CORE COMPETENCIES AND THE FINANCIAL HEALTH OF A FIRM

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ABSTRACT

Almost thirty years ago, Prahalad and Hamel (1990) argued that over a long period of time firms can develop core competencies which are hard to replicate (due to uncertain imitability), and thus create sustainable competitive advantages. One popular example of the core competence concept is General Electric (GE). GE has been recognized widely not only for its technical expertise but also for its skilled development of managerial talent and for its long-successful approach to portfolio management of diverse businesses. In this exploratory proposal, we examine GE over a long period of time through the 2007/2008 global financial crisis to understand the impact of core competencies on the financial health of a firm. Our approach explores how divestments may reduce core competencies and how growth into new businesses can generate new ones.

***Keywords**: Core Competencies, Business Portfolios, Financial Health of Firms*

1. INTRODUCTION

Core competencies *a la* Prahalad and Hamel (1990) is viewed as a foundation for sustainable competitive advantage for firms. Prahalad and Hamel (1990) argued that over a long period of time firms can develop core competencies which are hard to replicate (due to uncertain imitability), and thus create sustainable competitive advantages. One popular example of the core competence concept is General Electric (GE). GE has been recognized widely not only for its technical expertise but also for its skilled development of managerial talent and for its long-successful approach to portfolio management of diverse businesses. GE not only built core competencies in technical areas, but also built a reputation for the core competence it developed in managing technical competencies as a portfolio.

For more than a century, GE has been involved in every phase of the development of electrical and electrical equipment industries. GE was a part of or had an investment in any related development, from turbines to light bulbs to appliances to locomotives.

Profits from growing sales created the ability to finance sales through credit, and the extension and management of loans became a business in itself. In this proposal for research, we present a brief literature review followed by our hypotheses and a conclusion on what we anticipate to find through this study.

2. LITERATURE REVIEW

The basic idea of managing a firm as a portfolio of investments certainly is a reasonable one. Managers invest resources in different areas, some of those investments may turn out to be more beneficial than others, and managers then decide whether to continue investing, to seek new areas in which to invest, or to end (and possibly divest) investments in particular areas. Those areas may be defined as, for example, products, markets, technologies, or geographic areas. This constitutes the basis of the multi-business corporation.

The fundamental questions in this approach are how to measure the investment (time and/or money, for example), when to assess the investment, and on what basis to measure the benefit or return. The last, the basis on which we measure the results of an investment, is the fundamental issue for assessing the consequences any strategic investment: what did we get in return for our investment?

Corporate portfolio management often measures performance heavily in financial terms, considering actual and projected rates of return and the cost of capital, when deciding whether to re-invest in business units, invest in new areas (such as through acquisitions or internal development), or sell off businesses.

Because the future becomes more unpredictable the farther forward we look, expectations are discounted; near-and medium-term returns may be weighted more heavily than long-term ones. That is, when time value of money is brought into picture, any returns that are in distant future are discounted more than those returns are in nearer future. This we view as one major disadvantage to managing firms investing heavily in developing core competencies and building sustainable competitive advantages on these core competencies.

We can think of core competencies at the business unit level by focusing on technological skills (e.g., Kim, Lee, and Cho, 2016; Patel and Pavitt, 1997). More broadly, as in the case of services, we can consider the combination of technology, knowledge, and relationships leading to innovation (e.g., Kandampully, 2002).

At a corporate level, it is interesting to consider the perspective of futurists. Futurists study how to study the future; they have adopted the concept of core competence in their studies of superior foresight—the improved understanding of future scenarios, decision options and likely outcomes (e.g., Hines, Gary, Daheim and van der Laan, 2017; Major, Asch and Cordey-Hayes, 2001). When you examine a firm over very long periods, you may observe that firms which have this superior foresight could be linked not only to their sustainable competitive advantage but also the consistent superior performance. Most of the time, you will observe that superior performance in terms of customer satisfaction and revenue growth will be superior in terms of financial performance.

But, when you look at the stock market and the randomness of stock performance, the stock market performance of a consistently customer-focused firm may be a random walk. But, given the fact that most stock market evaluation is based on the satisfaction of major shareholders, a below-par stock market performance will lead the managers to do exactly what they should not do – apply financial portfolio theory to business portfolio or competencies portfolio management. Though some could argue that shareholder value should be the focus of every strategy, it is not possible to develop a firm strong in competencies by divesting certain competencies which may be crucial for their success in future.

Certainly, we are not the first to suggest that the skill of managing a corporate portfolio of competencies can itself become a competence.

The core competence view of companies (Prahalad and Hamel, 1990) is, in essence, portfolio management in terms of knowledge. It is, then a subset of the broader view of a company as a portfolio of acquired or developed resources (e.g., Mahoney and Pandian, 1992). Competence is not only technical; it "also involves *the governance process* inside the organization" (Prahalad, 1993, p. 45, emphasis in the original). Javidan (1998, p. 61) cogently places particular emphasis on the latter and urges that companies view corporate strategy as "not just a portfolio of businesses and SBUs but also as a portfolio of competencies". In this view, the primary role of corporate strategy is to focus on long-term development and use of core competencies across SBUs.

Unsurprisingly, this corporate-level core competence—the ability to manage a set of technical competencies—does appear to have limits. Kim, Lee and Cho (2016), for example, identify an inverted U-shaped relationship between technological diversification and firm growth. Just as too little diversification may fail to exploit a strong technological core competence, too much diversification, particularly unrelated diversification, may make it difficult to capitalize on an existing competence. In other words, too much diversification overtaxes the firm's competence in portfolio management.

While much attention has been paid to the development of core competencies and their role in generating benefits from diversification and acquisitions, we wish to focus on the role of core competencies in the financial health of the firm. When managers are forced into managing diversified firms as a portfolio of businesses, as Seeger (1984) pointed out over emphasis on strategic business unit (SBU), misapplications of business portfolio management occur. Such misapplication could lead to what Kim, Lee and Cho (2016) observed – an inverted U-shaped relationship between technology diversification and growth.

3. BRIEF HISTORY OF GE SINCE 1980

Stanislav (2009) provided an in-depth analysis of the strategies adopted by GE over 3 decades starting from when Jack Welch took over GE as its CEO. There are many cases written about this period in many strategic management textbooks extoling the virtues of running a firm on efficiency and growth. This is the period when the application of business portfolio management had been at its heights. Welch implemented a restructuring to streamline the operation of GE which retained businesses which could be classified into the limited number of strategic sectors and divesting businesses which could not be included in these strategic sectors.

Welch went on a growth strategy which focused on retaining or acquiring businesses considered the best or the second best with huge growth and profit potential and divesting businesses which were not. Such decision making was what Seeger (1984) cautioned us against. But, GE was the darling of stock market in those days since it provided the growth and profitability overlooking the balance sheet details – leverage and mismatched core competencies which could lead to decline in future (our view). Another dominant logic Welch used was getting the most out of every individual manager.

This was a time when either you thrived in GE or you were out of GE. As pointed out by most researchers, loss of human capital leads to erosion of competencies and as Ramanathan pointed out in a recent phone conversation that the turnover of human capital could be used as a measure of loss of competence. To a great extent, the decline in human capital was possibly the maximum during Welch's tenure as CEO. Stanislav's (2009) view is that due to excessive focus on efficiency and growth could have led to GE losing out growth opportunity for the future as well as loss of human capital required to sustain core competencies. Another observation relevant to our study is that the business unit GE Capital brought 50% of GE's revenue. This is another issue which Seeger (1984) pointed out when a CEO talked about the core business as a "Dog" which should be divested based on BCG business portfolio analysis. GE Capital was to support other businesses and its revenue could not have been there unless the business units' had products and services that brought revenue.

Since Jeff Immelt took over as CEO, he had to face hostile shareholders, one of the worst terrorist attacks in the US and resultant economic turmoil. He was in the unfortunate situation with scandals like Enron and WorldCom and the .com crash. Immelt had to reassure his shareholders that the sliding share price would recover if he built a strong company with long term growth in profits. He consciously managed GE's public image through many public relations efforts (Stanislav, 2009).

Immelt ensured that the human capital outflow was arrested by being a people friendly CEO. But, he faced some of the worst economic and financial situations which found earlier forays into areas which needed divestment of its financial services unit. GE had to get Berkshire Hathaway to invest billions of dollars in GE shares. Despite surviving the global financial crisis, GE share price had been declining and the future of GE is being questioned today.

4. HYPOTHESES DEVELOPMENT

4.1 BUSINESS PORTFOLIO MANAGEMENT AND CORE COMPETENCIES

Since business portfolio management is more focused on improving immediate financial returns than long term financial health, firms tended to divest businesses not delivering the expected performance goals. Such divestment decisions could lead the firm into losing competencies required for success at a later in future.

Some competencies could be essential components of other core competencies the firm had been building over many years. Since the stock market focuses on the immediate growth rate and profitability, business portfolio analyses may overlook the need in future for competencies embedded in every SBU and as these competencies are shared across other SBUs these competencies become core competencies.

Hence, we hypothesize that *higher is the number of SBUs divested, lower will be the number of core competencies*. With respect to GE, we observe that GE has been losing a lot of human capital during an era of focus on growth and efficiency during Jack Welch's time as CEO.

4.2 RELATED BUSINESS STRATEGY, CORE COMPETENCIES AND GROWTH RATE

Related business strategies are built on existing competencies, resources and strengths. Whereas, unrelated business strategy could be built on acquisitions. Jemison and Sitkin (1986) discussed in depth the problems of developing related business strategy through acquisition. Whereas, acquisition is well-suited for unrelated business strategy.

Also, since core competencies take a long time to develop, related business strategy will lead to lower growth rate compared to unrelated business strategy since unrelated business strategy does not depend on any core competencies or resources already available. Though the overall profitability of unrelated business strategy is lower than that of related business strategy, the higher difference in growth rate of unrelated business strategy could lead to higher stock returns in the short run. So, firms attempting to improve stock returns could go for faster growth rate and reduce investment in developing core competencies.

So, we hypothesize that *core competencies when a firm develops related business strategy will be higher than when the firm develops unrelated business strategy*. In our preliminary examination of GE, we observe that the growth before Welch was almost always organic and hence related business strategy.

Whereas, during Welch's tenure as CEO, GE has been acquiring businesses which indicated that these may be based on competencies GE lacked before the acquisition. Since most acquisitions were successful, we presume that these acquisitions were unrelated. In our detailed study, we will use appropriate measures for diversification to assess whether the nature of diversification had changed, also, we will examine whether the acquisitive diversification was related or not.

4.3 CORE COMPETENCIES AND FINANCIAL HEALTH

Financial health is a complex phenomenon and it is difficult to have a unanimous measure of financial health. We argue that if a firm was financially healthy, then it should be able to sustain any turbulence in the external environment.

There are many elements which could be used to measure whether or not a firm can sustain any financial upheaval in the market. Some simple ideas could be measured by the financial leverage (e.g., debt/equity ratio), retention ratio (e.g., retained earnings/profit after tax) and earnings growth rate.

Some assessment of how core business revenues drive the corporate revenue. This is an example of how the firm depended on its core competencies to earn its living. For example, when Immelt took over as CEO, over 50% of revenue came from GE Finance whereas GE's core competencies were developed in technology and hence its revenue should have come from these businesses rather than a subsidiary which was to help increase its core businesses.

One major reason for our contention is simply that GE was not built because of its access to capital but because of its technological core competencies. Another way to examine financial health is to examine the distribution of its revenues. If major source of corporate revenue was just one of its multiple businesses, it would indicate that the firm would be in difficulty if that business failed or even faced decline in revenue. As the global financial crisis started, most companies that depended on credit availability faced bankruptcy or some large firms were bailed out by US treasury.

Though GE was not in such a condition, it had to get financial help from outside firms and had to divest businesses to survive the economic decline that followed. We argue that GE would never been in such a situation if it stuck to its century old practice of building on competencies. Hence, we hypothesize that *the financial health of firms building on core competencies will not decline*.

5. CONCLUSION

We believed that core competencies are not only the corner stone for sustainable competitive advantage but also the foundation for financial health of firms through its life. GE which is the best company of 20th century ran into trouble when faced with global financial crisis of 2007.

Though it struggled to survive the global financial crisis, it had infused capital from outside and divested businesses to remain focused on its traditional businesses built on core competencies.

Because of divestments forced on it due to business portfolio analysis, it may never be able to become the giant with no financial woes in future. Since we believe in core competencies, we want to see GE restore itself to its financial highs soon.

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J Rajendran Pandian completed his Ph. D. in strategic management from the University of Illinois and has taught in various universities around the globe. He has published in various peer reviewed journals. His research includes competitive strategy, internationalization strategies, resource-based view and entrepreneurship.

Mark Pruett has published and taught regarding a variety of strategic management issues, including competitive and corporate strategy, commercialization of innovation, entrepreneurship, international business, creativity, and technological change. He has a Ph.D. in strategic management from the University of Illinois and an MBA from the University of North Carolina.