsourcing, alternative delivery channels, and the ability to variablize inputs will grow, reducing fixed costs. As a result, smaller firms will proliferate in such industries as consumer goods manufacturing, applications software, specialty retailing, and design services. By contrast, in networked businesses, where the number of possible interactions increases exponentially with the addition of each node, interaction efficiency is the key to competitive advantage. As recent acquisitions and mergers in telecommunications, transportation, banking, and mass retailing suggest, scale expansion is likely to take place in such businesses. In general, there will be a shift toward more networked forms of business configuration.

- ***More efficient market mechanisms:*** The lower cost of search and communication will force a move to more efficient market mechanisms for exchanging goods and services. As interaction costs fall, some of the features associated with markets will come into play: lower transaction costs, more transparent prices, and a larger pool of buyers and sellers who can communicate with each other. Thousands of genuine electronic markets will be created by the open standards and low interaction costs of Internet.

Another facet is that the traditional role of intermediaries will disappear or be transformed into market making or synthesis. Intermediaries have traditionally exploited the lack of transparency in supply and demand in circumstances where it is costly for buyers and suppliers to search for and communicate directly with one another. But as these interaction costs fall, more providers go directly to consumers via telephones and the Internet, and more consumers do their own searching using the new media and on-line search agents.

Moreover, Market-making opportunities will proliferate in almost any industry where a market can be created around information detached from the physical flow of goods.

- ***Customer service:*** It will be far easier for any company, regardless of size, to reach new customers anywhere in the world. As interaction costs fall, traditional assumptions about distribution and consumer reach will be overturned. Once, giant multinationals with established brands and local presence were the only players that could aspire to reach consumers all over the world. Under the old model, a company sold its products locally and expanded gradually Being global was synonymous with being huge. This is no longer true. Many companies will be born global. Today, even the smallest start-up has access to a global market for its products. Aussie Lures, a tiny business run from a garage in Sydney, sells fishing lures to customers across the world via the Internet. In addition, direct sales and distribution will become the norm rather than the exception. Not only will finding and reaching new customers be simpler, tailoring products for them will be easier, faster, and cheaper as well (e.g. Levi Strauss, Customfoot, Time magazine, Amazon).

Also, Communication with customers - advertising, research, and marketing - will shift from broadcast to narrowcast mode as the cost of interacting with individual consumer falls. The "magic cookie" technology embedded in Netscape, for example, enables the software to maintain an automatic record of the sites a user visits. Eventually, it will be able to capture information about the interactions themselves, such as amount spent and items purchased.

To sum up, by decreasing in interaction costs as discussed above, there will be revolutionary changes in the way industries and organizations define themselves and their structure as well as in a way that customers will be served and will be communicated. These great changes have already begun. In the next section, the theory of unbundling have been deeply discussed which will enable us to explain these ongoing changes

1.3 Unbundling the Corporation

In this section, the theory of unbundling, developed by John Hagel III and Marc Singer (1999), has been introduced and discussed in detail. Firstly, the framework of Hagel and Singer (1999) has been explained. This framework greatly facilitates the understanding of these phenomena by introducing three core businesses of the organizations. Afterwards, some examples of this concept have been presented in order to provide more support for our research purpose and showing the importance of the subject. Consequently, we have introduced unbundling as a new growth strategy for corporations and discussed over the new viewpoints that managers and practitioners should employ in order to fully exploit its advantages. Finally, we have described the differences between unbundling and outsourcing.

1.3.1 One Company: Three Businesses

Most companies today are still an unnatural bundle of three fundamentally different, and often competing, business types. These are core businesses or processes of an organization- which are those that other businesses shape due to their existence (Hagel, 2008). These core businesses are:

- Infrastructure management businesses (IMB*)* – high volume, routine processing activities like running basic assembly line manufacturing, logistics networks or routine customer call centers
- Product innovation and commercialization businesses (PIC) – developing, introducing and accelerating the adoption of innovative new products and services
- Customer relationship businesses (CRM) – building deep relationships with a target set of customers, getting to know them very well and using that knowledge