

FIRMS AND THEIR GROWTH IN THE GLOBALIZATION ERA

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One firm's design and production activities and also marketing functions took place under the same roof a few decades ago. In the 1970's, as multinational corporations started to locate labor-intensive activities in developing countries, this situation changed. Soon, due to the production and technological flows involved, it has become obvious that the organization's internal structure is less important than the structure of the value chain in which the organization is only a node. Nowadays, different functional areas of the organization are not analyzed in their organizational context, but in a globalized business environment which is characterized by a network of interconnected organizational structures.

I. GLOBAL VALUE CHAIN. CORE AND PERIPHERAL FIRMS

1. TYPES OF VALUE CHAIN'S GOVERNANCE IN A GLOBALIZED BUSINESS ENVIRONMENT

Traditionally, various functional areas of the organization are analyzed in their organizational context. The organization itself evolved towards a more complex structure proper to a kind of network of interconnected organizational structures in a globalized business environment. The organizational conditions "are often the result of global forces"¹ within what is called "global value chains".

"The concept of a global value chain recognizes that the production of goods and services has become globalized. A shirt, for example, may be designed in New York, cut in India, assembled in Kenya, and sold to a consumer in Los Angeles."² Various parts of the final product are often manufactured in different geographic locations situated at hundreds of km distance one from another.

The internal organizational structure became less important because the production and technological flows involve, often, more than one organizational

¹ McCormick, Dorothy; Schmitz, Hubert (2001). Manual for Value Chain Research on Homeworkers in the Garment Industry, p. 17.

² Ibid., p. 17.

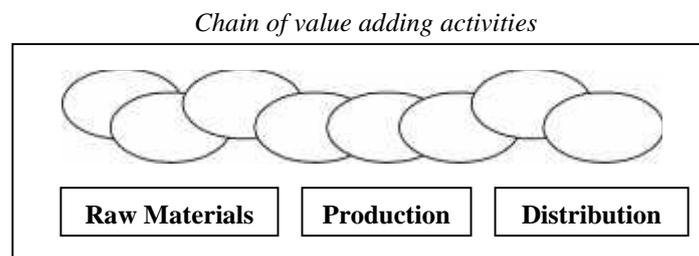
structure. The global value chain has become inter-linked organizational structures based on various flows of values within networks of organizations.

The structure of the value chain in which the organization is only a part became more important than the structure or functioning of different areas within the organization. “In the past, manufacturing usually happened in one place. Large firms had their design, production, and marketing functions under one roof, or at least within easy reach of one another. (...) Even the re-emergence of multinationals corporations in the 1950s and 1960s did not change this very much. Firms establishing plants in foreign countries undertook the full range of manufacturing activities in each location.”³

By the 1970s, multinational corporations started “to locate labor-intensive activities in developing countries as part of a global restructuring and rationalization of their operations.”⁴ They realized that sourcing some parts of the production process in developing countries would reduce the costs.

“The design, production and marketing of many products now involve a chain of activities divided among enterprises located in different places.”⁵

The chain is the collection of all “product’s stages of development, from its design, to its sourced raw materials and intermediate inputs, its marketing, its distribution, and its support to the final consumer.”⁶ Designing, purchasing raw materials, production and distribution are all inter-linked stages within the chain of value adding activities.



Source: Adapted from McCormick, Dorothy; Schmitz, Hubert (2001). *Op. cit.*, p. 18.

Services such as finance and transport “may be needed to keep the process going.”⁷ These are so-called “supporting services” needed at each stage of the value chain.

The five stages – “design, inputs, production, wholesale, and retail / remain a handy device for understanding each step of the process.”⁸ There is, also, a “less

³ Ibid., p. 17.

⁴ Ibid., p. 17.

⁵ Ibid., p. 17.

⁶ Ibid., p. 18.

⁷ Ibid., p. 18.

⁸ Ibid., p. 18.

visible structure”⁹ of the value chain that is “made up of the flow of knowledge and expertise necessary for the physical input-output structure to function.”¹⁰ It is, actually, the input-output structure of inter-linked unique organizational capabilities which can make the difference between various interconnected organizations in terms of competitive advantage. “The flow of knowledge generally parallels the material flows, but its intensity may differ. For example, the knowledge inputs at a product’s design stage may be much greater than the material inputs; production, on the other hand, needs large quantities of materials, but in many cases requires only standard or routine knowledge.”¹¹

We are more concerned with the intensity factor of the “flow of knowledge and expertise” that is able to transform a company from a standard or routine knowledge-based organization to a unique or greater knowledge-based one. The extent to which an organization can attract as well as generate greater knowledge inputs and outputs may have a significant impact on that organization’s capability to induce core competences as a prerequisite for generating competitive advantage.

Another dimension of the value chain is its geographic spread. “Some chains are truly global, with activities taking place in many countries (...). Others are more limited, involving only a few locations in different parts of the world.”¹² A UK retailer may, for instance, contract with a Romanian garment producer. “The finished goods will then be shipped directly to the UK retailer.”¹³

Finally, there is the dimension of the value chain in which various actors can have the power to control some or all activities making up the chain. The UK retailer from the previous example may have the power to control the way the Romanian garment manufacturer produces the garments.

Another retailer, for instance, may have the power to control “the way he sells, but may be limited (indirectly controlled) by the range of goods available from wholesalers and producers.”¹⁴

“The pattern of direct and indirect control in a value chain is called its governance.”¹⁵ McCormick and Schmitz identified four *main types of governance* shown in the following table.

⁹ Ibid., p. 18.

¹⁰ Ibid., p. 18.

¹¹ Ibid., p. 18.

¹² Ibid., p. 18.

¹³ Ibid., p. 18.

¹⁴ Ibid., p. 19.

¹⁵ Ibid., p. 19.

Market	Firms deal with each other mainly in "arms-length" exchange transactions
Balanced network	Firms form networks in which no one firm or group of firms exercises undue control over the others. Firms prefer to deal with other members of their networks.
Directed network	Firms form networks that tend to be controlled by certain lead firms. The lead firms specify what is to be produced by whom and they monitor the performance of the producing firms.
Hierarchy	Firms are vertically integrated, so that they can directly control all or most of the activities of the chain.

Source: Adapted from Humphrey and Schmitz (2000) apud McCormick, Dorothy; Schmitz, Hubert (2001). *Op. cit.*, p. 19.

The power of one organization to control all or some parts of the process of creating value along the value chain may induce advantages in terms of cost control factor.

There are so-called "lead firms" that "do not merely buy goods in the market. Rather they specify what is to be produced by whom, and they monitor the performance of the producing firms. In some cases, the networks are directed, or "driven" by large producers such as transnational corporations or other large integrated industrial enterprises."¹⁶

In the apparel industry's value chain the situation may change as "many leading brand-name companies do no production themselves. Instead, they concentrate on design and marketing. Their strength as buyers enables them to dominate certain value chains. They determine what fabrics will be used, what styles will be produced, and in what colors."¹⁷

Directed and/or non-directed relationships between companies govern value chains in different sectors and industries. Some organizations like the "lead firms" manage to control other companies and, consequently, they are able to induce directed relationships. Other organizations "form networks in which no one firm or group of firms exercises undue control over the others."¹⁸ These are *non-directed networks*.

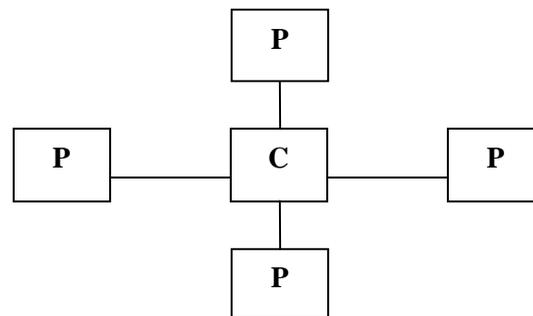
¹⁶ Ibid., p. 20.

¹⁷ Ibid., p. 20.

¹⁸ Ibid., p. 19.

2. CORE AND PERIPHERAL FIRMS. A CASE STUDY

Calling back to the second dimension of value chain, its geographic spread, we recall the distinction McCormick has made between those chains which are truly global and the chains which are but regional chains as long as a lead firm gets control over companies located in other different countries on a certain area (a region). The theory of core-periphery relationship defines the leading firm calling it core-company and the other firms which are under its control appears to get but a peripheral, highly dependent position within the value chains. Figure below describes that type of value chain constellation.



C = Core-firm or "lead-firm"
P = Peripheral firm

The firms operate like actors getting power to control at different degree the same value chain, as McCormick himself underlines it. The core-firms have not only the greatest power of control they can exert over the highest number of activities making up the chain, but they come to distinguish themselves by their geographic reach that is by overarching geographic control of the value chain constellation.

Let's take the example of OMV in Romania. "OMV bought a 51% stake in Petrom for EUR 1.6 billion late 2004, becoming the largest oil and gas group in Central and Eastern Europe."¹⁹ Petrom became part of a wider value chain controlled by OMV.

Moreover, Petrom became a so-called "peripheral firm" as part of the value chain controlled by OMV. The issue of considering one company as being either a peripheral firm or a core firm in an economy was addressed by Eric Nilsson, professor at California State University San Bernardino, Department of Economics.

He argues that "the core includes the large giant firms. These core firms are typically able to avoid extreme competitive environments and, as a result, earn higher profit rates than average. The periphery includes the other firms: small and

¹⁹ Privatization Barometer. Available from: <http://www.privatizationbarometer.net/news.php?id=7943>

medium sized firms which face high levels of competition and which typically earn fairly modest profits. A single industry might have within it firms from the core and firms from the periphery. The core firms typically dominate the industry and sell the most profitable product lines within the industry. The peripheral firms in the industry might be stuck in relatively unprofitable product lines and are often small niche players in the market.”²⁰

Nellson’s idea is that the core firms dominate the market while the peripheral firms are dominated by the market. The second observation is that the core firms are really capable to develop and promote their own policies while the peripheral firms are almost unable to promote their own policies within a certain value chain constellation.

Petrom might be regarded as a peripheral firm in a globalized business environment dominated by large giant firms like Royal Dutch Shell, British Petroleum, Conoco Phillips, Exxon Mobil, Chevron.

Nevertheless, it is worth mentioning that OMV is not among the biggest petroleum companies in the international market. OMV might be rather considered as a company aspiring to become a lead-firm. OMV is, actually, pursuing a strategy of consolidation by acquiring firms like Petrom in order to secure its position in a market dominated by large giant firms like the ones above mentioned.

OMV proved to be successful in its policy of consolidating its value chain of integrated activities. Petrom became a strategic node within an integrated network of companies and activities like exploration, production, distribution and retailing of OMV’s product portfolio.

Petrom is the “anchor firm” acting as a key catalyst in Southeastern Europe: “Following the acquisition of a majority in Petrom, Romania and Austria are the main sources of our oil and gas production, and together account for about 75% of our output of 338,000 boe/d. Due to the massive increase in production brought about by the Petrom acquisition, we have already surpassed the target of doubling output to 160,000 boe/d by 2008.”²¹

The net profit reported by OMV as a group in the first three months of 2006 was 430 million EUR and OMV Petrom generated 251 million EUR (58% of the OMV Group’s net profit). In the same time, Petrom’s sales accounted for 20.7% comparing with OMV (including Petrom).

The conclusion is that the majority of the positive financial results of OMV Group are due to Petrom’s activity. Petrom managed to generate more than half of the OMV group’s net profit.

²⁰ Nilsson, Eric. *Core and Periphery in Capitalism: Power, Profits, and Human Flourishing*. Available from: <http://economics.csusb.edu/faculty/nilsson/nilsson.htm>

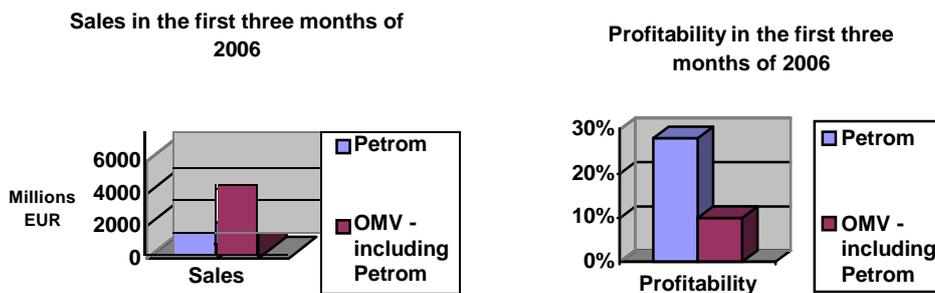
²¹ OMV’s Annual Report 2005. Available from OMV’s corporate website, p. 12.

Table

– Millions EUR/USD –

Company	Sales	Net Profit	Profitability
Petrom	(Euro) 893	251	28,1%
OMV			
(including Petrom)	(Euro) 4,298	430	10%
Rompetrol	(\$) 504	-23	-
Royal Dutch Shell	(\$) 75,964	7,000	9,2%
British Petroleum	(\$) 67,082	5,265	7,8%
Conoco Phillips	(\$) 47,900	3,290	6,8%
Exxon Mobil	(\$) 88,980	8,400	9,4%
Chevron	(\$) 54,000	4,000	7,4%

Source: Companies' Reports



Petrom proved to be much profitable than OMV as a group in the first three months of 2006. Petrom's profitability figure of 28,1% comparing with OMV Group's (10%) combined with the fact that Romania and Austria are the main sources of the oil and gas production, accounting for about 75% of the output of 338,000 boe/d proved that Petrom has become a major source of competitive advantage for the entire OMV group. Petrom is more than a *peripheral firm* within OMV's value chain. It has become a so-called "*anchor*" firm for the entire OMV as a group.

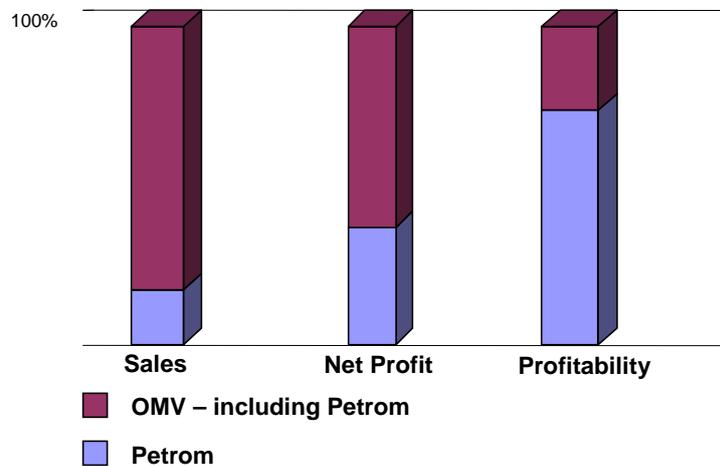
Assuming that Petrom would not have been part of the OMV Group, than the profitability of the OMV – excluding Petrom – would fall to 5,2%. Moreover, more than 50% of the actual profitability of OMV (including Petrom) is due to Petrom's contribution. It means that 20,7% representing the contribution of Petrom (the proportion of Petrom's sales in OMV's sales (including Petrom) for the first three months of 2006) generated half of the profitability of the entire OMV group.

Table

– Millions EUR –
(continuea)

Company	Sales	Net Profit	Profitability (%)
Petrom	893	251	28,1
OMV (excluding Petrom)	3,405	179	5,2
OMV (including Petrom)	4,298	430	10

Source: Companies' Reports



“As importantly, the 80–20 ratio seems to hold true for many input/outputs, causes/consequences, or efforts/results.”²² It also holds true for our example in which, on the one side, Petrom’s contribution (sales reported by Petrom) represented 20,7% of the OMV’s sales as a group (including Petrom). On the other side, keeping in mind the idea of 80–20 ratio, the results showed that Petrom generated 50% of the OMV group’s profitability (including Petrom).

“Richard Koch, author of *The 80/20 Principle*, suggests that the key to earning more and working less is to pick the right thing to do and only those things that add the highest value.”²³ It seems to us that OMV “picked” the right “thing” to do, which is Petrom. The Romanian company proved to be able to generate one of the highest values comparing with the other companies being part of OMV’s group.

²² Ibid.²³ Ibid.

The conclusion is that OMV relies on Petrom's capacities. The fact that OMV is pursuing a strategy of consolidation by incorporating firms like Petrom shows that the Austrian corporation has not yet become a so-called "lead firm" on the overall market like others, e.g. Royal Dutch Shell, British Petroleum and Exxon Mobil. Firms like OMV need "anchor" firms, i.e. activities and markets being controlled by local firms like Petrom in certain local markets, in order to consolidate their positions and, therefore, increase their market shares as prerequisites for becoming "lead firms". Firms like Petrom are, actually, acting instruments by which corporations like OMV would become "lead firms".

When we change the reference frame taking into account the position of such firms not only as "actors" within the value chain, but particularly within the overall economy, where they share with other similar firms a common sector of activity, we can conclude that firms like OMV and/or Petrom are illustrating a special type of firms. That is why we notice more than two sectors of the capitalist economic system as Eric Nilsson argued. There are, actually, three sectors as follows:

- f The sector of the *core firms* made up of "giant firms that dominate particular industries and the economy (and have divisions in many different industries)"²⁴;
- f The sector of the *peripheral firms* comprising the majority of the small and medium sized firms in the economy;
- f The sector of the *transitional firms* which is made up of the following possible types of companies:
 - o Corporations aspiring to become high ranked companies among the similar firms upon the market;
 - o Corporations aspiring to become high ranked firms as to their profitability compared to the profitability of another similar firms;
 - o Corporations aspiring to consolidate their positions and, therefore, increase their market shares as prerequisites for becoming "lead firms";
 - o Corporations aspiring to become the "anchor" firms as a key catalyst throughout an area like that of a Southeastern European one.

We can conclude that such a difference is owed to the effect of the positions the two firms get within a wider value chain. Hypothetically, we can say that their difference is due to the effect of being "lead firm" compared with getting but a certain, rather peripheral position in the chain.

The conclusion is that the insertion of a firm in a value chain does not annul the dependency effect upon a firm following its insertion in a given value chain.

We can emphasize that a firm like Petrom is not properly speaking a peripheral firm although it is not neither a core firm. What makes from a certain firm a core-firm is its dominant role in the constellation of the firms similar by their own nature and economic content. "The common characteristic of the

²⁴ Nilsson, Eric. *Op. cit.*, p. 165.

members of the periphery is that they are not *giant*: most are very small. They have generally failed to achieve any dominant position within their industry”²⁵.

We may conclude that Romanian company has the significance of a “leverage point” in the value chain of the entire Southeastern and Central European oil market, which locate Romania itself in a strategic position for the entire region.

II. MAPPING A VALUE CHAIN

1. HOW TO MAP A VALUE CHAIN

McCormick and Schmitz argue that the value chain analysis can provide an understanding of the way the producers of developing countries can acquire production capabilities. Once they gain access to a chain’s lead firm, McCormick argues that “they are pushed to upgrade their production capability very quickly.”²⁶ Kaplan and Norton used the concept of synergy to designate such an effect of upgrading the production capability very quickly once a certain producer gains access to a lead firm. The production flow and workers’ skills along with the best practices and hands-on advice are transmitted across the borders that previously kept on separated those firms. Another area wherein the value chain analysis proved to be useful is that of “understanding the distribution along the chain”.²⁷ As long as you come to know “how and by whom a chain is governed”, you may understand, by consequence, “the distribution of gain among firms along that chain.”²⁸

Value chain analysis allow us also to find “leverage points for policy and organizing initiatives”²⁹, that is, it allows us to understand the “workings of a chain” which help us further “to identify levers where policy and/or organizing could be used to improve the distribution of gains. Value chain analysis can help us to answer questions like “who has the power to change things?”³⁰ or “which actors are the right ones to pressure?”³¹ Is there any reason to look at the lead firm also as the ones which has entitled to exert the right pressure in order to get the suppliers “to raise their labors and environmental standards”³²? Finally, the value chain analysis appears to be helpful for “identifying funnels for technical assistance”³³: “Multilateral and bilateral donor agencies wanting to provide effective technical

²⁵ Ibid.

²⁶ McCormick, Dorothy; Schmitz, Hubert (2001). *Op. cit.* p. 22.

²⁷ Ibid., p. 22.

²⁸ Ibid., p. 22.

²⁹ Ibid., p. 22.

³⁰ Ibid., p. 22.

³¹ Ibid., p. 22.

³² Ibid., p. 22.

³³ Ibid., p. 22.

assistance to developing country producers are beginning to look at value chains. Their idea is to combine technical assistance with connectivity.”³⁴

The value chain analysis makes us rather optimistic about the integration process no matter where it brings about. It proved to be helpful for understanding issues such as “market access, skill acquisition, labor standard and many others.”³⁵

Let’s focus now on the methodology of value chain analysis such as McCormick and Schmitz worked it out to be of use for those who want to carry out researches based on such a theory. The examination of a value chain starts by mapping a chain that gives us a “visual representation of the connection between the actors”³⁶ Mapping value chains, in its simplest form, “is merely a flow diagram.”³⁷ It shows us the size of different actors in the chain, the degree of importance of different connection by comparing them with each other, the “bottlenecks and leverage points.”³⁸ Constructing a map is depending on the knowledge available to you about enterprises and workers “whose place in the global economy you try to capture.”³⁹

Which are the steps in constructing a map? McCormick and Schmitz consider the following steps which are to be run through whenever somebody resorts to such a type of analysis:

- f* Having a clear cut starting question. McCormick argues that if the question you are trying to answer by doing a value chain analysis cannot be understood straight away by somebody else and, on the contrary, “s/he only understand it after explaining it for 30 minutes, you do not have a clear question.”⁴⁰

Here is a type of question driving such an investigation: “what is the scope for local strategies to improve the learning opportunities of garment homeworkers in our regions? How do wage levels in our region compare with wages in competing regions?”⁴¹ Of course, one of the most significant question driving an investigation based on refers to the effect that are brought up by the insertion of a firm in different chains bring advantages in terms of skill acquisition and income.”⁴² Are these advantages fostering both the lead firm and the new inserted firm in the chain? Is an advantage like this spreading over the entire population of the area wherein the new inserted firm is located?

³⁴ Ibid., p. 23.

³⁵ Ibid., p. 23.

³⁶ Ibid., p. 39.

³⁷ Ibid., p. 39.

³⁸ Ibid., p. 39.

³⁹ Ibid., p. 39.

⁴⁰ Ibid., p. 39.

⁴¹ Ibid., p. 39.

⁴² Ibid., p. 39.

f Mapping the value chain. A value chain is made up of the activities carried out locally, their connections to activities elsewhere and to the market. To elaborate the final map “the quantification of key variables, identification of strategic and non-strategic activities”⁴³ are requested. Finally, we shall have the following types of maps:

- A map regarding the “number of the enterprises in each stage”⁴⁴;
- A map of the “average earnings in various part of the chain”⁴⁵;
- A map showing “the number of the workers in each stage of the chain”⁴⁶.

This map can be read from the top or bottom. Such a reading will discover us three chains:

- The first one, that of the positions occupied by different stages of the chain and displaying the feeding of goods and activities from local producers via wholesalers to retailers;
- A second chain that is made up of the selling activities of producers “directly to the retailers who drive chain”⁴⁷
- A third chain is that of the “vertical integration from retailing back to production”⁴⁸.

McCormick adds the fourth line connection between “parent company and subsidiary”⁴⁹

We are driven to take into account the difference between a chain connecting the enterprises placed in different stages of the chain and another chain illustrating the profitability of the same enterprises. The first type of chain portrays the market power of the firms (enterprises). The second type of chain shows the profitability rank of the firms. It, often, happens that a powerful firm on the market generates lower levels of profitability comparing with a firm having weaker market position than the first one. An outstanding example is given by comparing OMV (the Austrian petroleum company) with Petrom (a Romanian petroleum company recently acquired by OMV). The idea is that, before acquisition, OMV proved to be more powerful on the market than Petrom. The last one, after the acquisition, proved to be more profitable than OMV. The financial results for the first three months of 2006 showed that the profitability of Petrom was 28.1% comparing with 10% reported by OMV, including Petrom. The conclusion is that a gap between the market rank of a company and its profitability rank might emerge revealing an over exploitive relationship among the firms integrated within the same value chain. The most powerful firm may over exploit the most profitable company within a certain

⁴³ Ibid., p. 40.

⁴⁴ Ibid., p. 40.

⁴⁵ Ibid., p. 40.

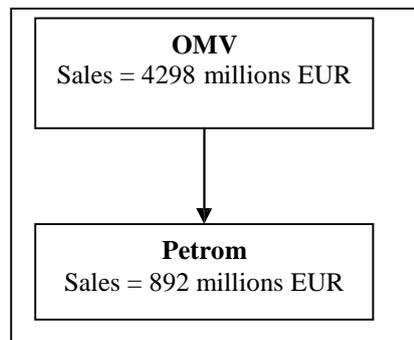
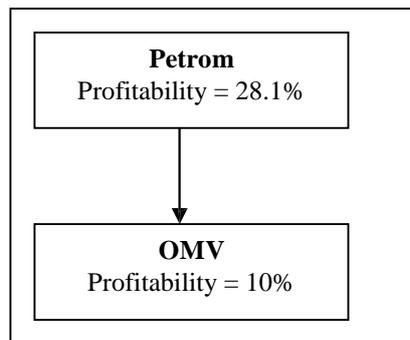
⁴⁶ Ibid., p. 40.

⁴⁷ Ibid., pp. 40–41.

⁴⁸ Ibid., p. 41.

⁴⁹ Ibid., p. 41.

value chain. So, asking “who has the power to produce value” is not the same with asking “who has the power to change things”.

Diagram A*Diagram B*

The two diagrams show two types of dependency between OMV and Petrom analyzed within a value chain:

- o The sales-based dependency relationship in which OMV has a dominant position in the value chain as this company reported higher sales comparing with Petrom. (see diagram A);
- o The profitability-based dependency relationship in which Petrom has a dominant position as this company reported a higher profitability comparing with OMV. (see diagram B)

The conclusion is that Petrom is conspicuously an “anchor” firm for OMV Group in terms of profitability whereas OMV is an “anchor” firm for Petrom in terms of sales’ volumes.

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