strategy+business

Recent Research

by Des Dearlove and Stuart Crainer

from strategy+business issue 48, Autumn 2007

Photograph © Randy Faris/Corbis

Recent Research

On the culture of spin-offs, Ken Lay's calendar, the synergies of digital retail, and the case against microcredit.

by Des Dearlove and Stuart Crainer

Accounting for Culture
Henrik Cronqvist (henrik.cronqvist@cob.osu.edu), Angie Low (low_40@cob.osu.edu), and Mattias Nilsson (nilsson@wpi.edu), "Does Corporate Culture Matter for Firm Policies?" Dice Center Working Paper No. 2007-1, Fisher College of Business Working Paper No. 2007-03-001, January 3, 2007. http://ssrn.com/abstract=954791

Anecdotal evidence suggests that corporate culture — "the way we do things around here" — influences corporate decision making, which in turn affects performance. But in the past, little attempt has been made to use empirical evidence to prove this link.

Henrik Cronqvist, assistant professor of finance at Ohio State University; Angie Low, of Ohio State and Nanyang Technological University in Singapore; and Mattias Nilsson, assistant professor of finance in the department of management at Worcester Polytechnic Institute in Massachusetts, broadly addressed the issue in their paper. They asked whether corporate culture is so ingrained that it defines the investment and

Des Dearlove
(des.dearlove@suntopmedia.com) is a business writer based in the U.K. He is the author of a number of management books and a regular contributor to *strategy+business* and *The (London) Times*.

Stuart Crainer
(stuart.crainer@suntopmedia.com) is a business writer based in the U.K. and a regular contributor to *strategy+business*. He and Des Dearlove founded Suntop Media, a publishing and training company providing business content for online and print publications.

operational activities of a company's spin-offs.

To test this issue, the authors analyzed the behavior of 286 spin-off/parent pairs between 1980 and 2004 across a range of areas. These included investment policy (portfolios and acquisitions, for example); financial policy (borrowing levels, debt maturity, cash holdings, and dividends); and operational policy (R&D, advertising and sales, and administrative expenditures). They also assessed the effect of corporate culture on performance, measured by return on assets (ROA) and return on sales (ROS).

The researchers' findings led them to four conclusions. First, there is a strong relationship between the investment, financial, and operational choices of spin-offs and those of their parents. For example, the authors write, "Parent firms with, say, abnormally low levels of leverage tend to produce spin-offs which also have an abnormally low appetite for debt."

Second, cultural effects are stronger in internally grown business units than in acquired business units. They are also strong in older companies. This is consistent with the idea that corporate culture is shaped by the experiences of an organization over time.

Third, companies preserve culture by selecting management teams that fit with their makeup. In other words, firms recruit on the basis of cultural preferences, ensuring that cultural biases are likely to be retained in future decision making.

Fourth, corporate culture affects economic performance. "Better-performing parents seem to produce better-performing offspring firms, after controlling for year, industry, and firm factors," the authors note. "Poorly performing spin-offs tend to come from parent firms that are themselves not performing well." In other words, if you want to take the measure of a spin-off, look at its parents.

Was Ken Lay a Typical CEO?

James Brickley (jim.brickley@simon.rochester.edu), "The Role of CEOs in Large Corporations: Evidence from Ken Lay at Enron." http://ssrn.com/abstract=958998

Most analysis of the late Ken Lay has focused on the ethical wrongs or financial intricacies of what happened during his tenure as CEO of Enron. James Brickley, Gleason Professor of Business Administration at the University of Rochester's William E. Simon Graduate School of Business Administration, chooses an alternative perspective. Brickley examines Lay's role as a manager and how that may have affected his knowledge of the financial shenanigans occurring at the company.

To be sure, the author may be a bit biased. He was an expert witness for the defense in the Enron litigation. (Lay was convicted of fraud but died in July 2006 before serving any prison time.) But that also makes him particularly knowledgeable about the meaning and minutiae of Lay's day-to-day activities. Indeed, to write this paper, Brickley rummaged through the 2001 calendar and itineraries of Lay as well as a number of his colleagues' and studied the details of Lay's meetings, his attendance at committee sessions, and his approval of transactions.

It is somewhat incongruous that it took a disturbing case like Enron to provide insights into how executives spend their time. Business literature is particularly lacking analyses of executive behavior. Henry Mintzberg's 1973 book, *The Nature of Managerial Work,* is one of the very few exceptions.

Based on his extensive research, Brickley's conclusion is that Lay's interpretation of the CEO's job was roughly in line with standard corporate practice and that he fulfilled the CEO's role with "reasonable diligence." This being the case, Brickley argues, it is unlikely that Lay would have known of the financial activities of those below him on the corporate hierarchy.

During an eight-month period in 2001 (the year Enron's tangled web of financial misdeeds so spectacularly unraveled), Lay had a mere four meetings with CFO Andy Fastow, who was responsible for many of the transactions that eventually brought about the company's collapse. By contrast, Lay met 29 times with president and COO Jeff Skilling, and 35 times with his chief of staff. (Brickley's presumption is that Skilling deflected Lay's questions about finance at these meetings and almost never talked specifically about the company's myriad transactions.)

Lay traveled widely but was in Enron's Houston headquarters all day 33 percent of the time and part of the day 38 percent of the time. His record of attendance at board and committee meeting over a four-year period was virtually 100 percent. His lowest performance — below 90 percent — was at audit committee meetings. During a four-year period, Lay signed only nine of 347 deal approval sheets, which had to be OK'd by managers at various levels depending on the size of the transaction (board members, for example, had to approve deals of more than $75 million).

Brickley concedes that what Lay actually knew and did not know is now beyond reach. But, putting Lay's guilty verdict aside, he argues that Lay was simply behaving like countless other CEOs of large corporations. Whereas the media has painted Lay as either completely detached from what was going on or complicit in it, Brickley says that he was highly involved and well-informed at a broad level about the company's businesses. But he spent limited time with the CFO and the chief accounting officer and relied on internal controls to ensure that the business did not do anything that could hurt shareholder value or that was unethical.

One of the repercussions of the Enron debacle is that CEOs today spend more time monitoring financial reporting and internal controls, because under the Sarbanes-Oxley Act they cannot claim, as Lay did, that they didn't know what was going on in the lower levels of their firms. This is understandable given the public's post-Enron backlash against CEOs, but Brickley warns that this means CEOs are spending less time on other activities geared to growing their businesses.

Don't Say Nix on Bricks or Clicks

Jill Avery (javery@hbs.edu), Mary Caravella (mncaravella@hbs.edu), John Deighton (jdeighton@hbs.edu), and Thomas J. Steenburgh (tsteenburgh@hbs.edu), "Adding Bricks to Clicks: The Effects of Store Openings on Sales Through Direct Channels," Harvard Business School Working Paper No. 07-043, February 2007. www.hbs.edu/research/pdf/07-043.pdf

If a retailer has both bricks-and-mortar outlets and direct channels, such as an online store and catalogs, how does opening a new physical store affect its business? Do the clicks decline at the appearance of the bricks?

Prior research suggests two phenomena can be at work in such situations. The first is cannibalization, in which the bricks-and-mortar store reduces sales in the other channels. This is more likely to occur when the different channels offer virtually the same products or services, when these channels target the same consumers, and when hands-on interaction with products or services is desirable before purchasing.

The second phenomenon is complementarity, in which the neighborhood bricks and online clicks support rather than detract from each other. Complementarity commonly occurs when consumers have a variety of channels through which to purchase products and they use different channels for different shopping experiences and preferences. Complementarity also is evident when a new channel adds to overall retailer brand awareness.

Jill Avery and Mary Caravella, Ph.D. students at Harvard Business School; John Deighton, Harold M. Brierley Professor of Business Administration at Harvard Business School; and Thomas J. Steenburgh, assistant professor of business administration at Harvard Business School examined the opening of four new stores by an unnamed retailer in a single U.S. state to analyze how cannibalization and complementarity work in practice.

The retail chain has online sales, a catalog operation, and stores in shopping malls. All of these outlets sell the same merchandise at the same prices, though each channel offers its own promotions and advertising. Sales from mall stores are greater than those from other channels, but Web and catalog revenues are increasing rapidly.

The researchers probed six years of sales data and used zip code matching to unearth the pattern of sales from different channels. Perhaps the most interesting conclusion: Instead of being mutually exclusive, cannibalization and complementarity can occur in tandem.

According to the research, the opening of a new store initially had a cannibalistic effect. In the surrounding area, sales in online and catalog channels typically fell by 10 to 20 percent in the period after a store's opening and slowly recovered over three years until returning to the levels they enjoyed prior to the new store opening.

At the same time, the effect of complementarity was felt. New customers were attracted to the store and, probably because the stores helped promote the retailer's brand, also began to make purchases on the Web and through the catalog. This brought more sales to the clicks channel, which, over a period of time, more than compensated for the loss of existing Web and catalog customers to the new store. For retailers, the reassuring conclusion is that bricks and clicks can happily exist side by side.

Why Microcredit Is Not Enough

Aneel G. Karnani (akarnani@umich.edu), "Employment, not Microcredit, Is the Solution," University of Michigan Ross School of Business Working Paper Series, Working Paper No. 1065, January 2007.
http://ssrn.com/abstract=962941

Microcredit — the use of small loans to help poor people set up businesses — has been hailed as an economic breakthrough. For example, in awarding the Nobel Peace Prize for 2006 to the Grameen Bank in Bangladesh and its founder, Muhammad Yunus, a pioneer of the microcredit movement, the Nobel committee concluded that microcredit can play "a major part" in eliminating world poverty.

Others, too, are fulsome in their support. The United Nations, which designated 2005 as the International Year of Microcredit, explains on its Web site that "microentrepreneurs use loans as small as $100 to grow a thriving business, and, in turn, provide for their families, leading to strong and flourishing local economies." And in his 2004 book, *The Fortune at the Bottom of the Pyramid,* C.K. Prahalad, a professor at the Ross School of Business at the University of Michigan, argued forcefully that we should recognize the poor as "resilient and creative entrepreneurs."

But Aneel G. Karnani, an associate professor of strategy also at the Ross School of Business — a colleague of Prahalad — begs to differ. "Most clients of microcredit are not

Rather than lend $200 each to 500 women, it is better to lend $100,000 to one entrepreneur who can employ 500 people.

microentrepreneurs by choice and would gladly take a factory job at reasonable wages if possible," he writes in his paper. "We should not romanticize the idea of the poor as entrepreneurs."

Karnani believes the case for microcredit has been overstated. Studies in this area, he says, suggest that although microcredit brings economic benefits, it is not sufficient to alleviate poverty. In some cases, he says, it can actually make families poorer through the additional burden of debt.

According to Karnani, the problem lies not with the loans themselves, but rather with the microenterprises they produce. The U.N.'s declaration that loans lead to thriving firms and flourishing economies, he says, is "hype." In fact, very few microentrepreneurs are able to scale up their businesses; most remain microfirms, operated by the poor with no paid staff, very few assets, and little prospect of sustainable growth.

"Some clients of microcredit are certainly true entrepreneurs, and have created thriving businesses — these are the heartwarming anecdotes," he says. "But the vast majority of microcredit clients are caught in subsistence activities with no prospect of competitive advantage."

A better way to tackle poverty, Karnani writes, is through the creation of jobs. Rather than lending US$200 each to 500 women to buy a sewing machine and set up a microenterprise, Karnani argues, it is better to lend $100,000 to one entrepreneur with managerial ability and business acumen and help her set up a garment-manufacturing business employing 500 people. Such a business can exploit economies of scale and modern business practice to create value for its owners and workers.

To illustrate his argument, Karnani points to differences among employment statistics for China, India, and Africa. In China, where poverty (defined by the World Bank as living on less than $2 a day) declined significantly between the late 1980s and late 1990s, the proportion of the population with jobs rose from 51 percent to 58.7 percent. In Africa, where poverty levels remain unchanged, the fraction of the population employed fell during the same period from 33.4 percent to 30.1 percent.

India's performance lies somewhere in between, and attempts to reduce poverty there have been hindered by low job creation. (Between the late 1980s and the late 1990s, the working population rose from 29.5 percent to just 35.8 percent.) Moreover, the average firm in India is less than one-tenth the average size of companies in other emerging economies. Microcredit will only lower the average.

Most worryingly, Karnani says, the current focus on microcredit is distracting attention from the real need for governments in developing nations to provide services such as public safety, basic education, public health, and infrastructure improvements — all of which increase the productivity and employability of the poor. India's current focus on high-skills sectors such as IT will not eradicate poverty, as it does not create sufficient jobs for the poor. "Seven world-class Indian Institutes of Technology do not compensate for a 39 percent illiteracy rate," the author writes. +

strategy+business magazine
is published by Booz Allen Hamilton.
To subscribe, visit www.strategy-business.com
or call 1-877-829-9108.

Booz | Allen | Hamilton