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Firm Boundaries, Transaction Costs Economics, and Capabilities of Lodging Corporations: a Conceptual Model for the Adoption of the Asset Light model.

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Abstract

Why did lodging corporations opt for the asset light model in the first place and why did they adopt it at different times? The answer to such questions could not only help further explore the fundamental question in strategy of why do firms' strategy differ, but also provide insights to managers as to the implications of such strategic choices on corporate performance. Built around three stages and three propositions, the theoretical model proposed in this article integrates constructs from the managerial capability, isomorphism literature, the resource-based view, and Transaction Cost Economics (TCE) to depict the triggers of vertical disintegration. This model underlies the dynamics of a highly significant phenomena in hospitality industry: the development of the asset light model.

Key Words *Vertical Disintegration, Asset Light, Capabilities, Transaction Costs.*

Theme *Miscellaneous*

Focus of Paper *'Theoretical/Academic'*

Introduction

Over the past two decades, companies in the lodging industry have departed from vertically integrated structures to select specialized and disintegrated scopes (Sohn, Tang and Jang, 2013). In October 1993, Marriott Corporation initiated this outsourcing choice with its split-off of into two separate entities (Blal, Hodari, and Turner, 2016). Since, the industry has witnessed lodging corporations disinvesting their real-estate to focus on the management and operation of hotel brands. This strategic choice to sell the real-estate asset and focus on hotel operations is labelled the asset light strategy.

This ownership choice led to the development of actors that specialized along the industry's value chain. Lodging corporations, led by Marriott in the United States, who altered first their vertical scopes, started with a spin-off of their real-estate activities from their operating activities while maintaining management contracts between the two newly formed enterprises. In parallel, another set of capabilities (i.e. real estate development and ownership) in the hotel real estate activity developed. Private equities, Real Estate Investment Trusts (REITs), and other entities specialized in hotel investment started to proliferate. Hence, for over two decades, these two types of firms developed specific and specialized capabilities. As a result, the lodging industry offers a unique empirical setting to investigate the contingencies of corporate capabilities, transactions, and environmental in shaping vertical scope of organizations for two reasons. First, the process of vertical disintegration is well advanced in the hotel industry as it started over two decades ago. Second, the changes in asset specificity is salient and established (Blal and Graf, 2013).

The developments associated with the asset light phenomenon are well acknowledged by the industry and academic communities. Yet, little is known and empirically tested about the triggers of these choices. In other words, what explains the fact that this strategic choice was applied by many actors in the industry? Why did companies choose first to adopt the model, while others applied it after? And by extent, what are the triggers for

vertical disintegration and how does it fit in the strategy literature? Answering these questions will allow academia to better understand the phenomena and managers to appreciate its implications for the future of the industry. In particular, it will support further investigation on the impact of such decision on the performance of firms. In this conceptual article, we develop a model depicting these relationships and theoretically answer these research questions.

Background Literature & Theoretical Model Building

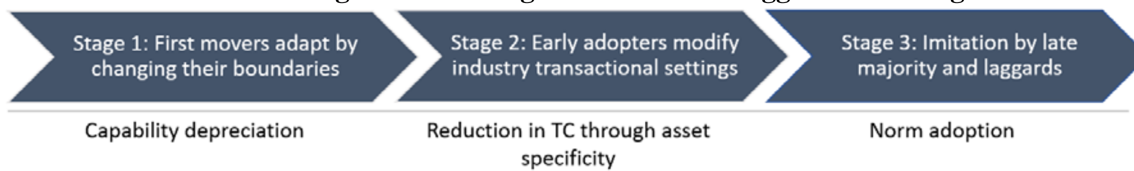
The integration of transaction cost economics (TCE) and capabilities perspective in explaining firm boundaries opened a promising agenda in the field of corporate strategy and firm boundaries in particular (Argyres and Zenger, 2012; Argyres, Felin, Foss and Zenger; 2012; Holcomb and Hitt, 2007). This integrative work postulates that environmental conditions play a role in defining boundary decisions. In particular, it proposes that the asset's attributes or the specificities of a single transaction are not the sole determinants of ownership, but rather that it is the match between the complementarity of the asset with the bundle of existing assets within the firm that shapes its boundaries (Argyres et al. 2012). Second, it supports that prior boundary choices impact capabilities within a firm (Argyres and Zenger, 2012; Jacobides and Billinger, 2006). Third, and as a result of the two previous propositions, this perspective considers that capabilities and transaction costs interact and co-evolve in an intricate and dynamic way to influence boundary choices (Argyres and Zenger, 2012; Jacobides and Winter, 2005).

While prior research has shown the contingent nature of the relationship between capabilities and transactions (Brahm and Tarziján, 2014; Fabrizio, 2012; Jain and Thietart, 2013; Mayer and Salomon, 2006; Ray, Xue, and Barney, 2013), no study to our knowledge, has investigated both exogenous and endogenous factors jointly as they shape boundary choices. To address this limitation, we propose to further explore the dynamics of this relationship by separating the exogenous factors (e.g. changes in the technological, sociological, and political environment) from endogenous ones (e.g. capabilities employed along the value chain and past boundary decisions) and examine them in light of the stages of disintegration of the hotel industry.

Specifically, we suggest in this model that the triggers for boundary changes vary with the stage of vertical disintegration in an industry. As an industry undergoes such structural change the relationship between capabilities and transactions varies over time to have different effects on corporations' ownership choices. In particular, the contingency elements which impact the decision to disintegrate vary for first movers and late adopters.

Our model depicts the differential rate of disintegration of lodging corporations (Figure 1). Building on the integrative literature on capabilities and transaction costs, we hypothesize that firms start to vertically disintegrate because the increase level of complexity depreciates existing capabilities relative to the new specialized firms. In this first stage, exogenous factors influence the decision. However, once the disintegration and specialization choice is implemented, these newly specialized firms will modify their industry's transactional context (Jacobides and Winter, 2005). Specialized firms will reduce the transaction costs in their environment through the reduction in asset specificity to fully capture the rent available through their distinctive set of capabilities. This triggers a second stage during which early majority vertically disintegrates. Our third proposition builds on the empirical work on competitive dynamics and diffusion by imitation and suggests that in the context of a disintegrated industry, where latent gain is available through trade from specialization, firms will disintegrate not for contingency between capabilities and transaction costs, but because of imitation.

Figure 1: A 3-stage model for the triggers of disintegration



External Factors and Capabilities as Shift Parameters

We put forward that external factors are the shift parameter for the first disintegration wave in a vertically integrated industry. In the first phase, propositions from the organizational economics prevail in explaining why these first movers chose to disintegrate (Crook, Combs, Ketchen, and Aguinis, 2013; Heide, Kumar,and Wathne, 2014). In particular, these firms purse efficiencies through new transactions created by exogenous factors. As suggested by the integrative literature on transaction cost- capabilities contingencies, they also do so to access complementary resources (Argyres and Zenger, 2012). In short, exogenous changes make it more efficient to conduct a transaction through a close partnership than on its own or on the market. We complement this existing knowledge by proposing that the changes in the environment increase the level of complexity of the tasks and activities along the value chain. As a result, the firm's existing capabilities depreciate and this situation makes it more attractive to transact with a new specialized partner to quickly access the knowledge.

The vertical disintegration literature examines capabilities and transactional conditions, at the industry level (Stigler, 1951; Holcomb and Hitt, 2007; Jacobides, 2005; Richardson, 1972). The theory explains how new intermediaries and specialized markets emerge to benefit from the gain from the trade of specialized production. As the differences in capabilities along the value chain across specialized firms generate this latent rent, the vertical disintegration literature proposes that firms specialize on activities along the value chain to capture the gain of specialization. The vertical disintegration perspective is attractive because it considers the effects of the transactional environment along with the capabilities in studying the determinants of boundary choices (Holcomb and Hitt, 2007; Jacobides and Billinger 2006). According to this approach, corporations within an industry will at some point disintegrate to benefit from the gains of specialization. Yet, aside from the "*desire to pursue gains from the trade of specialized production*" (Holcomb and Hitt, 2007: 468), the literature on vertical disintegration offers no predictive proposition on the question of what determines this choice to specialize. What determines managers' choice to specialize over other possible actions, and thus to modify the scope of their firms, remains unclear.

In line with the integrative effort, we propose that technological, economic, and legal changes which increase the level of complexity of an activity along the industry's value chain are a trigger for disintegration for first movers. In the case of the hotel industry in the early 1990's, as the technological changes unfolded to facilitate trade, the status of the REIT and institutional owners expanded, the level of complexity in the real estate ownership and development increased. As such, the real-estate ownership, management, and development capabilities within existing firms depreciated relative to the specialized actors emerging. First movers, acknowledged this differential in capabilities and start disintegrate that part of their value chain to benefit from the capabilities of the new specialized firms. In this case, in the transactional context of a vertically integrated industry, we suggest that exogenous factors affect capabilities which we suspect to act as a shift parameter between transaction and boundaries decisions for first movers. Therefore,

Stage 1: First movers adapt to the new transaction-cost capability contingency by changing their boundaries

In the hospitality context, the low interest rates and returns from traditional markets increased the attractiveness of the real estate market as an alternative investment. This inflow of capital combined with modifications in the REIT legislation in the United States supported the development of specialized institutional owners. This specialization enhanced the level of complexity related to the development and ownership of real estate. In other words, these changes in the environment support the development of specialized counterparts in the value chain which increased the level of complexity of the real estate development and investment activities. In parallel, hotel chains became less specialized, their capabilities did not match the new level of complexity, and thus they could then benefit from latent gains of specialization.

We put forward that triggers for disintegration vary with the life-cycle of the vertical disintegration process in an industry. In particular, we hypothesize that exogenous factors are the triggers for specialization for the first movers as they affect the contingency between capabilities and transaction costs. In particular, we propose that:

P1: In a fully integrated industry, exogenous factors affect the transaction costs- capability contingency and triggers a first disintegration movement.

Endogenous and Exogenous Effects: The Role of Asset Specificity

Following the question of what triggers the choice to specialize, lies the issue of how will these corporations further pursue the gain from the trade of specialized firms. Jacobides and Winter (2005) offer a framework to depict how capabilities, transaction costs, and scope co-evolve in an industry. They suggest that latent gains motivate endogenous reductions in transaction costs and initiation of contracting. Yet, the actual mechanism that enables managers to achieve these endogenous cost reductions remains a question that needs to be addressed in order to fully grasp the effects of capabilities and transactions on firm boundaries.

We propose to complete the integration of the existing work and suggest that specialized disintegrated firms within an industry will act on the critical value of asset specificity to further reduce the transaction costs involved in the specialized trade. After a first stage, where first movers disintegrate to adapt to exogenous changes, they will seek to further capture the latent gain of specialization through the reduction in the critical level of asset specificity. These first movers will focus on reducing the specificity of the assets involved in the transaction with their specialized counter-part.

Asset specificity is the prime construct determining the choice of ownership. Organizational economists view it as the principal factor responsible for transaction cost differences among ownership choices (Argyres et al, 2012; Crook, Combs, Ketchen, and Aguinis, 2013; Jain and Thietart, 2013; Riordan and Williamson, 1985; Williamson, 1996). TCE defines asset specificity as '*the degree to which an asset can be redeployed to alternative uses by alternative users without sacrifice of productive value*' (Williamson, 1985: 95). While recognizing that exogenous contextual factors can influence the degree of specificity, none of these approaches consider the changes in transactional conditions due to prior governance choices (e.g. choice to specialize) that are described in the integrative literature on the coevolution of transaction and capabilities.

We propose that the reduction in the degree of specificity of certain assets in the value chain will allow disintegrated firms to reduce endogenous transaction costs and fully capture the latent gain that specialized trade can offer. As specialized firms exploit the latent rent through the reduction of TC through lower specificity, they will consequently pressure for developing less specific assets. Hence, industries where firms are vertically disintegrated will favour generic assets in their specialized trade exchanges.

Stage 2: Early adopters and first movers modify their industry's transactional settings

This new setting (created by first movers and supported by early adopters) creates agency issues between the newly disintegrated firms and the specialized partners. Furthermore, the newly disintegrated firms act on their environment to reduce transaction costs and to act on the specificity of the asset on the market. Since asset-specificity is a shift parameter, they act on it to reduce the transaction costs. In the hotel industry, they achieve to do by creating a norm in the real-estate properties (Blal & Graf, 2013). Therefore, we suggest that:

P2. In the early disintegration stages of an industry, endogenous factors related to transaction costs are a trigger for the early majority of firms to disintegrate

Together with the early adopters, first movers, modify industry structure to allow them to benefit from their disintegration choice and optimize their new transaction cost-capability setting. They act on the specificity of the key asset in the disintegrated transaction to reduce the transaction costs as they access specialized capabilities through the new counter-parts.

Imitation

As most players in an industry undergo disintegration to adapt to exogenous changes which depreciated the relative value of their capabilities (first movers) or to benefit from reduced transaction costs from reduced asset specificity (early majority), we suggest that the triggers for disintegration amongst the last series of firms are independent from the capabilities-transaction costs considerations. Indeed, imitation rather than the contingency between the transaction costs and dynamic capabilities is the trigger for disintegration at this stage.

In the strategy literature, the idea that competitors decisions are related and that a firm's decision can influence a competitors' move is well established in the research on competitive dynamics and oligopolistic dynamics (Garcia-Pont & Nohria, 2002; Lieberman & Asaba, 2006). This approach has also supported the

development of the diffusion of practices within industries (Ansari, Fiss & Zajac, 2010). We suggest that as more and more actors in an industry undergo disintegration, imitation supports the last diffusion of this practice in the late stages of an industry vertical disintegration. Evidence that asset light and by extent vertical disintegration in the hotel industry became, over the last decade, has become a common strategic change in the industry (Blal and Graf, 2013; Sohn, Tang and Jang, 2013). This supports our perspective that, rather than the transaction-capabilities relationship, imitation is the trigger for disintegration amongst late adopters. In this case, social structures, and relationships are the main determinants of action. Here these actors modify their boundaries because the cost of imitation is at its lowest.

Stage 3: Isomorphism of late majority and laggards

Finally, the choice to disintegrate for the remaining actors of the industry will be guided by social structures and imitation. In particular, isomorphism drives the last group of firms to disintegrate (organization theory propositions). In other words, managers of latter corporations imitate what they perceive to be industry's key success factors instead of designing a strategy based on their capabilities. By affecting the specificity of the assets and the norm of the central product of the transaction (i.e. the property), first movers and early adopters reduced the cost of imitation and clarified the information about imitation. In this stage, propositions from organization theory apply. In other words, social structure and relationships determine the disintegration process. Here, resource dependency, stakeholder theory, institutional theory, and social network founding propositions explain why firms disintegrate. They are looking to adapt to a new norm in the industry and new relationship dynamic.

P3. In the late disintegration stages of an industry, isomorphism is the trigger for disintegration.

Limitations and Discussion

This model bears few shortcomings. First, it is conceptual and calls for empirical validation. This can be the subject of future investigations in hospitality and in other industries. Second, while it represents a significant integrative effort, other streams literature can further complement this model. For instance, the literature on financial contracts or agency could complete the discussion on exogenous and internal factors in the decision to modify the boundaries of the firm.

The contributions of the article lie in the innovative way in which it complements a developing literature in strategic management on the boundaries of the firm. It also significantly contributes to the understanding of three highly important phenomena: the growing importance of the market for lodging properties, the development of asset light strategy, and the rate of adoption of the disintegration structure. In sum, the model, through its three propositions and stages is a first attempt to depict the dynamics of vertical disintegration and its triggers. The founding proposition of this model suggests the contingencies between transaction costs and capabilities which drive the decision of ownership varies with the stage of disintegration of the industry.

This new insights into the dynamics of the relationship between capabilities, transaction costs and firm boundaries opens several leads for further theoretical integration as well as empirical research. Links and bridges with other findings related to the literature on TCE, capabilities and industry life-cycle in shaping firm boundaries can be further examined. For instance, the integration of the works on vertical disintegrations (Jacobides, 2005) can be a subject for another conceptual combination.

From a managerial standpoint, the model can also help exploring why certain firms were more successful than others with their asset light strategies. Based on the relationships presented in this paper, it is highly likely that laggards, who modify their boundaries because the cost of imitation is at its lowest are more likely to gain less from disintegration than first movers. Indeed, for these players, unfortunately, the available rent from specialization is also at its lowest. Such empirical studies could help managers in the formulation and execution of their ownership choices.

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