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Matching slack resources and investment strategies to achieve long-term performance: New perspectives on corporate adaptability [☆]

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ABSTRACT

Managers are continually challenged to balance the tradeoffs between adapting to rapidly changing market environments and focusing on existing core efficiencies. In this paper, we advance new perspectives on corporate adaptability by departing from the premise of the previous research that treats a firm's investment strategies and management of its slack resources in isolation. We contend that firms with adaptive capabilities attempt to match the type of slack resources (i.e., absorbed/specific or unabsorbed/flexible) with the nature of their investment strategies (i.e., exploration vs. efficiencies in existing assets). We further advance that the dynamics of strategy and performance relationship is moderated by the market turbulence level.

Our empirical evidence from a sample of adaptive technology-intensive firms shows that under stable market environments, firms tend to use flexible slack resources (such as cash holdings and cash flows) to finance R&D expenditures in growth options. On the other hand, specific resources (such as plant, property and equipment) are used to support capital expenditures in existing assets. Our evidence further indicates that matched firms' performance dominates that of unmatched firms, and, further, matched firms have fairly similar profitability in the long run. Under turbulent market environments such as the Dot.Com bubble (1999–2002) and the sub-prime mortgage crisis (2007–2009), we find investment in growth opportunities and innovation is slowed down while cash and liquid assets are accumulated to create a buffer against the risk of financial distress.

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1. Introduction

Recently, the increased level of global turbulence in the business environment has adversely impacted corporate profitability significantly diminishing its survival rates across a broad spectrum of industries (McGrath, 2012; Morris, 2009; and Stubbart & Knight, 2006). In this environment, managers have been continually challenged to balance the benefits and costs of adaptability which entails, at one extreme, maintaining an external focus to adapt to market changes (possibly incurring significant adjustment and opportunity costs) while, at the other extreme, focusing on a narrowly defined market to sustain short-term profits (risking to be left out when market changes occur). The predicaments of firms such as Research in Motion

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(Blackberry), Kodak, Xerox, Kmart, and US Postal Services are widely viewed as cases of “retarded adaptation” as opposed to “disruptive innovation” that may have caught management off guard.

Recently, in the management literature, the scope of research on corporate adaptability has been expanded to include both the role which is played by a firm’s investment and management of its slack resources under turbulent environments. Kraatz and Zajac (2001) find organizations with greater resources are much less likely to engage in adaptive strategic change. In their study, Voss, Sirdeshmukh, and Voss (2008) provide support for the role of customer relational and operational slack in promoting exploitation-oriented investment activities. However, they did not find support for the impact of financial slack in advancing exploration-oriented investment activities. On the other hand, Modi and Mishra (2011) find that while resource efficiency strategies in inventory, production and marketing domains are associated with superior financial performance, the gains exhibit diminishing returns.

Preserving financial flexibility by maintaining appropriate levels of slack resources such as excess cash and unused debt capacity has also been a growing area of research and practice in the field of financial economics. In general, firms with higher levels of financial flexibility are expected to have easier and cheaper access to external capital markets to meet funding needs arising from unanticipated earnings shortfall and (or) new growth opportunities (DeAngelo & DeAngelo, 2007; Byoun, 2008; and Gamba & Triantis, 2008). Using the real options framework, Myers (1977) and Myers and Majluf (1984) suggest that corporate moral hazard incentives associated with the use of risky debt financing may negatively affect the proportion of a firm’s market value accounted for by its investment in future growth opportunities. More recently, Brown, Fazzari, and Petersen (2009) provide empirical evidence showing that supply shifts in the availability of external and internal equity capital explain a significant portion of the dramatic 1990s boom, and the subsequent decline, in US R&D expenditures. Further, in a different study, Brown and Petersen (2011) find that firms with significant growth opportunities, but facing financing frictions, appear to manage their liquidity to maintain a relatively smooth path of R&D spending for innovation and growth opportunities.

In spite of some recent progress, performance implications of adaptive corporations have still remained unresolved. There is a need to develop a more convincing theoretical underpinning in this area supported by comprehensive and insightful empirical evidence. Drawing on the research in financial economics and strategic management, in this paper, we mainly focus on the former issue by introducing new theoretical perspectives on corporate adaptability that examine the relationship between resources flexibility, investment strategies and long-run performance under different market conditions. We depart from the premise of the previous research in finance and strategy that treats a firm’s investment strategies and management of its slack resources separately and in isolation. We posit that firms with adaptive capabilities attempt to match the type of slack resources with the nature of their investment strategies. We propose that, under conditions of stable market environments, performance of matched firms is neither dominated nor dominate that of other matched firms. During periods of unstable market environments, however, we further contend that firms may deviate from the matching rule either by accumulating cash to mitigate the consequences of economic uncertainty or by further aligning flexible slack resources to exploration-oriented investment opportunities to benefit from the prospects of rapidly changing environments. We also provide illustrative empirical evidence on our proposed hypotheses by exploring the slack resources and investment behavior of a sample of U.S. technology-intensive industries over the period, 1990–2011.

The paper is organized as follows. The conceptual framework underlying the adaptability and performance relationship for a firm is explained in the next section. In the third section, we investigate the joint impact of a firm’s investment strategies and slack resources on its overall performance and advance a number of testable hypotheses. In the fourth section, we present illustrative empirical evidence on our proposed hypotheses. Finally, in the last section, we provide a summary of our results and make suggestions for future research.

2. Adaptability–performance framework

As depicted in Fig. 1, we begin by framing the overall relationship between corporate adaptability and performance as being influenced by two broad and related factors identified as a firm’s investment strategies and management of its slack resources. It is further proposed that market and environmental volatility may act as an important mediating boundary condition influencing the relationship between adaptability and performance. For example, McKee, Varadarajan, and Pride (1989) find that the performance of various organizational strategy types is contingent on the dynamics of the market in which they operate. The conceptual and empirical implications of these influences are detailed below.

2.1. Corporate investment strategy

An established theme in the strategic management literature is that successful firms are *ambidextrous* – i.e., investment resources are deployed to maintain a high degree of balance between exploitation and exploration (Baum, Li, & Usher, 2000; Duncan, 1976; Gibson & Birkinshaw, 2004; Levinthal & March, 1993; and Tushman & O’Reilly, 1996). March (1991, p. 71) describes *exploration* to include “things captured by terms such as search, variation, risk taking, experimentation, play, flexibility, discovery, innovation” and *exploitation* to include “things such as refinement, choice, production, efficiency, selection, implementation, execution.” Earlier studies often regarded the *tradeoffs* between exploration and exploitation activities as insurmountable, but more recent research describes ambidextrous organizations that are capable of *simultaneously* exploit-

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