Beginning matters

How value emerges in a firm

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Abstract

Firm beginning matters because in the early days different configurations are tried to cope with challenges and opportunities of their environment. It is in this early days that a new organization emerge -it is forged- because of the continuous trial and error exercises. In this first stage, drastic changes might happen that determine and configure their internal organization, culture and values; that is possible because of the firm´s size, lack of path dependence and an incipient culture. If a fit between the new firm and the market´s requirements is found; then a second stage may be present were optimization as form of economizing become predominant, this efficiency comes with a cost: The firm´s righty. This paper is about the importance of the firm´s begging and how to some extent, its origin determines its future.

Introduction

The field of strategy has been evolving in a quest for better answers about firm performance. Before a firm can halt the entrance of new competitors, imitators and substitutes or leverage their core competences there is a previous step, an initial stage. This work is about how a set of resources and its configuration can deliver value in their initial stage, and how this configuration of resources and capacities can sustain their subsistence. It is argued that not only internal resources are important, but also their relation with external resources, which shape the initial firm's configuration, and determine its possibility of survival. An example of this the case of Southwest Airlines which may help to find out what was the reason of success in its early days.

In the search for better performance and the future, sometimes it is forgotten the emergent culture, relationships that have been forged through the time. Challenges that tiger a response in a form of a new configuration and a new culture inside of the firm, it is argued that in the early days of the firm a new and unique organization is generated, and the main futures of the firm are stabilized in the very begging. The firm because of its lack of path dependence and brand new management are willing to try new way to answer the opportunities and threats by doing so the generate a new organization. It is expected that this new organization optimize and economize its operation, stablish process and culture that on one hand reduce cost but on the other hand reduce it capacity to change and adapt to new realities

This work is based on the evolutionary thinking, where variation, selection and retention are the main thrust. In Campbell's evolutionary change theory he argued that selection, adaptation and retention are key dynamics that determine a variety in organizations[1]. This paper is separated in two stages; the first stage, the forge stage- is about variation and selection, the second is about retention of the configuration of resources capable to deliver value and its replication. It is argument that the emergence of value is configured in the early days of the firms' life. The first stage was named as forge stage, because several alternative configurations of resources are tried, like one experiment after other. Strategizing is observed in the form of experimentation. If a successful configuration, capable to deliver value, emerges from the interaction of the firm's resources and the environment.

The underlying logic of the present work is grounded theory building. It is select grounded theory building. Grounded theory building can offer a unique opportunity to create a novel and more accurate insight into the phenomenon under study[2].

First stage: Variations and selection

With a plan in a napkin, Southwest Airlines started its operations in 1967 and the first plane took off on 1971. Its founders were Rollin King and Herb Kelleher, Rollin King was a pilot with an MBA from Harvard and Herb Kelleher was a San Antonio lawyer who owned a small commuter air service. Because of the US airline regulations, the very beginning of Southwest Airlines was restricted to have interstate flights. The only states that were large enough to sustain interstate carriers were Texas and California. Three cities were targeted in Texas: Dallas, San Antonio and Houston. Those cities already had a service provided by Braniff Airways and Trans-Texas Airways. In1967, Kelleher filled out an application to Texas Aeronautics Commission (TAC) to serve in those cities.

Braniff, Trans-Texas, and Continental Airlines succeed in grounding Air Southwest Co. then a three-year legal battle began. At first, Keller lost the appeal in Austin State District Court. The explanation was that the three cities proposed already had enough flying companies. Then Kelleher appealed to the Third Court of Civil Appeals and seven months later this court ruled the same verdict. At this point, the founders thought about cutting losses and finish the startup of Southwest Airlines.

Air Southwest eventually prevailed in the Texas Supreme Court, which ultimately upheld Air Southwest's right to fly in Texas. In March 1971, Air Southwest Co. became officially Southwest Airlines Co. (SW). This year was hired Marion Lamar Muse, who was a former president of Detroit-based Universal Airlines. King, Kelleher, and Muse were able to purchase three planes at 90 percent financing and hired a new workforce in just 120 days. Finally, after three years of legal battles, in 1971, the first SW airplane took off. On June 18th, with three Boing 737-200s, Southwest began scheduled flights from Dallas to Houston and from Dallas to San Antonio[3].

In 1971, the fare from Dallas to Houston was $27, and from Dallas to San Antonio it was $28. Both flights took 50 minutes. Southwest set a flat fare of $20, Muse believed that they could break even with a load of 38 passengers. As soon as the new fare was established, it was imitated by other carriers: Texas International and Braniff.

When Rollin King and Muse visited Pacific Southwest Airlines (PSA) they were advised to set 25 minutes to turn the airplane. Southwest initially had two airplanes, one had been used in the Dallas-Houston route and the other one in the Dallas-San Antonio route. In order to offer one flight every hour, the board authorized the acquisition of a fourth airplane. The scheduled day for the delivery of the fourth airplane was on October 1st, 1971. This plane would help to have a flight every 60 minutes. However, it was realized soon that the acquisition had been a mistake. The financial charge was so high that it could end the company's life. Fortunately, because the aircraft had been negotiated under such favorable conditions, it was possible to re-sell it with a profit. This operation might have solved some financial problems, but the problem of one-hour in the hour flight was still present. One solution was to turn the airplane in 10 minutes. The team led by Bill Franklin accepted the challenge and the time was set; Franklin knew from his experience at Trans Texas that a ten-minute turn on a 737 was possible[4].

By the first quarter of 1972, in the report for shareholders, it was announced that 100% of the operations would be consolidated at Hobby Airport and this would eliminate the high cost incurred in Houston's Intercontinental Airport. As soon as the operation of Southwest was finally established in May of 1972, Braniff, with an old leased Boeing 720, started a service between Hobby Airport and Love Airport. Most of Braniff's passengers were in connection or non-revenue condition. At this time, Southwest was carrying about 90% of the local traffic. Dallas Forth Worth (DFW) was schedule to open in early 1973, so Southwest, taking advantage of the experience at the Hobby Airport, applied for an exemption to continue using Love Field. In June 6, 1972, the Dallas airport board denied Southwest the petition and filed a complaint on judge Taylor's court[5].

Several times the $10 flights between Dallas and San Antonio came under doubt, should Southwest give up this service? While in July, 1972 Southwest did lose $63,100 in regular flights, they made 35,100 in the $10 flights. This result was so impressive that Lamar Muse said "we were sitting there starving to death with a ham on our shoulders"[5]. That called for another course of action. Southwest dropped the $20 and the $10 tariff and in October a new kind of tariffs were introduced: Full fare, called executive class and low-fare called pleasure class. Executive class fare was set on $26 single way and $50 round trip. Pleasure class was half of the cost of the executive class.

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Fig. 1: Southwest experimenting new tariffs

Despite the changes, the Dallas-San Antonio route was not doing well during 1972. It was urgent to improve or eliminate this option. In January 1973, in a last attempt to improve this situation, Muse set a flat rate of $13 each way from Dallas to San Antonio. The announcement was a sixty-day sale, hoping that Braniff would not make any moves. Nothing happened for a while, but as soon as loads went up, they matched the price in every flight near Southwest, retaliation was the name of the game.

On February 1st 1973, Braniff Airways was announcing a sale: half price on the Dallas-Houston route, the only route where Southwest was making money. "Those bastards" exclaimed Muse Lamar, and arranged a meeting with Camille Keith, Herb Keller and Ray Trapp. After a two-hour session the only thing that was clear was that a newspaper ad should be developed, but what should it say? The ad started with "Nobody is going to shoot down Southwest Airlines out of the sky for a lousy $13[5]. SW started to offer a gift; the insight came from a realtor who was selling a new condominium to Muse. He took the idea, and for some time Southwest became the largest Chivas Regal distributor[3].

Some brochures were given to Southwest pilots and hostesses in uniform. The result was unexpected. From January 19th to February 17th 1973, the average number of passengers per flight raised from 39.1% to 63.1%. Although not all the expected passengers took the $26 fare, enough people did. For the first time in the history of Southwest black numbers were in order. In March of 1973, Southwest had a net profit of $18,173. March was also the end of Braniff's low cost fare from Houston to Dallas but it was not the end of the tariff in the San Antonio-Dallas route which Southwest kept for an indefinite time. With this tariff, Southwest erased the concept and the distinction between pleasure and executive fares *and created the low cost fare*.

From now on there was only one tariff in the San Antonio-Dallas market: $13 per flight, flat. The result is presented below:

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Fig. 2: Result of the new fare, in passengers

Based on [5]:115.

The increase in passengers was about 50% in a month. Now the average increase was even better. From 39.9% in less than one month raised to 63.1%. Every passenger above the breakeven point contributed directly to profit; the action of having a lower fare had a direct impact on the average passengers per flight as it is shown in the next figure[3].

In the search for expansion, Keller and King believed that the natural option was Austin. Muse believed that this was a mistake since the main competitor was the automobile evenmore Austin hardly needed another airline. There was another criterion, the small possibility that the new service could attract new customers to the current Southwest services. A service to Austin did not provide continuous load for the stabilized configuration of Southwest, but Rio Grande Valley did[3].

In March 21, 1975; Muse wrote a letter addressed to the board proposing a $16 million loan to prepay the Boeing's debit and cover the first mortgage of 4 new airplanes. The summary of the year 1975 in numbers was that Southwest had carried "1,136,000 passengers, a 50% up from 1994. [Southwest] totaled 298 million in revenue passenger miles, up 63 %; $23 million in transportation revenues, up 54%; and $3.4 million in income after providing $467,000 for employees' profit-sharing plan[5].

First stage discussion

In the first stage, on the early days of the firm, drastic changes are observed in the forge stage. Two of the main changes in SW were the two-tier fare system and the low cost carrier (LCC) that was neither in the original plan, nor the three-year legal battle. Those changes were possible because of its small size and its lack of path dependence. In the first stage, with the initial configuration of firm resources the emergent results are hard to predict. Some researches suggest that struggle is the first step to the Variation Selection Retention view. The firm might try several changes, expecting certain output, but the output could be far away of the first thought. In a interviewed to prominent and successful Silicon Valley's entrepreneur argued "that it is a grave error for founders to articulate a particular model of organizing in the early days of a new enterprise"[6].

In order to cope with challenges and unforeseen events, variations and selection process it is likely to happen. Variations can be carried out by several firms with different resources and different configurations just like in an experiment. There are several sources of selection; some of them are the option of trial-and-error, learning and imitation[7]. Slack, waste and even mistakes could be valuable in the variation and selection stage. "Like many of its innovations, Southwest's two-tier fare system was not the outcome of a sophisticated long-range planning retreat; it was the result of good, old-fashioned trial and error"[4].

In the case of SW, they had to start in a specific State in order to become a competitor. Due to its size and the population that place could be either California or Texas. They had only a pilot and a lawyer at the helmet in the company that allowed them to respond and overcome the constraint imposed by the larger carriers: they almost did not take off. It was their insight that prevailed after losing two initial interdictions. At his stage, after three years of legal disputes, possibly the major change was a resilience and an emergent culture.

The configuration of resources matters. When Southwest extended their service for the first time, they had two main options: Austin and Rio Grande Valley. Because of the importance of this city in Texas, it was not strange that two of the founders had a bias towards an expansion to Austin. But at this time, this city hardly needed another airline, and that could bring problems to Southwest when they applied for the certificate of Public Convenience Necessity. However, a limitation was that Austin did not provide a continuous load for the stabilized configuration of Southwest, while Rio Grande Valley did. What was different was the way to relate the firm assets, and external assets were important when the decision of the selection of the most suitable airport was taken according to the emergent configuration.

As time has passed, it is possible to look at the configuration and to have an explanation, an *ex-post* explanation of how the value emerged[8]. It could be possible that the reasons why such configuration had emerged are embedded in the first stage of the firm.

Immitation

There are cases where even imitation can provide divergent results. SW was in part an imitation of Pacific Southwest Airlines (PSA). President Lamar Muse declared that SW operation and manual were a copycat of PSA[9]. Also, SW was imitated by other major competitors. Continental Airlines created Continental Little and with US Airways, initiated a fare war in the East Coast. An extension of the war against Southwest, but in the West coast, was initiated by United Shuttle. This war and the acquisition of Morris Air ended up with a decline of 54% in their stock price. Fortunately to Southwest, clones did not succeed, and later all of them were canceled. Imitation can diverge in their results, SW variations and selection allowed to have a lasting adaptation. Selection is not always beneficial for a particular firm. Sometimes the emergent process can deliver an adaptation[10].

In 1991 Itami and latter on 1996 Michael Porter explained that “the essence of strategy is choosing to perform differently than rivals do.”[11] Porter contrast the Southwest Airlines activities with hub-and-spoke systems. He also argues that Southwest Airlines *differs* from other airlines, and that it is why Southwest surpasses its rivals. But while Porter (1996) Southwest’s example is contrasted with an actual environment, *Southwest configuration was initially set up to compete as an interstate carrier. Long before the Airline deregulation allowed to Southwest to fly out-of-Texas, Southwest had their main configuration of what their business should be.* After the deregulation there were expansions but no major changes in Southwest[12].

Southwest Airlines uses only Boeing 737s, how did they come up with this idea? The first idea came from Rollin King, He proposed to use Lockheed Electra L-188 planes. Muse argued against and the preference was set for Boeing 737-200, and after for DC-9-30, BAC-111-400, DC-9-10, Boeing 737-100 and finally Caravelle. Because of the recession in the airline industry, Boeing ended up with there white-tail (brand new airplanes) airplanes that couldn’t be sold. Unfortunately, Boeing had high expectations. SW decided to go for their second preference; a brand new DC-9-30. Before concrete this operation, Muse wrote under what conditions they would be willing to reconsider the option of acquiring Boeing airplanes. At the last minute, they got an agreement and Southwest could get brand-new Boeings 737-200[5].

In this case, it was found that, in a small size firm, experimentation was part of the SW business definition and it was possible to end up with configurations that did delivered value in the early days as well as it does today under different scenarios and environments.

Second Stage: Retention

On 1976, Herb Keller filed an application to start operations in Austin, Corpus Christi, El Paso, Lubbock, and Midland-Odessa. Lamar did not expect to have a result until the end of the year. On October 27, 1976, a TAC examiner issued a favorable decision to Southwest. Braniff and the City of Fort Worth filed a petition for reconsideration, which was denied. Even though Boeing headed the delivery, Southwest had to wait about six months. That was not a problem, because cities that would receive the new service were not eager for this service, mostly because they were afraid to lose their trunk airline. Southwest growth was astonishing; in just one year Southwest would duplicate its fleet from six aircrafts to twelfth. With a new loan, Southwest prepaid Boeing’s debt and placed an order for four new aircrafts scheduled for delivery from June to December 1977.

Traditionally, Southwest expected that Braniff and Texas International could delay the TAC approval by using legal maneuvers. Southwest got surprised that this was not the case. Good news could be a headache when one is not prepared. If TAC approved the new Southwest air service soon, Southwest would not have aircrafts to serve the five new destinations. Economic resources were gathered via emission and loans. With this resources part of the short-term debt was covered and Boeing offered two available aircrafts.

From February to September of 1977, Southwest saw itself involved in a milliard of new operations. Even though no new airplanes arrived, Corpus Christy was incorporated. In this new operation there was an increase in passengers from February to May that went from 133,000 to 161,000 and consequently the increase in average flights went from 73.2% per flight to 76.2%. With the inclusion of the seventh aircraft, four new routes were opened from Dallas to Midland-Odessa and other four from Dallas to Lubbock. The eighth airplane was delivered on June opening six new flights from El Paso. The ninth was used to beef up the market of Dallas-Houston, and the tenth aircraft started the service in Austin. At the beginning, Austin did not turn out to be as profitable as other services. But, considering that there was no highway from Houston to Austin and the fact that Austin was the entrance to three cities far away, this city became a relevant operation.

If 1977 was not an average year, 1978 promised to overshadow their previous year. Two main events happened; the first one was the Air deregulation and the second one was that Muse Lamar stepped down as Southwest CEO.

With the deregulation of airline industry and the possibility to be a national carrier, Muse Lamar believed that Midway Airport in Chicago could offer the same opportunities that Love Airport had in Texas. Midway Airport was near downtown Chicago, Illinois. Even more, from this airport there were about 14 possible destinations that were between 200 and 500 miles. When trying to promote this project, Muse found resistance and even opposition from Mr. King and in the end Muse signed his resignation. Two years later, the first service outside Texas began in 1979, from Dallas to New Orleans[5].

In May, the New York Stock Exchange accepted to trade the Southwest stock. LUV was selected. In 1982, Herbert D. Kelleher became President, CEO, and Chairman of the Board. Southwest inaugurated its first service to San Francisco, Los Angeles, San Diego, Las Vegas, and Phoenix. At that time Southwest was in both sides of the US, east and west coasts.

After stepping down, Muse Lamar started a new airline on 1981: Muse Airlines which served from Love Airport at Dallas to Houston. The air-traffic controllers strike in 1982 reduced the numbers of controllers and airport landing lots, stopping Muse's plans for expansion. By December 1984, the company was actively seeking a sale or merge to reduce its continuing losses. Southwest acquired Muse Airlines, changed their routes and renamed it to TransStar Airlines. Two years later it was closed due to unacceptable losses[4].

A major SW backdrop came from Denver, where the service had to be discontinued because of the bad weather and congestion at Stapleton Airport. In 1990, Southwest became the major U.S. airline and announced a one billion-dollar revenue. In 1993, According to the U.S. Department of Transportation, SW entered a new market with a fare reduction in average of 65% and increased its passenger traffic by around 30%. 1994 was a difficult year for Southwest. After their continuous success, it was on the radar of major competitors that imitated the Southwest model. Continental Airlines responded with Continental Little that, along with US Airways, started a fare war in the East Coast. An extension of the war against Southwest, but in the West coast, was initiated by the Southwest clone: United Shuttle.

This war and the acquisition of Morris Air ended up with a decline of 54% in its stock price. Fortunately to Southwest imitators did not succeed, and later they were canceled. With the end of the year came the end of the airline industry recession. After 31 years of profitability, Southwest started to offer online boarding passes via southwest.com. In 2004, with the opening of their service on Philadelphia, Southwest operated 2,800 daily flights to 60 airports U.S. wide.

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Fig. 3: Growth of Southwest's Pre-Tax Income

Source: Compustat

Second stage discussion

Surprisingly, it was found that firms in the second stage do not alter the main way of creating value. At this stage, firms do not respond anymore to their environment; as soon as the configuration of resources emerges in the first stage it turns solid. If the configuration is successful, then it could face different environments and still keep delivering value, sometimes in settings that are wide different from their original one, "Many stabilities of the organization of process are (potentially) energy-well stabilities — steady organizations of process that are constant because it would require more energy than is available to alter the organization of the process"[14].

Replication

Replication is one of the key leverages in the second stage. It is the possibility to reproduce the emergent resource configuration of the firm. Despite the fact that SW was born originally with the idea of being a regional airline, it took advantage of their internal configuration of resources to replicate its operations beyond Texas. But SW was not alone; it was not the only one with a successful configuration ready to expand their operation in the deregulated US airspace. There was also Air California and Pacific, but they pursued a different pace in their expansion strategy. PSA and Air California looked for a rapid expansion policy but they became involved in intense airfare wars with their larger rivals. "These —replicator organizations, which focus on growth through exploitation rather than continuous innovation are emerging in many sectors as a dominant economic phenomenon of our time"[15].

Economizing

Economizing is about improvement and cost reduction. In the second stage SW has reduced the cost per mile. In 1991, Williamson discussed about the role of strategizing and economizing. On one hand, he argues that the role of strategizing is based on a power perspective, while economizing is based on an efficiency perspective, and "[i]n the long run, the best strategy is to organize and operate efficiently"[16].

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Fig. 4: Zoom in the 2nd Stage

On the other hand, according to Porter, "operational effectiveness is not strategy"[11]. He expressed that at the same time operational effectiveness and strategy are important for a superior firm's performance, but they work in different ways. This paper considers that both positions are valuable and they can explain a part of the performance of the firm but in different stages of its life. Thus, it is suggested that Porter framework may be more related to the first stage whereas Williamson to the second stage. According to the findings, Porter's position prevails in the first stage. It seems that strategy has more impact in the first stage, where the configuration is emerging, but in the second stage, retention and replication, it has more to do with economizing than strategizing.

The second stage offers empirical evidence in which firms do not always adapt their configuration to the environment. The configuration was ready to be duplicated and ready to reduce slack. Technologies are a device to improve the firm's performance "The productivity frontier is constantly shifting outward as new technologies and management approaches are developed and as new inputs become available"[11].

Path dependence

Path dependence is historically conditioned. "Lock-in Phase is characterized by a further constriction, which eventually leads to a lock-in, that is, the dominant decision pattern becomes fixed and gains a deterministic character; eventually, the actions are fully bound to a path"[17]. Surprisingly, it was found that the firms did not alter the main way of creating value in the second stage. At this point, the configuration of the firm did not respond anymore to its environment, it froze as soon as the configuration of resources had emerged in the first stage. If it is a successful configuration, this configuration could face different environments and still keep delivering value, sometimes in settings that are wide different from their original.

In this stage, a dominant pattern becomes deterministic and different course of actions become no longer feasible[18]. Activities and routines embedded in the firm's configuration become more bureaucratic, there is documented evidence consistent with the path dependence idea[18]. In the second stage, in part for their memory, it is expected that aged firms do not change. However, valuable configuration does not last forever. The delivered value is expected to gradually lose its potential; no matter how valuable the initial configuration may have been; firms die in the end. To support this view, data provide evidence that in an industry the majority of firms do not survive over a long period of time[18].

In the second stage, the firm freezes its configuration of resources and becomes more defined in their culture, routines and major decisions. SW "has maintained the same strategy and operating style that it maintains to the present. It concentrates on flying to airports that are underused and close to a metropolitan area"[6] coupled with a series of decisions that together sustain and allow a low cost operation.

IBM is one example that shows how a mature firm can be focused on results, customer's attention, and emphasis in improving profits but still can fail to commercialize 29 separated new technologies. "The alignment that made the company a 'disciplined machine' when competing in mature businesses was directly opposite to that needed to be successful in emerging markets and technologies"[18].

There are arguments against the idea that firms are static and do not adapt to their environment[19]. "Various studies have highlighted cases of persistence and irreversibility of organizational strategies, designs, and competences by drawing, for instance, on awkward routines, groupthink, or fixed cognitive maps"[17]. There is a recent discussion about how a firm can be at the same time flexible and capable of adapting as well as carrying out "activities [that] should be coordinated and streamlined to deliver that value"[20] it is called ambidexterity.

Conclusions

This work is about how value emerges in the firm's early days. Two main stages were found; the first one includes variation and selection whereas the second one encloses retention and replication. The first stage in a firms' life is about experimentation and adaption; variations in its initial configuration that may end up with a valuable configuration of resources. It was found that an initial configuration is shaped from the interaction of internal, external resources, threats and opportunities that its environment presented. In the first stage, when the iron is red it is a shaping stage, that is, value emerges as a result of experimenting different configurations. New resources were acquired and a new culture and routines emerge and they are consolidated as time goes by.

It is possible that the higher impact of a strategy can be achieved in the firm's first stage. Southwest could do some experimenting because of their lack of path dependence, risk seeking, size, endurance, challenges and its willingness to try different variations in its configuration of resources. Because of its low visibility (partly because of its size and partly because its newness) within a few years in operation, the initial configuration had the biggest changes and a permanent impact. Southwest's original plan did not include being a low cost carrier, not even flying only 737 Boeings; the original idea was limited to fly inside Texas. According to this example, it is advisable to start with a soft idea about what the firm should be, no vision or mission at this stage that can be transformed and aim to find a valuable configuration. If a new firm does not have a shaping period of experimentation, then it is highly possible that the firm will not subsist.

Once the configuration of resources is ready and the iron is cold, it is possible to think on the second stage (retention and replication). In this stage the best strategy seems to be economizing, where the reduction of waste and the implementation of new technologies take place. Along with the creation of synergies, the configuration could be enhanced and replicated; that might allow the firm grow in size and profit if the configuration keeps its emergent value on other space-time locations.

A fundamental distinction between the two phases arises. The strategies that worked in the first stage of the firm seem to be disruptive in the second stage; and the opposite is valid as well. It is probable that a strategy or a configuration that was valuable in the past is no longer valid. In that case, strategies as well as the resources configuration should be time-space constrained.

Regarding the failure of imitation, there are several reasons why a strategy could not be replicated. It may have failed partly because it was embedded in the configuration of the firm, and similar strategies with small differences or minor changes end up with wide different results.

Strategy field is based on the premise that there is space to drive the firm to a certain level of performance. On the other hand, the pure ecologist field claims that it is mostly randomness what determines the firm's outcome. This paper meets those theories halfway, there is a major possibility to have a lasting impact in shaping the firm's DNA and it is related to the beginning of the firm's life; the first stage.

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