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The emergence of world-class companies in Chile: Analysis of cases and a framework to assess integration decisions ☆

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ABSTRACT

This study discusses important corporate strategy decisions made by some of the most prosperous companies in Chile within an environment of deregulation and openness to international trade. The study uses a case analysis and develops a basic framework that facilitates the understanding of some of those decisions. The findings contradict, in part, the view that liberalization might favor an entrepreneurial focus and might promote the emergence of intermediaries. The cases in this study show that, despite being in an environment of deregulation and openness, these companies have become world-class through the integration of their business activities.

1. Introduction

The Chilean economy over the last three decades has been a source of continuous interest to scholars and practitioners (see, e.g., Bosworth, Dornbush, & Laban, 1994; Walziang & Horn, 2008). In the past, Chile followed significant protectionist policies. However, the Chilean economy is now very open, embraces free-trade reforms, and negotiates multilateral and bilateral agreements (see, e.g., Cato Institute, 2009). According to its macroeconomic indicators, the economy is prospering. Despite of the success of its economic trends, much less has been said about the specific strategies that successful Chilean companies use to drive growth in a privately driven economic system.

The main objective of this study is to describe important corporate strategy decisions made by some of the most prosperous Chilean companies in an environment of deregulation and openness to international trade. These decisions are associated with the integration of related activities, given rise to multi-business companies. The world-class companies analyzed in this article (LAN, Falabella, and Arauco) have grown phenomenally in the last decades and have some of the highest market capitalizations in their industries worldwide. The study complements the case analysis with the development of a basic framework that facilitates the understanding of some of the conditions under which a multi-business company is better able to allocate resources than a single-business company. As such, this study adds to the knowledge on strategic management by being one of the very few that analyzes the behavior of some of the world-class Chilean companies that have emerged alongside of economic liberalization.

According to the observations in this study, the integration of these companies increased during the last few decades, and country and company characteristics might explain this phenomenon. This finding is interesting given that most of the literature argues that trade liberalization is an influence for disintegration. For example, in Grossman and Helpman (2002), trade openness increases the incentives to outsource by thickening the secondary market, which lowers the cost of matching suppliers and producers. Alongside the same lines, Pascali (2009) shows that vertical integration is less likely when asset specificity associates with trade openness.

This work also relates to the theory of diversification based on the excess capacity of productive factors (see, e.g., Penrose, 1959; Wernerfelt, 1984, 1995; Montgomery & Wernerfelt, 1988; Kor & Mahoney, 2004). This theory argues that diversification can be an efficient choice if failures exist in the market for resources. Therefore, this study looks mainly at companies in terms of their resources. However, differently from Montgomery and Wernerfelt (1988), this analysis does not conclude that large companies earn decreasing average rents when they pursue related diversification. When interactions/complementarities exist among business units of the same organization, the participation in new business units might add to the profitability of the original business unit.

The study chooses to focus on only a few companies, rather than on a wider sample, in order to have a more comprehensive examination of top management teams' responses to changes in the business environment. Relying on large samples of companies is not applicable to the study of a small cluster of companies, which is the most common situation in Latin American countries (Anand, Brenes, Karnani, & Rodriguez, 2006). Building a theory based on case studies is a research

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strategy that involves using one or more cases to create theoretical constructs, propositions, and/or midrange theory from case-based empirical evidence (Eisenhardt, 1989; Eisenhardt & Graebner, 2007). Consistent with Woodside (2010), this research involves direct observation within the environments of the case by asking case participants for explanations and interpretations of data, and analyses of written documents and natural sites.

This study also relates to the literature that analyzes the relation between institutional context and company diversification. Economists have tended to view institutional contexts primarily in terms of the extent to which the presence of specialized intermediaries characterize the contexts (Spulber, 1996). Khanna and Palepu (2011) argue that intermediaries are important for companies because they might raise the willingness to pay (WTP) of consumers and lower companies' costs, whereas Williamson (1985) suggests that the optimal scope of a company is a function of ambient transaction costs and, therefore, of the extent of specialized intermediation.

Khanna and Palepu (2000) argue that the gradual emergence of intermediaries will characterize the Chilean economy. This study's findings contradict this view in part. The companies analyzed in this study show that, despite being in an environment of deregulation and openness, they have become world-class through the integration of their business activities. This integration has allowed the companies to better allocate and leverage their key resources. The first possible explanation for this finding is that integration is an example of a suboptimal strategy arising from an inefficient market for corporate control, whereas the second explanation is that the deregulation of markets that are intrinsically small does not necessarily motivate the development of relevant intermediaries for companies that need to be large in order to compete internationally, encouraging company integration. The profitability of the companies analyzed here and the close monitoring of them by many institutional and private investors tend to argue against the first hypothesis.

The organization of this study is as follows. After this introduction, the second section presents a basic framework to analyze the scope decisions. In the third section, we introduce the case analysis and apply the framework developed in the second section to the cases. In this section we also present a summary of the chronology of trade liberalization. Conclusions are presented in the fourth section of the article.

2. Corporate strategy and optimization in the use of resources: A simple framework

The strategic management agenda has discussed the relation between resources and integration decisions for several decades (see, e.g., Penrose, 1959; Wernerfelt, 1984, 1995; Montgomery & Wernerfelt, 1988; Doving & Goodeman, 2008). Although the framework for this analysis has roots in the earlier work done in strategic management by authors such as the aforementioned, the analysis presented in this article is different in that a company can either use its resource in its own production or the company can sell the unused portion of the resource in the market. As a result, the company optimizes a two-part function where one part relates to the value the company gets from using the resource internally (e.g., to expand current activities) and the other part relates to the value the company obtains by selling the unused portion of the resource in the market. Decisions about the uses of a resource are interdependent, because greater internal use creates less availability to sell the resource in the market, and vice-versa.

The concept of value function is the focus of this discussion. Specifically, v(N) is defined as the value function to be maximized where N shows the set of choices made by the company. The concept of value function has been used to analyze different strategic management decisions in which the issues of value creation and/or value appropriation arise (Brandenburger & Stuart, 1996; Chatain & Zemsky, 2007; Lippman & Rumelt, 2003). To illustrate the concept of value function and the concept's relation with the choices of the businesses undertaken by a company, let b_i be business i, I_i be a resource (or vector of resources) required to participate in that business, and $I_{i\ldots m}$ be a vector of resources required to participate in businesses i to m. Thus, our study defines the following: $v(I_i, b_i)$ equals the value of the company by participating in a single business b_i; and $v(I_{i\ldots m}, b_i,\ldots b_m)$ equals the value of the company by participating in businesses b_i to b_m ($m \neq i$).The company might also choose to use only part of the resource I due to, for example, restrictions associated with the size of the market. In this case, the value of a single-business company is:

$$v\left(I_i{}^S, b_i\right) + v\left(I_i{}^{CS}\right) = \text{value of the single-business company} \tag{1}$$

where I_i^S is the portion of the resource used by the company in business i and $v(I_i^{CS})$ is the value obtained by selling the remainder of the resource in the market. The resource can be sold to intermediaries or to producers of other goods. The value of $v(I_i^{CS})$ is zero when the resource is exhausted by its use in business i or when the resource is not exhausted but is no longer able to get any further value in the market. On the other hand, the value of the multi-business company is:

$$v\left(I_{i\ldots m}{}^M, b_i, \ldots b_m\right) + v\left(I_{i\ldots m}{}^{CM}\right) = \text{value of the multi-business company} \tag{2}$$

where $I^M_{i\ldots m}$ is the resource actually used in the multi-business case, and $v(I^{CM}_{i\ldots m})$ is the value obtained by selling the unused part of the resource in the market. Eqs. (1) and (2) show that a multi-business company outperforms a single-business company as long as:

$$v\left(I_{i\ldots m}{}^M, b_i, \ldots b_m\right) + v\left(I_{i\ldots m}{}^{CM}\right) > v\left(I_i{}^S, b_i\right) + v\left(I_i{}^{CS}\right). \tag{3}$$

The assumption here is that the use of the resource is exhausted when the company participates in multi-businesses. As such, a company prefers to be a multi-business organization as long as the inequality (4) is satisfied:

$$v\left(I_{i\ldots m}{}^M, b_i, \ldots b_m\right) > v\left(I_i{}^S, b_i\right) + v\left(I_i{}^{CS}\right) \tag{4}$$

where business i corresponds to the single business that maximizes the value of $(v(I_i^S, b_i) + v(I_i^{CS}))$, and businesses i…m corresponds to the combination of businesses that maximizes $v(I^M_{i\ldots m}, b_i,\ldots b_m)$.

The fulfillment of expression (4) depends, among other variables, on:

i. The degree of development of the market for intermediaries (buyers) for that resource. A higher development of this market increases the value of $v(I_i^{CS})$ and the likelihood of observing a single-business type of company.
ii Economies of scope. Larger economies of scope increase the value of $v(I^M_{i\ldots m}, b_i,\ldots,b_m)$, favoring a multi-business type of organization.
iii Economies of scale. Larger economies of scale increase $v(I_i^S, b_i)$, favoring specialization and the single-business organization.

3. Case analyses

This section reviews the cases of three Chilean companies that, despite being in competitive sectors and in an environment of deregulation and openness to international trade, have become world-class companies through the integration of their business activities. This integration allows these companies to better allocate and leverage their key resources and to take advantage of different types of synergies, such as economies of scope. The analysis follows the suggestions of Pettigrew (1988) and constrains the variation due to size differences among the companies by only selecting large companies in