Strategy Tradeoffs in the Knowledge and Network Economy

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In traditional “value chain” firms, the main activity tradeoff is between differentiation and low cost. Increasingly, however, firms are creating customer value through networks (e.g., AOL) or by providing knowledge-based solutions for customers (e.g., venture capital firm Kleiner Perkins). This article discusses the quite different activity tradeoffs faced by these “value networks” and “value shops”. It then explores the tradeoff between exploitation (focusing on short-term performance) and exploration (focusing on transcending short-term activity tradeoffs). Finally, in reviewing the implications for managers, it discusses the problem of trying to manage different types of business (value chains, networks and shops) within the same corporation.

“Tradeoffs are essential to strategy. They create the need for choice and purposefully limit what a company offers.” Porter (1996, 69).

Tradeoffs determine the fit between the competitive context and the firm’s internal value creation. Porter (1996) defines tradeoffs as necessary choices along the firm’s efficient frontier, where any choice implies giving up one thing in return for another. A firm may, for example, experience difficulties in trying to meet a broad set of highly differentiated customer demands. The same activities may not be suitable for both serving inexpensive hamburgers and providing “haute cuisine” meals in a restaurant. Not only may the synergies between activities be sparse, but the activities themselves may also be in direct conflict with each other.

We suggest that the fundamental aim of strategy should be to transcend the immediate activity incompatibility tradeoffs, that is to improve the outcome on one dimension without worsening the outcome on any other. Transcending the activity tradeoffs, however, requires exploring new technologies or new ways of doing business, rather than just exploiting present resources.

The traditional model of strategy is rooted in the old economy. It gave, and still gives, useful guidelines about competitive advantage for industrial firms – service businesses as well as manufacturers – with many tangible assets and many employees. It focuses on issues such as where to compete within the value chain and the tradeoff between differentiation and cost efficiency (Porter 1985).

However, old economy firms are increasingly having to learn new economy tricks. Dramatically fast
innovation and the processes that support it are becoming more important across every industry. The new economy is not about creative evaluation. It is about new ways of value creation.

In this article, we focus on some of the new strategy tradeoffs in this increasingly complex and dynamic environment. These complement the traditional tradeoff between differentiation and cost.

- First we emphasize two types of value creation that are much more prevalent in new economy firms: value based on networks and value based on knowledge.

- Second we emphasize time tradeoffs over activity tradeoffs. By “time tradeoffs” we mean the balance between exploiting existing solutions and exploring ways of transcending them (March 1991). “Activity tradeoffs” involve choices between differentiation and cost.

To illustrate our arguments, we describe two new economy firms, AOL and Kleiner Perkins. AOL (at least until it acquired Time Warner) was primarily a network-based business. Kleiner Perkins, a leading venture capital firm in Silicon Valley, is primarily a knowledge-based business.

After introducing AOL and Kleiner Perkins, we describe three generic types of value creation based on “value chains” (the traditional manufacturing model), “value networks” such as AOL, and knowledge-based “value shops” such as Kleiner Perkins. The activity tradeoffs faced by the firm vary with the type of value creation. As a result, so do the exploration/exploitation tradeoffs required to overcome these, as we then discuss. Finally, we highlight three managerial implications:

- Exploration versus exploitation is the fundamental tradeoff.

- Strategy tradeoffs depend on whether the firm’s underlying model of value creation is based on a value chain, a network, or knowledge.

- Business-level tradeoffs have corporate implications.

America Online and Kleiner Perkins

America Online (AOL) in January 2000 became the world’s largest media company by acquiring Time Warner. Started under the name of Quantum Computer Services by Stephen Case and James Kimsey in 1985, the company changed name to AOL in 1991. AOL has been a pioneer in online interactive services. By 1995 it had five million subscribers, who paid for access to an online community built mainly around chatrooms, news and entertainment. Early on, AOL overcame the fact that the number of members of the community was low by offering unique mass-appeal content, such as access to media personalities and news. Later – when it had more members – it introduced interactive services among subscribers in the form of chatrooms, where members could exchange information and ideas on common interests (Palepu and Hutton 1997). When the World Wide Web took off, AOL set its sights on becoming a leading internet service provider (ISP), rather than trying to hold on to exclusive content. The members gained access not only to the whole Internet, but also to a “walled garden” of other AOL customers and services.

The number of members grew to 26.7 million in 2000. AOL’s acquisition of Time Warner and the subsequent acquisitions of cable TV companies may reflect an effort to replicate its previously very successful strategy. By buying cable TV operators (including within Time Warner), AOL can extend its service to cable-based broadband, bringing the Internet into the living room. To get an interactive broadband network going, AOL needs content as a driver to persuade people to buy interactive equipment and services. When a critical mass of members with broadband access is reached, this will open the way for enhanced customer-to-customer interactive services.

How does AOL create value and how is this reflected in its strategies? AOL creates value by connecting customers. The value of being a member of a network like AOL increases with the number of other customers that join the network, a “the-more-the-merrier” network effect. The company’s main investment has been in attracting new customers. In the early 1990s it undertook a massive marketing effort, which included handing out millions of free easy-to-use software disks, co-marketing efforts with computer companies (software, hardware and publishers), as well as print advertising featuring toll-free telephone numbers for ordering AOL software. The promotion was estimated to cost at least $40 per new member. Revenues come from subscriptions, service charges, third party access (eg advertisers) and revenue sharing with firms that benefit from internet services provided
to their customers. Value depends on managing the size and composition of a large customer base.

**Kleiner Perkins Caufield & Byers (KP)** is one of the premier Silicon Valley venture capital firms (and, as it happens, the main one behind AOL). It has, over time, created enormous value by identifying potentially successful technology start-ups and by helping these to commercialize their innovations. Eugene Kleiner, one of the famous “traitorous eight” who left Shockley Labs to establish Fairchild Semiconductor in 1957, set up Kleiner Perkins. The Fairchild group consisted of technology managers who would later become the founding management cadre for the US West Coast semiconductor industry. They also included the future founders of Intel (Gordon Moore and Robert Noyce) and of more than 30 other Silicon Valley companies. These people had technology insight and a feel for how to commercialize new technologies. Over time, Kleiner Perkins helped launch such notable firms as Sun Microsystems, Genentech and Compaq. They nevertheless did not become “superstars” until the age of the Internet.

Today, the same focus on technology, industry and entrepreneurial competencies is maintained in Kleiner Perkins. They hire only people who have proven technology company credentials, and who have excelled in innovative surroundings. John Doerr is now the most influential partner at KP. He is behind start-ups such as Netscape, @Home, and Amazon.com, as well as a string of other companies. Doerr worked in sales at Intel and co-founded a chip company before he became a venture capitalist. Other general partners have had executive roles in other technology companies such as Sun Microsystems, Microsoft and Symantec.

Venture capital firms out-compete commercial and investment banks in funding successful innovation because their key people are better at assessing technologies and entrepreneurs. The people in the venture capital firms are the product. Their competencies allow them to (1) separate potential winners from likely failures, and (2) increase the odds of success of the companies they pick. Furthermore, venture capital firms commit their own funds to underscore the credibility of their assessments. This requires deep knowledge of technology and markets, not of financing per se. Their success is not due to them beating banks in financial wizardry, but rather in having competencies in technology and entrepreneurship that no bank could match. In fact, there is no Kleiner Perkins partner who has a financial background! The traditional banks simply lack the intelligent capital of the venture capital firms such as Kleiner Perkins in the innovation game.

These two firms – AOL and Kleiner Perkins – are interesting examples of “new economy” firms. They both create value in ways that differ greatly from the manufacturing model.

AOL and KP illustrate how relevant strategic choices are strongly related to the type of value creation. Real choices reflect tradeoffs. Manufacturing firms make tradeoffs between cost and differentiation. Networks, such as AOL, make tradeoffs between the size of the community served and the range of exchange services that can be offered to that community. Knowledge firms, such as Kleiner Perkins, make tradeoffs between the depth of specialization in particular areas and the breadth of problems they can take on.

### Three Types of Value Creation

Manufacturing firms, problem-solving firms and mediating firms face different types of tradeoffs. In fact what is a tradeoff between incompatible choices in one type of firm, may be a complement of strategies in another. In the discussion below we outline the properties of the three value configurations: “value chain”, “value shop” and “value network” (Stabell and Fjeldstad 1998) – before discussing the tradeoffs associated with each.

**Value chain – the manufacturing model**

In the value chain (Porter 1985), firms create value by transforming inputs into more refined outputs. The process of value creation is sequential: value is added at each step. The strategic challenges associated with managing a value chain are related to creating products with the right quality at the lowest possible cost. The main ways to reduce costs are through economies of scale, efficient capacity utilization, learning effects, and efficient product and information flow. Critical drivers of value creation include the interrelationships between primary activities and product development, marketing and service, ie activities that support manufacturing, logistics and marketing. The outputs
of the value chain are products. These products can be assessed independently of the producer or the production process. Examples of firms that create value as chains include producers of automobiles, clothing, electronics, food, computers, furniture, and pharmaceuticals. Although the archetypal value chain firm is a manufacturer, many of the concepts and strategy choices are also relevant to “industrialized” services such as fast-food restaurants.

The generic strategy tradeoff suggested by Porter (1985) – differentiation versus low cost – is central to strategic decision-making. This tradeoff stems mainly from economies of scale, but also from product signalling and competence incompatibilities. Firms can trade off product variety for unit cost, as variety to meet differentiated customer requirements reduces potential scale effects. The differentiated firm compensates by charging a premium price, reflecting the adaptation to particular requirements. This is fundamentally an internal tradeoff for the firm to decide on the variety of its product portfolio. Should the firm pursue a strategy of a highly differentiated product portfolio, like Motorola in microprocessors, or one of constrained variation over several generations, like Intel? This internal tradeoff becomes an industry positioning tradeoff if cost economies of scale or market signalling represent critical mobility barriers that prevent firms from competing in each others’ segments. However, if mobility barriers are associated with knowledge or network effects, then the high volume producer may both capture a premium price and have the lowest manufacturing cost. This may help explain the sustained competitive position of Intel, which both serves the widest market, and commands the premium price in the industry.

Value networks – the mediating network firms
The value creation of value networks lies not in transforming objects per se, but in their mediation. Consider a stock exchange. A stock exchange does not produce any tangible products; it allows traders to communicate and transact. Similarly, a telecom operator does not transform products or services; it connects people who want to communicate. The challenge for any value network is to build a “club” of members which is sufficiently large, and in which the members complement each other. Value networks compete to capture rents from positive network effects (Katz and Shapiro 1985), ie where one new member of the network increases the value of the network for all members.

All parties are customers of the mediator, as long as they transact across the network. Stated differently, the value network creates value by helping its customers exchange things, money, and information, or by moving the customer physically or virtually between locations. Travel and electronic conferencing services are examples of the latter. When value networks are used to organize markets for products – as done by eBay and other online auction firms – they substitute or complement value chains. The value is found in how the specific network gives buyers access to sellers of what they want, and vice versa. Examples of companies creating value as networks include commercial banks, airlines, postal agencies, telecom operators, insurers, brokers, stock exchanges and overnight delivery companies.

Size may both increase value and reduce costs simultaneously for networks, and create “winner-take-all” situations through bandwagon effects. The relevant tradeoff may therefore not be between volume or niche markets. The conflict is not in the scale of operations, but in the scale of the network versus the range of services that can be provided. This is an issue of compatibility. Almost anyone can be reached by a voice phone call; because the phone systems of the world are built around compatible standards and they interconnect. The number of people who can be reached via a video conference call is tiny in comparison. The Internet may improve compatibility through the diffusion of a standard protocol, TCP/IP. It represents a range increase in the service from voice-only to voice-and-data, allowing richer interaction to take place. Membership is the source of tradeoffs in networks. Network firms face tradeoffs in terms of reach (the number of customers served) and range or richness (the nature and extent of transacting that can be provided between those customers).

Value shops as knowledge firms
The value shop creates value by solving unique problems for customers. Mobilizing resources – essentially, relevant competencies – in order to solve particular problems creates value. Problem solving involves developing solutions tailored to problems that the clients will not – or more often cannot – solve themselves. The major value creation is linked to understanding the problem and finding solutions,
ie going from a present to a more desired state (Simon 1977). This is the outcome of a problem-solving cycle.

The value created by the “shop” is not directly related to costs. Although solving a certain problem (e.g., medical, legal or financial) may involve very little direct effort from the expert, it may be extremely valuable to the client. A surgeon can make a diagnosis and undertake a medical procedure in a few days that may be invaluable to the patient. A lawyer may in a few minutes see a judicial solution to a problem that is worth millions of dollars to the client. Examples of companies that create value as “shops” include accountants, academics, investment bankers, venture capitalists, physicians, designers, lawyers, business consultants, advertising agents and consulting engineers.

Whereas both the value chain and the value network rely on economies of scale— in production and membership reach, respectively—there are economies of small scale in problem solving. Often, fewer are better in a team (assuming that the members have the required expertise); the small numbers avoid the extensive co-ordination required in large, complex projects. Nevertheless, knowledge firms may also enjoy scale advantages in knowledge networks, where the ability to draw from a large potential competence-base for a given project may provide competitive advantages. This may be the explanation for the large scale of global consulting firms such as Accenture. Competence is the source of tradeoffs in value shops. Solving advanced problems requires highly specialized expertise. Specializing may limit the scope of problems that the firm can undertake and the approaches to solutions that it masters. Conversely, scale may reduce efficiency because of higher co-ordination costs.

The main activity tradeoffs associated with each type of value creation are highlighted in the left-hand column in Table 1 (overleaf).

Most firms exhibit some traits of all three types of value creation. For instance, value chains undertake problem-solving activities, such as product development, design and marketing. Nevertheless, these and other problem-solving activities are undertaken by industrial firms in order to sell products. Thus, despite the importance of product development in the automotive industry, what the firm gets paid for is the car. Similarly, networks also undertake both problem-solving and transformation activities, but what they get paid for is the mediation they provide (“access and exchanges”). Hence, in order to determine what type of value creation is taking place, we need to look at what the firm gets paid for by its customers.

- **Value chains** sell products that are the outcome of a transformation process. The customers pay for the total quality of the product.
- **Value networks** sell mediation between customers or places. The customers pay both for access to the network and for exchanges via the network.
- **Value shops** sell competencies and approaches to help solve unique problems. The customers pay for solutions to – or effort spent on – their problems.

Having outlined the activity tradeoffs, we now focus on the time tradeoff—namely between exploration and exploitation—in each type of value creation (the right-hand column in Table 1).

**Exploration versus Exploitation**

Balancing exploration and exploitation entails balancing prioritization of today versus tomorrow, accepting that it takes time to develop the resources required for competing successfully tomorrow. Exploitation refers to the short-term improvement and refinement of present opportunities, competencies and solutions. Exploration is associated with the long term, and implies experimentation and the search for new opportunities, competencies and solutions. The returns on exploitation are closer in time— and space— than the returns on exploration. A firm that only explores puts itself at a short-term risk, as it neglects present opportunities. Conversely, the firm that puts too much emphasis on exploitation risks not surviving in the long term, because it neglects building knowledge to seize new opportunities. The challenge of determining an appropriate balance is made difficult by two traps (March 1995).

- **In the failure trap** the firm does not have the patience to wait for the payback on exploration, which leads to a vicious circle. Realizing value from an exploration is both time-consuming and uncertain. Applying a short time perspective to exploration makes almost all new ideas look bad, regardless of whether they actually are good or bad.
The success trap is associated with too much exploitation, i.e., the firm being satisfied with the returns on exploiting present knowledge and technologies. Present success will tempt the firm to continue exploiting at the neglect of exploration, although exploration is necessary in the long term.

The critical resource tradeoff related to this is thus between investing in capabilities that allow the firm to transcend activity tradeoffs in the future, versus capitalizing on current resources. A case in point is a frequently overlooked insight by Porter (1985, 20), that the cost versus differentiation tradeoff may be overcome by firms pioneering a superior technology. However, such investments can be profitable only if the activities exploiting the results create value and the investing firm can appropriate the value. Appropriation requires some form of mobility constraints related either to the resources employed in value creation, or to the industry in which the resources are being employed. The advantages will not be sustainable if other firms are able to immediately substitute or reverse engineer a new tradeoff which transcends technology.
**Time tradeoffs in value chains**

Value chain firms innovate in terms of new products and ways to create them. Hence, the manufacturing firm must obtain efficiency without committing too heavily to present solutions, which limits exploration. Focusing only on present skills will reduce the firm’s ability to understand how the market is changing as well as its ability to create new products. This entails committing resources for future value creation. The most central time tradeoffs in manufacturing are associated with investments in product and process development and in branding. Many of the required investments are irreversible. Exploitation is also risky because it may lead the firm into the success trap, but it is necessary in order to be efficient.

Consider the case of insulin production. In the 1980s Genentech pioneered the commercial application of genetic engineering with the creation of perfect synthetic insulin at less that 1% of the cost of the conventional process. This insulin synthesis was the first laboratory production DNA technology. Prior to this discovery, insulin was extracted from the pancreas glands of swine and cattle slaughtered for food. It took about 8,000 pounds of animal pancreas glands to produce one pound of insulin. The costs were high and the quality variable. Some patients suffered allergic reactions to insulin derived from animals. The genetic substitute, which was chemically identical to human insulin, entirely eliminated these allergic reactions. Through genetically-engineered human insulin, Genentech thus developed a new technology that gave a superior product at much lower costs, transcending the cost versus differentiation tradeoff in the earlier manufacturing processes.

The activity and time tradeoffs are intertwined in the cost versus differentiation dichotomy. The sources of costs and value at any given time are very different, and for the purposes of discussing strategic tradeoffs they should be separated. In exploration, additional costs are associated with investments for the future, whereas in differentiation, cost disadvantage comes from failing to achieve minimum efficient scale. The additional price obtained through differentiation is sustained by having a degree of local monopoly power in segments with unique preferences, whereas the price premium related to exploration may come from absolute advantages over firms with inferior capabilities across all segments.

**Time tradeoffs in value networks**

Networks fail when they do not achieve scale in terms of customers or nodes. Network scope drives the value of membership and determines the nature of potential services. If a network firm introduces a broad range of services too early, these will be useless. If the firm is late in expanding service range, the subscription may become outdated and uninteresting to the customers. Networks must hence develop and diffuse a feasible range of services to their customers. This range is relative to competitors and depends on the state of maturity of both the service market and the market for enabling equipment. One example of unsuccessful network introduction was the premature attempt to institutionalize video-telephony in the early 1990s. In this case, multimedia equipment, high bandwidth communication and video conferencing software were all sparse at the time of introduction; in addition there was the uncertainty, which still exists, about underlying customer demand.

In the early stages of a specific network industry all firms have strong incentives to grow fast because:

- network services are usually “experience goods” (customers need to try them out in order to judge their quality);
- value creation depends on network effects (there was little point in getting video telephony before others had it).

One thus needs to distinguish between two phases of network value creation: building new networks or communities, and maintaining and developing established communities.

Building new networks entails creating network effects. Nobody wants to join a club without members. Firms employ a variety of strategies in order to establish a critical mass. Examples include: “giveaways”, as in mobile phones; “Trojan horses” – selling products for a stand-alone purpose with a future potential as a network access (eg PCs as future internet clients); “piggybacking”, where new services are bundled with existing ones (eg bundling browsers with operating systems); and “interconnecting”, where the services of a complementary network
provide scale (eg mobile phones can be used to call fixed-line customers). Not recognizing the challenges of building communities can be costly. Too often top-down initiatives focus on developing the new technologies, rather than on establishing the new communities. Thus, firms fail to innovate and build what is key to the actual value creation. One example is pre-1998 Microsoft, which for a long time was technology-oriented rather than community-oriented. Microsoft was very late in establishing MSN, its internet service provider, and has not reached the membership levels of AOL.

Maintaining established communities, however, also requires a high degree of co-ordination which can be detrimental to experimentation. AT&T, for example, has had difficulties exploring new communities. This may in part be explained by a high degree of top-down co-ordination of existing networks. Consequently, AT&T has had to acquire established communities, such as that of McCaw Cellular in 1993. McCaw – which built a broad cellular “community” in the US in the 1980s – did not introduce new technologies, but rather focused on attracting customers. In fact, McCaw’s technological base was close to outdated at the time of its $12bn acquisition by AT&T.

**Time tradeoffs in value shops**

Value shops face a time tradeoff between competence specialization and scope. Shop exploration is associated with taking risks. Shop exploitation, on the other hand, is linked to staying with proven solutions. If value shops increase scope too early – without sufficient specialization – they risk providing irrelevant services. However, if the shop specializes too much without integration of multiple competencies, its growth potential will be limited. This is because the shop will be unable to take on rich problems, due to its narrow competence base. Value shops, moreover, need to be particularly careful about “success traps”, ie sticking too long to existing solutions. A Scandinavian engineering firm in the early 1990s excelled in certain areas linked to geotechnical measurement. However, the firm lost its competitive edge over a few years. One reason was that it started accepting routine jobs, which did little to build new competencies or to improve its reputation. Still worse, it used the routine jobs to expand fast, hiring less qualified employees and neglecting to train them properly.

Fast growth for knowledge firms will tend to lessen their uniqueness. Value shop performance is driven by the “quality” of the problems acquired. Relevant problems may emerge from any client. Fixed relationships may therefore hinder access to interesting problems, and thereby lead to foregone opportunities to learn, innovate and improve the firm’s reputation. Wachtell, Lipton, Rosen & Katz, a New York law firm, managed to establish a superior position within M&As in the US in the mid-1980s by carefully selecting people and projects, and by deliberately choosing to enter into no fixed relationships (Starbuck 1993). This enabled the firm to take on the most complicated cases and to offer law graduates the most challenging work environment. Furthermore, the firm chose to forego growth opportunities in order to retain its high level of competence.

The value shop must, by definition, be able to adapt uniquely to each situation. Knowledge firms experiment through recruiting new people and taking on new projects. New, breakthrough projects are sometimes taken on despite the prospects of financial loss. Such pioneer projects are taken on in order to learn and to develop competencies in new areas, often in co-operation with a lead client. The top-down process in the value shop serves more as legitimization than as an actual driving force. In problem-solving firms, new directions and innovations usually come from specific projects. That is where new opportunities are recognized, and where new learning takes place. True bottom-up strategic initiatives in knowledge firms – such as in venture capital firms, law firms and business consulting boutiques – are particularly viable because the personnel are highly competent.

**Conclusions and Recommendations**

There are substantial differences between the three types of value configuration. They require different mental frames capable of leading management to make the right tradeoffs.

- Value chains have a process bias because they compete on cost-efficient manufacturing and distribution of products.
- Value networks have a customer composition bias because competitive advantage is linked both to
how mediation is performed and to whom or what the mediator can connect.

- Value shops have a people bias because competence scope is the source of sustainable advantage.

Firms that try to operate with all three forms of value creation internally may have competitive disadvantages as a result of not being able to make coherent value creation tradeoffs. Below we highlight three implications for managers.

**First, exploration versus exploitation is the fundamental tradeoff**

Trying to be all things for all customers is not a good strategy; it is not even a strategy. A strategic advantage implies doing things better and in most cases this requires careful matching of activities and resources for the customer segments chosen. Tradeoffs exist because activities have to be different in order to meet differing customer requirements. We have given several examples in this paper. However, we have also given several examples of how some of these conflicting requirements can be overcome through successful strategic investments in exploration that change the way value is created. We have called this the time tradeoff. The time tradeoff has strong implications for how managers and researchers evaluate performance. Investments in capital assets are easily accounted for. Much less so the investments made in product and process innovation, brands, competencies and network memberships.

**Second, strategy tradeoffs depend on the firm’s underlying value configuration**

Firms differ in the way that they create value for their customers. Their strategy tradeoffs differ accordingly:

- Value chains face process constraints associated with the way their products are manufactured and distributed. Tailoring products to smaller differentiated segments reduces potential scale advantages in the activities.

- Value networks face network constraints associated with the range of services that can be offered within the scope of the network. Greater scope in terms of more customers increases the possible exchanges, whilst the richness or complexity of the services offered reduces the number of customers that can participate.

- Value shops face competence-constraints associated with the breadth and depth of the problems they can solve. Specializing in a particular area may be necessary in order to solve highly complex problem. However, specializing within a limited personnel base reduces the variety or breadth of problems that can be solved and the approaches that can be taken.

- Strategic investments in (1) new product and process technologies, (2) new network communities and related services, and (3) new competencies and client relationships respectively, aim to overcome current tradeoffs faced by the firm.

**Third, business-level tradeoffs have corporate implications**

In the short term, the conflicting requirements of the three configurations may be so strong as to make them incompatible. In the longer term, the conflicts may be a source of fundamental corporate transformation, where value creation is shifted from one configuration to another. Both the activity and time tradeoffs have serious implications for how to think about corporate strategy. This is illustrated by looking at two examples in which there are clear problems associated with combining different types of value creation within one corporation.

“Firms that try to operate with all three forms of value creation internally may have competitive disadvantages”

- When looking at the challenge of simultaneously managing both a commercial bank (as a network) and a venture capital firm (as a shop), some inconsistencies appear. In order to be successful, a venture capital firm must be configured with slack resources in order to tackle unique opportunities quickly as they emerge. The free resources are required in order to have the needed diversity of competencies available, and in order to mobilize sufficient resources to pursue engagements in start-ups. In contrast, if commercial banks are to be successful, they need to manage a large set of customers efficiently. This means that they need to put in place standard procedures in a wide range of areas. The value of a commercial bank to the customer lies in providing low cost and high value, which can be attained only through a large set of appropriate customers.
AT&T provides another interesting example. In the 1980s, AT&T consisted of business units that undertook all three forms of value creation. However, as competition increased due to deregulation, it was increasingly difficult to simultaneously (1) compete and interconnect with, (2) sell equipment and software to, and (3) do problem solving for other phone companies. All in all, the different value creation logics posed tradeoff problems leading to serious competitive deficiencies. The telecom operator (today’s AT&T) was obliged to purchase equipment and consulting services internally, even when outside companies offered superior value. This meant that it was sometimes stuck with second-best solutions in terms of infrastructure. The consulting and engineering business (Lucent Technologies, including Bell Labs) struggled with its task of showing integrity vis-à-vis potential clients. These were often competitors of the telecom operator. This meant that Lucent did not get a number of the projects for which it was best qualified (in terms of competencies). Consequently, it did not learn and develop as much as they otherwise could have. The computer firm (NCR) could be accused of prioritizing the internal operator and not providing optimal service and products to “outside” customers. This meant that its external market was restricted in terms of potential customers, and that NCR did not reach efficient scale despite the substantial size of the internal AT&T market. Both the value chain (NCR) and the value shop (Lucent Technologies) were spun-off in 1996. Today, AT&T is a pure value network (long-distance, cellular and cable-based) which, in turn, has acquired other networks such as Teleport, IBM Global Network, TCI (with @Home) and MediaOne. The performance of each of the three divested entities improved considerably after the AT&T divestiture.

A high-profile current example which raises some of these issues is AOL-Time Warner. At present, AOL-Time Warner is a media conglomerate which combines network businesses with some context creation businesses like Warner Brothers studio (which can be classified as value shops) and downstream business (eg movie distribution and exhibition) which are primarily value-chains. The resulting corporation has huge resources, reach and muscle, but managing the strategy tradeoffs in such a wide range of business will be challenging. The major corporate strategic question is whether this conglomerate is managed as a set of independent business units, or whether competitive advantage of one business logic, for example the network business, is built by control of the two other.

References