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Dynamic capabilities view for closing the capability gaps in business model's transfer process: A case study of Japanese international retailer

Hajime Kobayashi

Professor, School of Commerce, Meiji University, 1-1 Kanda-Surugadai, Chiyoda-ku, Tokyo, Japan, 101-8301

Email: hkoba@meij.ac.jp

Yasuaki Saito

Former Professor, Doctor of Commerce, College of Community Studies, Shukutoku University, 200 Daiganjicho Chuo-ku, Chiba, Japan, 260-8701

Email: yasusait@soc.shukutoku.ac.jp

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**Work-in-progress paper**

**1. INTRODUCTION**

The firms are trying to close the capability gaps and (re)generate the business system locally, but there are differences (heterogeneity) among firms in this ability. This paper analyze how international firms (re) generate own business model for closing the ordinary capability gap caused by foreign expansion. There are many difficulties in (re)building own business model across borders, which hinder the adequate working of the ordinary (operational, substantive) capabilities that the company intends to perform globally. This paper refers to the breakdowns/malfunctions of ordinary capabilities (here after OC) as the capability gaps.

Based on existing analysis, we classify two types of the capability gaps, replication (standardization) problem and adaptation problem. The first capability gap (replication problem) implies that we cannot do things rightly. While we try to transfer the best practices into foreign countries, we face the knowledge transfer problem. The second capability gap (adaptation problem) implies that we cannot do right things in foreign context. We must search out the best answer. This paper analyze how international firms rebuild own business model by solving the second capability gap as the adaptation problems. In doing so, we adopt IMP's ARA dimensions and a dynamic capabilities view of the firms (hereafter DC).

This research aims to clarify the dynamic transfer process of the retail business model focusing on the working of the three DC's sub-capabilities. We conduct a qualitative case study by collecting and analyzing longitudinal data about a Japanese international retailer called Ito-Yokado. As a contribution of this paper, we have found several combined effects of DC's sub-capabilities on the evolutionary process of retail business models within local business ecosystem.

**2. PRIOR RESEARCHES**

Entering the field without any prior knowledge about the phenomenon under investigation is hardly realistic. We used our prior knowledge to see the relevant data and to fragment collected data into significant categories. Empirical unit of analysis in this paper is the business model. The business model, in general, represents the firm's strategizing logic for value

creation and appropriation (Zott and Amit 2010). Although the definition of the business model is varied, for empirical research, a business model is seen as an empirical phenomenon of real firms. We define business models as simplified representations of the value proposition, value creation and delivery, and value capture elements and the interactions between these elements (Massa *et al.* 2017).

In IMP tradition, business models have three dimensions; activity links, resource ties, and actor bonds (ARA). Therefore, when international firms go globally and try to rebuild own business model within local business ecosystem, they must solve the three adaptation gaps according to ARA dimensions.

In our view, traditional DC views often adopt static analysis and lack the dynamic view of capability lifecycle process. We analyze empirically the searching process for closing three capability gaps in business model (re) generation based on “dynamic” analysis of DC view.

According to Teece (2018), business model generation and DC must be combined analytically. Using Teece’s (2007) influential framework to organize and illustrate our arguments, we distinguish between ordinary capabilities (OC) and dynamic capabilities (DC). OC is a company's best practices (the ability to "do the thing rightly") and to enhance technical fitness. In other words, OC is the ordinary ability to efficiently carry out the normal functions that a company must perform, and can be acquired and enhanced by day-to-day practice.

On the other hand, DC is the ability to "do the right thing", sensing the business opportunities and threats created by environmental changes, making the necessary investments to seize them, and reconfiguring the existing resources and routines and transforming the existing business model. According to Teece’s framework, DC is divided into the following three sub-capabilities.

1) Sensing capability: the ability to recognize opportunities and threats associated with business environmental changes. Teece usually describes sensing (and shaping) capabilities as explicit, deliberative learning and elaborative formal reasoning and analysis. We call this sub-capability as entrepreneurial capabilities for business model.

2) Seizing capability: the ability to mobilize available resources and knowledge to solve above strategic issues and to create value from doing so. We call this sub-capability as architectural capabilities for business model.

3) Transforming/Reconfiguring capability: the ability to systematically reconfigure the resources and knowledge the focal firm and its stakeholders hold and continuously transform existing business model for better value capture. We call this sub-capability as governance capabilities for business model.

In our view, traditional DC concepts often adopt static analysis and lack the evolutionary view of capability. We analyze empirically the searching process for closing three capability gaps in business model (re) generation based on “dynamic process” analysis of DC.

Our research questions are as follows.

RQ 1: How DC works in order to close the three adaptation gaps in business model (re) generation within local ecosystem?

RQ 2: What kinds of adaptation problems firms must solve longitudinally during (ordinary) capability lifecycle?

### **3. RESEARCH METHOD**

We selected as the research setting a Japanese international retailer (Ito-Yokado Co.) embedded in foreign context in China. Ito-Yokado is a kind of extreme case and paradigmatic case (Flyvbjerg 2006). The extreme cases sampling provides information on unusual cases, which can be especially good in a more closely defined sense. The extreme cases often reveal more information because they activate more basic mechanisms in the situation studied. In

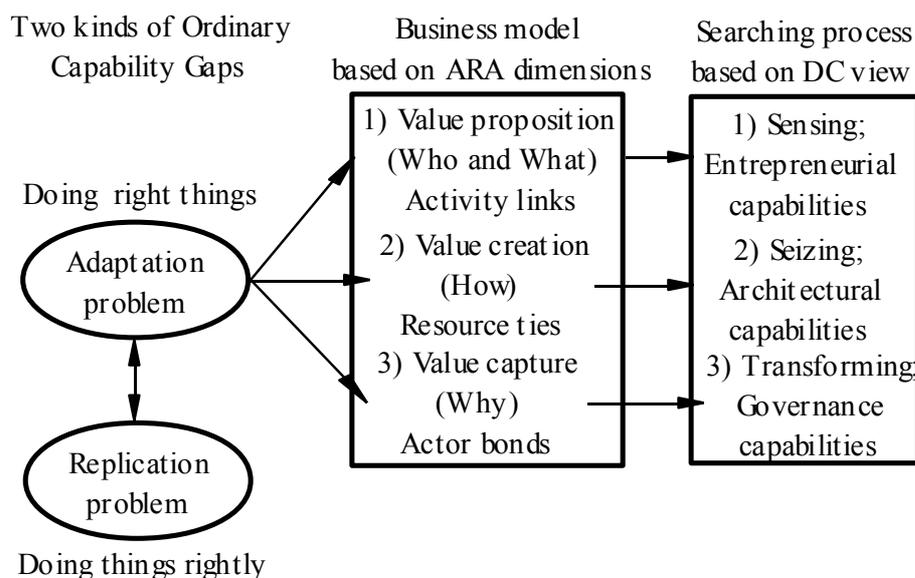
addition, the paradigmatic case is useful when we try to demonstrate the value of new theory by using concrete examples.

We think the research method adequate for dynamic process-based phenomena might be longitudinal qualitative research. We adopted a general methodology of analysis linked with data collection to develop inductive theory (Suddaby 2006). We define theory as a set of interrelated constructs (concepts), definitions, and propositions that present a systematic view of phenomena. When the objective is to achieve the greatest possible amount of information on a given problem or phenomenon, a random sample may not be the appropriate strategy. As a result, we relied on purposeful sampling followed by theoretical sampling.

#### 4. CASE DESCRIPTION

We set several conceptual categories tentatively for organizing interview data and archival material of the case firm. (See figure 1)

**Figure 1: Conceptual categories for dynamic process analysis of the adaptation problem solving based on the three ARA dimensions and three sub-capabilities of DC**



The business model transfer process of Ito-Yokado could be organized based on DC view as follows.

#### **1) Local and on-line search for closing capability gaps (1997~about 2009): Logical incrementalism**

The retail business model that Ito-Yokado has proud in Japan is generally called the General Merchandise Store (GMS) and invented its famous ordinary capabilities, such as single item management based on POS system, hypothesis & verification cycle in procurement (prevention of the loss of sales opportunity and excessive stock), and collaborative team merchandising through close relationships with suppliers. These ordinary capabilities pushed Ito-Yokado into one of the leading retailers in Japan.

In 1997, Ito-Yokado, based on the request of the Chinese government, selected two cities (Chengdu and Beijing) as the first time foreign market entry. Ito-Yokado thought that they

could contribute to the distribution modernization by spreading cutting-edge OC of retail business to China. However, when transferring the retail business model, the firm inevitably faced various capability gaps at the operational level (Teece 2017).

After entering local markets in China, the firm found out the following negative gaps in OC.

- 1) The name 'Ito-Yokado' as corporate and store brand was helpless.
- 2) The single item management procedure based on the POS system could not be implemented because of technological limits and lack of adequate human resources in China.
- 3) It was impossible to arrange product assortments in line with local customer needs.
- 4) No employee understood the true meanings of customer-oriented operations.

The reputation of Ito-Yokado accumulated in Japan was not useful at all, and few suppliers responded to the supply of goods. In order to solve the adaptation problems caused by these capability gaps, the executives of Ito-Yokado relied on only the entrepreneurial capabilities as DC's sensing. In doing so, they had nothing but to find the right answer through trial and error. At that time, what was the right business architecture was ambiguous, and the firm could not use the governance capability based on the relational assets (social capital, trust).

In the face of the current state of big deficit, they were forced to adopt the fire-fighting and/or logical incrementalism.

One of the executive managers we interviewed recalled back and said as following:

*"The performance was very bad, at first we transplanted the way of Ito-Yokado in Japan as it is to the Chinese market. We did not adapt to the Chinese way of doing. Sales volume was sluggish. When we made a store at that time, we were not considering the special conditions of China. We just imitated things in Japan."* (From an executive manager at Sales Headquarters, Chinese)

For working the entrepreneurial capabilities, several institutional architectures set up. In 1998, they set up a system to listen directly to customer's requests and held the first "customer roundtable", collected about 20 to 30 customers. They collected customers' voices every day from the department, shared at the weekly meeting of the collected information, and reflected in the correction of the assortment. Ito-Yokado recognized not only the negative aspects of OC, but also the positive aspects. Local customers and suppliers highly appreciated Ito-Yokado's following points of OC unexpectedly.

- 1) Adoption of open display system
- 2) Clean store environment, in particular the cleanliness of the toilet and the floor, the free preparation of toilet paper
- 3) Hospitality and responsiveness in Japanese style
- 4) Quality guarantee system of sold products and proximity placement of related products
- 5) Strict adherence to payment due dates for suppliers
- 6) Adopting in-store shop method, giving up the adoption of direct buying method

By working the entrepreneurial capabilities to eliminate several adaptation problems, a hybrid architecture of GMS and department store appeared as the "unintended outcomes". Compared with GMS that was adopted in Japan, the business architecture in China became to strengthen department store-like elements. It was not the result of intended working of architectural capabilities. In addition, market-based governance mechanisms were adopted, which were the result of a compromise with local trading practices.

## **2) Local and off-line search for closing capability gaps (about 2010~2013)**

The revision of business strategy started from the question of the basic assumptions for value proposition. In 2008, the part of top management had suspicion that the business strategy of mass marketing (providing cheaper and better products) may not be sufficiently functional and

competitive in the future market of China. According to the fiscal data, the annual average sales growth rate of Ito-Yokado in Chengdu declined to 24% in 2010, compared to 33% annual average sales growth rate at the peak. This rapid growth decline awakened management's sense of crisis and in 2010 a new value proposition called "high quality GMS (high quality everyday life) was discussed within the company. After all, in 2010, the value proposition "high quality GMS" was devised to clarify the meaning of differentiation in Ito-Yokado in Chengdu. Even though the value proposition of high quality GMS is an extension of differentiated marketing, the business definition was more concrete and sophisticated.

However, strategic change in Chengdu that decided to change into differentiated strategy did not proceed smoothly. This change was initially not accepted by employees/suppliers or by customers that adhered to current value propositions. Challenging new things obviously involves risk. Even with new initiatives that respond to changes in customer needs, sales may not necessarily be raised immediately, but in some cases it will take time to emerge.

*Although we changed our business strategy to differentiation from 2007 to 2008, we declared the concept of high quality GMS in 2010 instead of changing the operational method, because we were behind the change of the market. So, we changed the business idea. By raising the concept of high quality, we made major changes from product assortments to sales method."* (From a senior manager of Sales Headquarters, Chinese)

In order to change quickly to high quality GMS, in 2010 they set up a CIY vocational education school and began working on a systematic training for human resource. At the CIY vocational education school, systematic training is provided separately as common education curriculum and functional skill education, mainly for executives and executive candidates.

*"After all, the key success factor is what kind of education is going to be done all organizational levels. We are focusing on human resource development. I invest most in it. I use about 2 to 3% of sales for education. Overseas training also adopted. Experience is important for studying. If you experience good things, you will find a good image. Coaching education is also doing. While asking various questions, let them think. This is also introduced in 2013. It is not seniority but how they think by themselves. While incorporating various methods, I am always thinking how everybody can move on their own initiative. It is important how we can make such an atmosphere. The learning atmosphere does not collapse once it can be created. I am putting great efforts in such things".* (From former COE, Japanese)

The performance trend as a feedback signal from the business environment was often ambiguous as a clue to judge the necessity of reviewing the business strategy. In Chengdu they switched to a differentiated strategy, but in Beijing the business strategy of mass marketing continued. Looking back at the result as of 2018, Beijing's business has been shrunk and Chengdu's business is steadily growing. Today, Chengdu has successfully established seven stores, but in Beijing it has decided to shrink the business to one store. Though strategic change in Chengdu was clearly successful, this judgment is a kind of retrospective sense making.

### **3) Distant and off-line search for closing capability gaps (2014~current)**

From around 2014, the awareness that the business environment has entered a new era has been born. The information on product categories and departments that consumers can access rapidly increase by Internet environment. Customers' requests for products and store departments are further enhanced in China. In addition, Chinese consumers began pursuing spiritual satisfaction rather than material satisfaction as same as Japan. In the face of the rapid

growth of Internet business featuring infinite product assortments and the qualitative change in customer needs pursuing the richer mind, Ito-Yokado try to seek the strategic renewal for new differentiated strategy and value proposition.

*"Now, no consumers are somewhat insufficient materially. They are pursuing a richer lifestyle than ownership of goods. Lifestyle is a comprehensive thing. By buying just one product category, a comprehensive thing could not be actualized. We need to systematically respond to this problem. In order to maximize the efficiency and effectiveness of comprehensive coping, we must eliminate the organizational barriers among divisions and initiate the organizational change program."* (From vice president, Chinese)

"Lifestyle proposition" is not simply to sell each single item, but to show interesting life scenes, and propose new lifestyles to customers. In order to provide an "enjoyable experience", Ito-Yokado focused on making experience-oriented store format. All stores have focused on proposing new lifestyle to customers, and edited the sales floor by theme according to consumer's life scene. At the same time, in order to respond to the consumer needs of shopping on the Internet, they began full-scale efforts to cross-border EC business, aiming to converge real and net (so-called Omni-channel strategy).

In order to respond to this task, Ito-Yokado decided to expand the search scope more and carried out extensive organizational reforms. They increased the frequency of overseas visits to concretely imagine the near future lifestyle that Chinese customers want. In addition, they conducted a total organizational change to facilitate information sharing between headquarters and stores and among product divisions in order to jointly create new retail format.

These systematic transformations involve increasing the weight of overseas surveys as distant search. The relative importance of distant search by overseas visits can be regarded as trying to achieve a higher level of entrepreneurial capabilities. In addition, although usual Chinese executives rarely go to the store, Ito-Yokado executives welcome customers every morning and they will see off customers every evening. By looking at the shop front, they check whether the management philosophy or strategic policy that they normally emphasize is practiced on site. The biggest advantage of Ito-Yokado is that its management philosophy and strategic plan will penetrate employees and employees will execute with high capabilities (Qin 2018).

*"Whether top management has a clear long-term vision and they can actualize the consistence of saying and acting is extremely important in order to motivate employees. Although most companies have good strategies, they cannot do it. One of the reasons is the inconsistency of the top management. The top executives of many firms look at the cost when implementing the strategy, they give up it."*(From a sales manager of local supplier, Chinese)

The feature of the third phase of capability closing is that the search depth is further deepened and at the same time the search scope has been expanded further abroad.

## 5. DISCUSSION

In this preliminary research, we have found the different combinations of three sub-capabilities influencing the successful transfer of retail business model across borders. In first phase, entrepreneurial capabilities for value proposition were playing the leading role, when finding out the right activity links for focal firm and relevant stakeholders. In addition, when stabilizing the business model successfully, it was important that all stakeholders be motivated to accept the value appropriation mechanism and carry out the assigned activity links. The task

of building resource ties from the beginning was extremely difficult, and it was not possible to demonstrate the architectural capabilities as intended. In this stage, because the activation level of architectural capabilities was low, the hybrid business model appeared unintentionally.

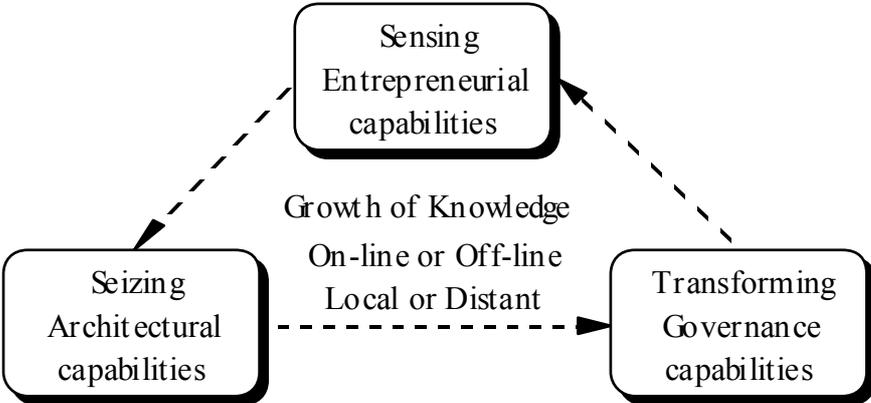
In second phase, the firm tried to shift from the value definition of mass marketing (providing cheaper and better products) to the value proposition of differentiated marketing (so-called high quality GMS). In this stage, the entrepreneurial capabilities still remained high activation level. The high performance achieved by the company proved the legitimacy of the entrepreneurial capability and gave them a greater bargaining power.

The increased bargaining power raised the level of governance capabilities and helped strengthen the actor bonds. At the same time, the business architecture for resource mobilization was reviewed from the scratch, and various organizational processes supporting resource ties were devised. The architectural capabilities were activated, and the shape of the landscape that the firm has to climb gradually emerged. However, the company was not able to draw the correct landscape image with confidence.

In third phase, the poor performance of the old business in Beijing proved the legitimacy of the new landscape to the firm and stakeholders and created the new value of "Lifestyle Proposition" by further refining the value concept of high quality GMS. The meaning of this change in value proposition was to provide more experiential value in the way added to the shopping convenience. The convenience provided by the retail format is often called utilitarian value, and experience is equivalent to hedonic value concept. The new "Lifestyle Proposition" set up a difficult task of finding out how to create the right balance of convenience and experience in the retail business. This requires companies to actualize more sophisticated architectural capabilities.

Various combinations of three sub-capabilities emerged in the transferring process of retail business models. Due to the single case analysis we cannot do some generalization on this combination pattern. The only thing that can be pointed out from this study is that the content of the combination of sub-capabilities continuously change over time. In this research, we described the change of combination patterns arbitrarily divided into three phases, but speaking exactly, it is impossible to separate time-dependent events. What we can point out at this moment is that DC would promote the growth of business knowledge by capability combinations based on searching strategy. It is asked what kind of priority is given to the combination of three sub-capabilities to lead to rapid knowledge growth.

Figure 2: Spiral pattern of the growth of knowledge through capability combination



## 6. CONCLUSION

Early in the market entry phase, the company tried to close the capability gaps that occurred in the OC mainly by improvisational try and error (so-called logical incrementalism). As the performance gradually stabilized, the company and stakeholders believed in the effectiveness of emergent business model and tried to systematically improve the level of OC in more planned manner. At this time, the levels of entrepreneurial capabilities for sensing and governance capabilities for incentive compatibility were very important.

In around 2008, Ito-Yokado, that sensed the signal of the modulation of market demand, attempted to review the basis of value proposition. The value proposition so far was based on mass marketing (providing good quality product for affordable prices) as same as Japanese business, but as the income level of Chinese customers rises and a lot of competitors entered, it became questionable to continue this business model.

At that time, interestingly the evolutionary path of the capability combinations showed a bifurcation, because the working level of three sub-capabilities was different between Beijing and Chengdu. Ito-Yokado in Chengdu changed its value proposition to differentiated marketing, but in Beijing continued mass marketing. In the face of almost the same business environment, the working level of DC was different in two cities.

At this time, it was attempted to improve/nurture the architectural capabilities to support the level of entrepreneurial capabilities at Ito-Yokado. However, the effect on the level of entrepreneurial capabilities was not deterministic. Entrepreneurial capabilities are often myopic in nature, so it is difficult to adopt a choice that sharply breaks the stable current OC (Levinthal and March 1993). Due to Beijing's poor performance, the business strategy of Ito-Yokado in China has been unified, but the delays in responding to the business environment in Beijing were fatal, and now have managed only one store.

In recent years, the wave of digitization has come to the retail sector as well. Alibaba.com is emerging as a huge online retailer in China. Ito-Yokado strongly recognizes the need to spiral the growth of knowledge to a higher level through the capability combinations in order to cope with this radical distribution change. It seems that the priority from which to review the sub-capability has a major impact on the subsequent knowledge growth.

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