Management First partial

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Management of cultural companies and institutions

CAPITOLO 1

1.1 ECONOMIC ACTIVITY

1.1.1 Choices

-Each of us continuously makes *choices* among alternatives: 1. Altruism 2. Opportunism 3. Speculation 4. Satisfy a need

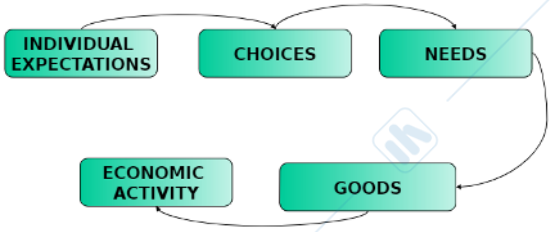
- Choices are:

1. Rational =when each alternative is evaluated based on available information and the choice falls on the best alternative which maximizes the benefit with respect to the resources used

2. Impulsive = unplanned and in response to a stimulus

Choices are influenced by public opinion and the desire to adapt or to stand out one's behavior to a group → so they are influenced by the resources available and imply the involvement of other people and the exchange of goods

We define economic activity all processes of production and consumption of goods and services carried out to satisfy people's needs



People have expectations that translates in to choice or alternatives → they are related to needs (basically how life works) → one possibility to address this needs are goods (needs: status → goods: bag of Chanel) → by that you perform economic activity

-the product is the understanding of the needs of the people, they can be real or induced (part of marketing)

-people are different so needs are different so products are different/ needs for a person change during time/ social groups stimulated specific needs → people choice can be influenced because choices can be irrational and influenced by resources (money)

1.1.2 Needs

A need emerges when there is a sense of necessity, deprivation. They can be intrinsic or driven by external environment. There are two kinds:

1. Physiological = product of human biology and common to all people (like sleeping, eating...) → essential

2. Social = more varied and complicated, they are strongly influenced by the context in which people live → non-essential

There is a hierarchy of need: 1. physiological 2. Safety needs 3. Social 4. Reward (someone that tells you you're doing fine) 5. Self-achievement (to have more, the next step)→ you have to satisfy the lower needs in order to feel the higher needs

Some needs can be satisfied by goods or services, others are not (symbolic values)

Needs changes over time as a function of various factors

1.1.3 Goods

-economic goods are useful to satisfy a specific need and scarce with respect to their demand.

- classified in: primary goods (=primary needs); non-essential goods (non-essential needs)

-it could also happen that when a good is **complementary** the increase in demand for the first determines an increase for the second (like coffee machines and pod) → the company decides if they want to make machines expensive and then the parts are cheap or if you want to introduce the product to the markets you make it cheaper

-**substitutes** goods satisfy the same needs and are fungible in the eyes of the costumer (this will characterize the competitive environment in which firms operate → companies have to differentiate their offer; broadly undifferentiated goods are defined **commodities**)

-**Intermediate** goods are targeted to other enterprises that use them as a part of their offering to end users

-**single use vs durable** (the perceived price of the single used should be low, even though after all is not→ ex. clothes were a durable use but after fast fashion they have become single use because they cost less and it stimulates clients to continuously purchase new products)

- **luxury goods** are timeless product with a highly symbolic value, targeted to a small loyal market

-**private vs public** goods are adjectives used both to define the legal status of the organization that produces them (a non-profit firm or an enterprise) and to characterize methods of consumption (exclusive or non-exclusive)→ The difference between the two is often defined by the law (public good is a good that has two characteristics: non-exclusive and non-rival → it does not exclude multiple times uses)

Special case: INTERNET is not a pure public good; it often requires fee so it is exclusive but the consumption of information by one user does not reduce its availability to others so it's non rivalrous

1.1.4 Exchange

- economic goods can be:

1. **Donated**= the return is indirect or of a non-financial nature (to have leverage, express affection, social pressure, give back to others...) → gifts imply gratuity, sharing and participation

2. **Exchange**= goods are transferred at a price on in exchange for other goods or credit; it's a characteristic of market economies and goods can be exchange for money (in a sale the seller transfer services, goods and monetary assets while the buyer provides money or credit) or other goods (barter, the latter sale) → the monetary value attributed to the goods and services acquired is defined as the **price** (the conditions of the exchange can be defined)

3. **Shared**= is related to the possibility to use a good by virtue of a specific statue; a good is not owned but you can have access to it so only the right to use it is transferred

-each exchange is qualified by different conditions → at the basis there are processes of **negotiation** involving private goods or public goods, the availability of financial resources, the coverage of risks and work → negotiation never take place in condition pf complete transparency

1.1.5 The market

-The market is defined by a set of negotiations → the more numerous the negotiations and the more codified the conditions of exchange, the more the **market** is considered **perfect**: the transaction are alike,

the price is evident and everything is codified/ **imperfect**: information about the price are difficult to obtain, transactions are less and each one of them requires complex negotiations (like for a piece of art)

-despite the market being efficient, no correlation exists between price and intrinsic quality of the good

1.1.6 Economic processes

-Economic activity takes place through organized processes made up of series of **operations**:

1. Institutional processes= define the legal and formal characteristics of the organization in which the processes take place, the perimeter of its responsibility, the setup, the transformation and the closure

2. Production processes=group together operations similar in nature, or linked to a same output → it regards core operations, financial operations, asset management, tax management

- **Core operations**: they are the key activities characterizing the firm's specificity. They are associated with purchase – transformation –sale of the goods produced. In addition there are risk negotiation processes, administrative and organizational processes.
- **Asset management**: complementary to core operations. It has to do with the investment of savings and the management of extra liquidity
- **Financial management**: refers to decisions associated with the coverage of financial needs of the organization
- **Tax management** group all operations associated with tax expenditures, covering the cost of services provided by the public administration

3. Organizational processes=define duties and responsibilities and hierarchical relationship between roles managing specific activities

4. Administrative processes=group key operations concerning the collection, processing and distribution of information necessary to make economic choices

1.1.7 Factors of production

-economy processes require different factors of production; primary factors as work and capital are common to all types of economic activity and are only partially fungible; in general production factors are in part **fungible and complementary** → some production processes can be carried out using labor or by automating production

-economic activity is a continuous dynamic of exchanges and relationships because it is driven by constant search of **efficiency and innovation**

-economic activity is **risky** by nature since firms are born and die constantly mainly because it's difficult to stay efficient and effective for a long period of time

1.2 DECISION-MAKING

-economic activity translate into a continuous series of decisions among alternatives → people act to maximize their own individual well-being

-two conflicting theories on Individual decision making:

1.**Homo "oeconomicus**": the decision maker (perfect rationality, opportunism decision, bring to isolation) → a person who allocates resources to obtain the highest possible level of income and wealth

2. **human being**: decisions that are driven by solidarity, generosity, curiosity, maximizing your well-being, usually it is a group member (rational+ irrational) → because in reality people actions are subject to restrictions

-Theory of Herbert Simon 1972: people's choices are subject to risk and uncertainty since they are made in condition of **bounded rationality** → The process of choosing involves initial expectations, stories of experience, information, evaluation of alternatives (not easy and subject to error + rarely individual)

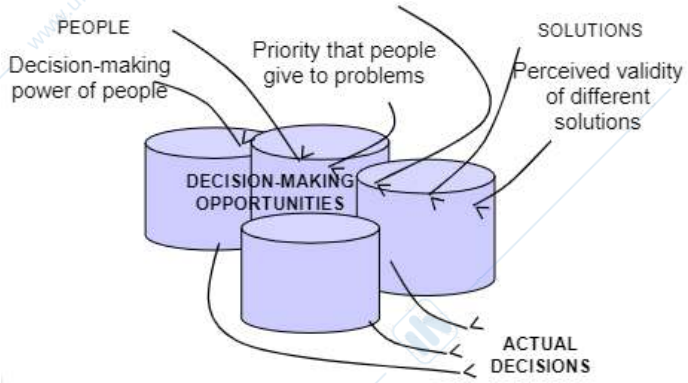
1.2.1 Social groups

-very often decisions are made within a social group, but a person can belong to different social group at the same time or during his life time thus being involved in different decision making processes

-social groups are formed by a small group of people and a primus inter pares that is a coordinator that exercises influenced on the other members

-Organizations have clear goal, formal structure …hence a model of perfect rationality however decisions made at social group level are often nonlinear and non-completely rational

-each group member contribute to the collective decision-making process by bringing problems and solutions



-The decision-making process is subject in part to chance and in part to subjectivity

-group decisions are strongly effected by the level of **trust**, the greater the trust the greater the tendency act in a cooperative manner

-Alternatively it can be guided by **opportunism** and it will be oriented towards maximizing the efficiency of the exchange processes and will often have short-term horizon

1.3 INCOME, VALUE AND IMPACT

-economy activity produces results:

1. Direct vs indirect

2. Economic vs non-economic

3. Positive vs negative

1.4 TYPES OF FIRM

A firm is thus a set of persons organized around a common goal, that last in time, that utilizes and transform production factors to produce goods or services that satisfy people's needs in a continuous process of internal and external change. A firm does not resort pathologically to a third part resources, they are auto sufficient

- A firm is characterized by the following elements:

1. **Durability**= firms oriented their choices as they will endure forever, even if sometimes it doesn't work

2. **Dynamism**= firms change continuously over time as a result of external and internal events

3. **Unity**= the firm must converge around a unitary goal because decisions affecting one part of the firm affect it all

4.**Autonomy**= each firm autonomously defines its own goal and generate enough resources to do that

-firms fulfill the need for social relationship: social interaction not only is fun but can be used as instrumental

-Firms grow, sometimes at the expenses of other competitors that have to shut down or being incorporated

-firms are differentiate due to their fundamental goals:

1. Families

- Important economic actor because they are the consumers; small sized organization (in media 2.4)
- Looking at the families behavior can tell us how the economics are doing
- relevance of informal rules for big decision
- Kids are the continuity of the family
- Core operation: income generating activities through external work; investments; internal work; consumption activities
- Italian families are very conservative (own houses and don't have debt)→ so they reduce consumption and have less mobility → to protect from risk they buy insurance RISK

2. Enterprises

- Aims mostly economic → they are the main economic actor in which production activities are prevalent
- They are classified in macro category: primary food processing, manufacturing, service and construction
- Economic interests towards compensation of workers and shareholders and mechanisms for sharing profits and capital gain
- Core operation: purchase, transformation and sales
- Risk management activities may be very relevant (in particularly when the company operate in different geographic market)
- Asset management may be very strong in enterprises operating in some sectors (insurance – banking)
- Financial management may be core for some organizations(operating in the financial sector, such as private equity companies or venture capital)
- Tax management

3.Public Agencies

- social and economics goal
- very complex and have many people that work for them, they have a lot of activity, political and economic outcomes
- geographic responsibilities and hierarchy (State, local governments)
- companies that are fully or most own by the state (Rai, post office, ferrovie..) → shared owner
- public agencies perform economic activity when: *defense,* education, health care, justice, *law making*, public safety, international relations, culture, welfare
- their activity is typically funded through taxes so tax management is part of their core activities
- culture is funding by the state in many occasions ex. Opera
- why should the government intervene in the market?
    - Pure goods
    - Noncompetitive markets (monopolies)
    - Companies would generate bad externalities (ex. pollution)
    - Incomplete markets

- Information asymmetries
- Marginal markets
- Merit goods

so theories suggest that the market needs a third role like the state to control the market → you need regulations and the state to intervene when there is FREE RIDING (when you act against common good and you can take advantages at the expense of others) ex. Evading taxes → if you tolerate free riding you aren't encouraging trust that is fundamental for the market

4. Nonprofit organization

- private organizations which are in between companies and public organizations because they have social goals but from a juridical point of view they are private
- they are not allowed to distribute net earnings but instead uses them to help pursue social, cultural, educational or political goals (reinvestments)
- they satisfy a portion of social needs that the state cannot meet

1.5 CONFIGURATION OF DIFFERENT ACTIVITIES FOR SIMILAR FIRMS

-Firms that operate in the same field may have different configurations based on the analysis of:

1. The characteristics of their institutional structure= the design of the firm, its aims, boundaries of its economic activity, ownership, governance..

2. The characteristics of operations = operating activities absorb most of the firm's work force, costs and revenues (they can be carried out within the firm or outsourced to others); the operations are grouped in:

- Core operations = sum of the typical activities carried out by the business
- Risk management = regards the possibility for the firm to reduce the impact of specific risks (it cover itself through insurance company)
- Asset management = regards income that come from resources produced by the core operation that exceed the financial needs; the liquidity is invested to allow the company to generate additional income available to face business risk
- Financial management = series of activities aimed at covering costs and investments that business sustain before selling; the coverage of financial needs may take place through risk capital or loan capital
- Extraordinary operations= implies rare events that cause costs and revenues to arise that must be recorded
- Tax management= All business have to pay taxes in exchange for the right to use public goods supplied by the State; there are two types: taxes related to purchased goods and not directly related to the use of public goods (independent of whether the specific business makes use of those goods)

1.6 SPECIALIZATION

Specialization affects all aspects of economic activity. There is a specialization in goals, main activities and how they are structured. In each category there are further levels of specialization by size, industry and function. The choices about the size is important for the survival and the development of the firm. Also geography matters since firms can be just in a country or in more than one. For example a company could decide to locate its activities in countries with low labor costs.

In each type of firm people perform specialized activities.

The degree of specialization is influenced by economic and non-economic considerations. **A specialized economic actor is more efficient** than a non-specialized one: the quality is higher, production times lower and production processes are optimized. Production on a small scale is not economical.

Specialization **brings** many ECONOMIC **ADVANTAGES**:

- **Learning processes is the result of repeating** the same activity and this lead to developing manual ability.

- Specialization compensates for the limitations and non-uniform distribution of individual skills.

- Specialization encourages the differentiation of technical and managerial orientation: some activities require high level of specialization and a broader range of skills.

- Specialization reduces the cost of preparing for and transitioning from phase to phase. - Specialization compensates for the different technical performance level of facilities and equipment.

- Specialized workers can more easily be identified as experts so there are positive effects on job identification and motivation.

- Specialized systems are more efficient than non-specialized systems.

- There is recognition by the capital markets because specialized companies divide their risks over multiple areas of activity.

There are many disadvantages too:

- Costs of coordination because companies distribute resources over different areas. - Lack of market absorption when costumers change their preferences or competitors change their behavior.

- Costs of rigidity: the sequence of activities is very structured.

- Need of specific investments.

- Demotivation due to fragmentation: in *Modern Times* Charlie Chaplin shows that this work lead to alienation and a reduction of motivation.

We start thinking about specialization with the first industrial revolution that brought a major change in how economic value is created and distributed.

The first person that started theorizing this concept and asked how to produce efficiency is Taylor. He was active around the 20s and the 30s and he focused on organized work within factories that produced a great amount of goods. He asked how to parcel the production process, how to maximize efficiency, how to reduce costs.

This led to STANDARDIZATION. Economic activity had new features:

- Technical transformation processes were mechanized.

- Work was broken down into single tasks assigned to different people.

- Products started to become more standardized.

- Mass production began.

Today we still have many companies managed in this way.

Specialization can be associated with big size, in particular when standardized products are produced, this implies large volumes of production with identical or very similar characteristics for relatively long period of time. In this way you reduce the need of complementary goods if you have a standard good. This

phenomenon is the standardization of production processes and this makes possible to take advantage of specialization and it exploits it. Products and process standardization involves standardization of parts and components and this is called NORMALIZATION. Then is also a standardization of complementary goods (paper and printers, DVD and readers) and we speak of UNIFORMITY where standards are defined at the system level. Instead when the components of a product are particularly complex they can be defined as MODULES (modularity) in order to divide its production into multiple sub-systems. These are produced independently but they work together. This allows the possibility to combine different components for a broader range of final solutions.

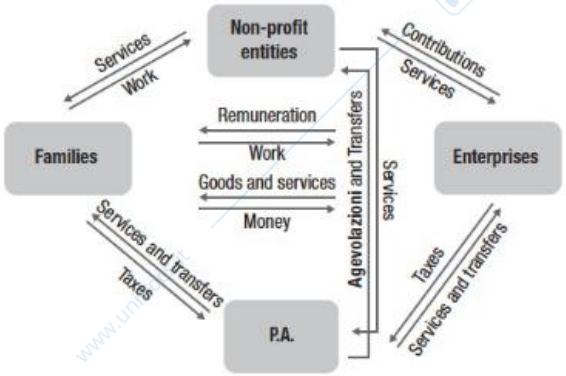
Products in these ways are consumed by many people and the circulation process is accelerated.

There are many pros and cons of standardization:

PROS	CONS
Large-scale production reduces unit manufacturing costs	Limited choice (not good to target specific segments of demand)
Cost of choice by consumers is reduced	Rigid production process
Standardized product are easy to spread around and their use may create network effects. The value of a good or a service is a function of how many people use it	May discourage product and process innovation
Easier to implement quality control	

1.7 RELATHIONSHIP BETWEEN FIRMS

-firm are in mutual relationship as they are complementary: members of family work at enterprises receiving payment in return. The income generated make it possible to purchase goods from enterprises or invest their savings. Enterprises can also obtain funding from specialized financial enterprises. For the production of goods and services enterprises negotiate with other enterprises. Enterprises and families receive certain services from the public administration in exchange for payment of taxes. Non-profit organizations offer complementary or substitute services thanks to the donations or volunteer work from enterprises and families or again from public administrations' endowment funds.



CAPITOLO 2

INSTITUTIONAL STRUCTURE

2.1 Actors

Performing economic activity requires a continuous organizational effort by a multitude of people over time, around common economic and non-economic activity

-people carry out economic activity to bring contributions of various type to the business → **actors**:

- **Shareholders**: contribute with **capital** when a company is established and through its life, have expectations on **rewards** and have an **interest in the business's continuity** and health (like public entity grant gratuitous use of a public building or a private actor to make a monetary contribution → based on contributions people have expectations of rewards as remuneration of their investments and they expect their **value of the share to increase** over time)
- **Stakeholders**: **all** of the **actors involved** in the life of the firm (shareholders, managers, workers are the holders of primary interests / external interests divides in primary (strongly affected by the economic performance like suppliers, customers and competitors) and secondary holders)

-contributions and rewards are of economic and non-economic nature → their **nature** is **not** always clear **explicit or balanced** between various actors

-Business models in the so called "**sharing economy**" make available to **third parties** goods or services that are underutilized, allow for the generation of income around the marginal exploitation of resources already used (ex. Airbnb) → behind it there are at times claims that says sharing economy is actually economic exploitation hidden behind another name

-Two theories for the right aim of the enterprises:

1. **Shareholder's view**= the responsibility of enterprises regard exclusively **economic sphere** and is aimed at producing **renumeration for shareholders** because they are bounded by **contractual relationship** (like with suppliers and clients). So investments in corporate social responsibility are reasonable as indirect forms of investments in reputation

2. **Stakeholder's view**= affirms that the ability of a company to survive over time depends on its capacity to simultaneously satisfy the expectations of all stakeholders simultaneously and find an **equilibrium** → but even when the interests partially compete

Since decision are made in conditions of incomplete information, information asymmetry and uncertainty the acceptance by the various stakeholders of the firm's overall decision is always conditional.

2.2 The institutional structure of firms

The **institutional structure** is the sum of the structures and mechanisms relating to its *ownership, governance and control*. Through it, it is possible to **reconcile the interest between the stakeholders and the economic governance.**

-in case of enterprises the characteristic of the structure are **defined by law**

-The governance structure are responsible for making decisions for the business / the institutional structure defines the distribution of rights and responsibilities among the different categories of stakeholders

-the model is divided in:

1. **OWNERSHIP**

The ownership of an enterprise lies with **shareholders** in proportion to their **contribution** → they contribute with their capital without prior guarantee of being compensated (capital *at risk*), and they are the last to be compensated → the **risk** is being rewarded by recognizing their right to participate **directly** in the **governance** of the enterprise

-The economic governance body that brings together all of the contributors of capital is the **shareholder's meeting** which appoints the members of the **board of directors** (the supreme economic governance body)

-The ownership of the shares can be concentrated in the hands of few (like family enterprises) → the **more concentrated** ownership is the **easier** it is for **exercise** and maintain control however it can limit the capital markets

-Some companies create **economic groups**: small number of shareholders create a **holding company** that has the relative majority of the shares → shareholders exercise control even with relatively small percentage of shares

-shareholders can sign **agreements** agreeing to **act in concert** with regard **to certain strategic** business decisions

2. GOVERNANCE AND CONTROL

- The board of directors is the supreme economic governance body regulated by the civil code regarding their characteristic and functions

-it is made up of a small number of people chosen from lists with specifical technical skills → it is responsible for strategic decisions, business plans, the appointment of company management and salaries

-it is possible for them to act for their own interested instead of the majority of shareholders (so not all shareholders are represented, like stakeholders)

-to check the decisions adopted by the board:

→there are independent board member (control and risk committee) who have no relationship with any other categories of people in the company

→control structures monitor the administration, verifying compliance with law and founding documents and the regularity of financial statement → Board of statutory Auditors

→listed companies have also the obligation of certification of financial statements by specialized companies (auditing firms) that check the financial statement

The appropriateness of a governance system is to be evaluated based on:

1.The ability to adequately represent the stakeholders

2. The ability to safeguard the continuity of the business

3.The ability to reduce the information asymmetries characterizing the relationship between institutional stakeholders

Governance structures in different type of firms

- FAMILIES

-Governance decisions regard the activity of all of the family members, the assets could be joined together or the responsibility regarding support of the family

-governance decisions include choices on children education, relocation … decision that impact all family members therefore they involve all members

-the governance structure is very simple, informal and affected by financial and emotional factors + all family member's expectation must be considered

- ENTERPRISES

-decision-making process change as a function of who are considered the institutional stakeholders → from a shareholder's point of view the primary stakeholders have no formal representation in the board of directors while in a stakeholder's prospective they organized the economic governance bodies more extensively

-from a legal stand point enterprises are divide in partnership (where the shareholder's liability extend to their personal assets, are more risky but cheaper to manage) and join-stock companies (the liability of the contributors of capital is limited to the company's assets)

.b-Corp= companies that decide to formalized their willingness to participate to broader non-economic causes and devote part of their income to these causes

-The greater the company's ability to generate income and survive over time the easier it will be to reach the goal of reconciling the various interest

- PUBLIC ADMINISTRATION

-The agencies of the public administration grow because the collectivity believes it is preferable for certain goods to be produced for everyone and that certain activities be carried out to everyone's benefit.

-its structure is defined by law, and there are political and technical roles so it is important to avoid that the political side over-dominate the technical side

-They manage public resources so it's important transparency and the public interest should be based on individuals but because of huge information asymmetries to the public interest is not always taken into consideration

- NON-PROFIT ORGANIZATIONS

-the issue of accountability is very relevant for these company → these companies are created to achieve a specific goal and the money given to them cannot be controlled directly by them (every contribution is used for purpose of the organization)

-the stakeholders are the members, donors and workers

PATAGONIA CASE

Patagonia was a private company whose main goal was the pursuit of environmental sustainability. Its management changed multiple times and it was hard to find a CEO that could grow with the company. When Chouinard retires he continued playing an important role in company's decision and we can talk about a MANAGEMENT BY ABSENCE. In the 2000s Patagonia grew its sales at an average rate of 6% per year.

BUSINESS OF PATAGONIA

Patagonia is a B-corp. However they don't have advantages from a fiscal point of view but they believe in a cause and they want to incorporate non-economic goal in the strategy. The shareholders need to agree with this strategy and they managed to convince investors. Patagonia's product line was composed of 4 main product categories: sportswear, technical outerwear, technical knits and hard goods (packs and accessories).

The main goals of the company are:

- QUALITY: materials shape functionality, have to be recyclable, have to last longer, are clean and organic. However the costs are higher and for this reason Patagonia is more expensive that its competitors. A costumer would pay more because there are consumers that are conscious about the commitment to the environment. It is also against overconsumption.

- ENVIRONMENTAL ISSUES: Patagonia aims at reducing the environmental impact. To build - the best product there mustn't be an unnecessary harm.

- INNOVATION.

They wanted to create products that were simple, functional and multifunctional (in order to make the costumer consume less but consume better). Patagonia began as a very specialized company for climbers and later it specialized in many market segments reaching also normal people. It was born as an experiment to challenge conventional wisdom and present a new style of responsible business. However it has a 10% yearly growth target, 1% of revenues were donated to environmental causes and it made heavy investments in environment friendly processes.

The company's decisions were based on environmental considerations and aimed at decreasing the impact on the environment using organically produced cotton. This led to an increase of costs and as a consequence also the price of products raised. Moreover organic cotton was limited so the product line was reduced.

Patagonia was an industry leader in technological innovation and spent a lot in developing and testing raw materials. They worked on developing more durable fabrics and making zippers 100% recyclable.

Patagonia's choice of business partners was driven by its value not by commercial efficiency and so dealers and suppliers cooperated on the environmental project. They outsourced 85% of its manufacturing.

Patagonia pursued four sales channels: wholesale, retail, catalog and internet. It also owned 52 retail stores worldwide, considered as a physical representation of the brand. Patagonia wanted costumers to form a connection to the store beyond commerce.

Patagonia spent less than 1% of sales on marketing and advertising because it was against using the company's environmental position as a marketing tool to encourage customers to increase consumption. However thanks to these factors it attracted much attention from the media and the public..

Patagonia considered essential that employees have “dirtbags” characteristics, shared the values of the company so they were chosen basing on environmental concern and entrepreneurial spirit. Every building owned by the company was engineered in an environmentally efficient way. Employees received also many environmental benefits so they considered the company as a family. It was a family-friendly workspace and it was also one of the first companies in the US that provided both maternity and paternity leave. This is one of the best companies to work for and the profits were distributed to environmental agencies.

PATAGONIA’S ENVIRONMENTAL COMMITMENT

For Patagonia the commitment to the environment was the main mission so it wanted to provide solutions for the environmental crisis. However many of these goals were expensive, difficult and time consuming.

It wanted to improve the environmental impact of its processes and made many environmental initiatives. In spring 2010 Patagonia planned to launch an initiative called PRODUCT LIFECYCLE INITIATIVE. The purpose of the initiative was to lengthen the lifecycle of each product and reduce waste. Costumers were encouraged to limit their consumption to only essential products and to take responsibility for that consumption by choosing well-made garments with the smallest possible footprint. Patagonia’s goods were multifunctional, repairable and transparent about environmental practices. Costumers were asked to repair their products as many times as possible to lengthen its lifetime and once they no longer wanted it, Patagonia facilitates its reuse by giving it away or reselling it. It established an ONLINE SWAP MARKET to donate useful products to environmental activists and charities. When all options were exhausted costumers had to return the product to Patagonia to recycle it in the most efficient way. This initiative would have increased costs since these services required significant investments but profitability and growth were still important.

For the Product Lifecycle Initiative Patagonia considered providing services for other companies’ products. It inspired indeed numerous companies that adopted environmental practices.

This solution is not perfect so it is important to continue reducing environmental harm as much as possible.

PATAGONIA’S SWITCH TO ORGANIC COTTON

Patagonia’s products made from conventionally grown cotton generated environmental harm due to the consumption of large quantities of pesticides and water and due to dyeing. Then it found that ORGANICALLY GROWN COTTON produced the same environmental impact in most stages. Changes in the supply chain too were needed because only two supplier had experience with organic cotton. At the beginning there were quality problems as a result of the changes in the production process.

The main goal was to sell the line successfully and indeed organic cotton garments sold for 8% more than the garments made from conventional cotton.

TODAY’S MISSION

This September 2022 the founder of Patagonia decided to give away his entire company to trust and non-profit in order to fight climate crisis. Patagonia will continue to operate as a for- profit company but all profits will go to save the planet.

CAPITOLO 4

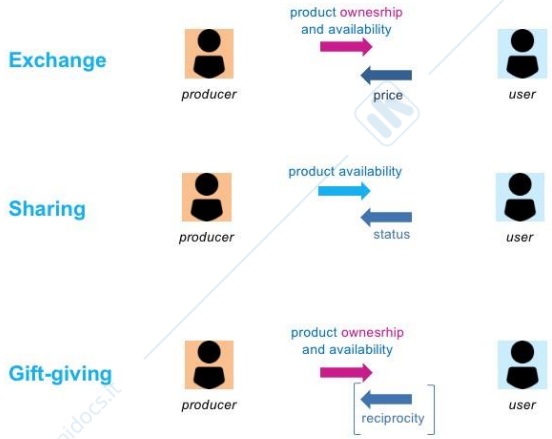
4.1 PRODUCT

-The aim of a company is to design and make available products (goods or services) that **generate a benefit** for those who use them; the costumer is required to paying the price (which cover the costs of creating the product) in exchange for the benefits

- The ability to fulfill a need is up to the costumer too because he has to learn how to use it before → benefit is a positive situation that comes after the potential of the need and the desire

VALUE FOR THE CLIENT= benefits ÷ costs (includes all sacrifices) > 1 if a costumer decides to buy it

-There are three access to resources (*exchange, sharing and gits*) and they are not in competition with each other. Sharing and gifts are typical of non-profit through gift and volunteers, but managing volunteers can be more difficult than employees because all the effort have to be guided and the use of common items has to be controlled and guaranteed for all those who are entitled (while in market is solved through the price) → all three mechanism **require trust**: in sharing that other will not that advantage of the situation, in gift that sooner or later the other will reciprocate and in market that the counterparts will honor expectations



-There are 3 ways to **get access to products and resources**:

- EXCHANGE (selling) of a **product** with **money** or with another **product** (barter). This can happen because products have a **price**. Through sales **organizations get revenues** that are used to reward the resources they used (employees, materials). There are different **exchange markets**:
  - **B2B**: the counterparts are organizations;
  - **B2C**: the counterparts are organizations and consumers;
  - **B2P**: the counterparts are organizations and public institutions.
- SHARING: it's possible thanks to the **individual's status** (for example in families).
  You can access to a product **without a direct price**. Today it's gaining more and more relevance. Public spaces (museums, squares), open source software, Wikipedia or family assets are examples of sharing.
- GIFT-GIVING: for example **volunteering** because this activity is **not paid**. In this way **consumers can access products without paying**. It's based on **reciprocity** because you can give back the gift in the future so a **relationship is created**. It is not necessary that the value or the product is the same or that you reciprocate immediately because in this case it would be an exchange. The mission has to be **consistent** otherwise you won't reciprocate the trust. There is always the **aim to start a relationship in order to reciprocate**. A gift-giving relation could be for example in Twitch.

4.3 NEEDS AND BENEFITS

-Benefits are positive consequences for costumers and they are the reasons why the costumer decides to buy a certain product → behind benefits there are wishes and desires

-Every costumer has his priorities regardless the price and the products bought depend also on the income

-Performances are what the product is able to do so they cause benefits and they are strictly linked

-There are many kinds of benefits:

- **FUNCTIONAL** benefits: the functions of the products so what the product can do (it's linked to the performances);
- **ECONOMIC** benefits: in order to create savings;
- **HEDONIC** benefits: when the product creates pleasure and these benefits are based on emotions;

- **SYMBOLIC** benefits: these can be communicative or identity benefits. Communicative benefits are about the symbolic meaning that a product has (such as it tells the others of the social status). Instead identity benefits are present when a product convey a representation of yourself.
- **PRIVATE** (individual or little group) and **COLLECTIVE** (whole society) benefits: come from the consumption of artistic and cultural products when they enjoy them.

Symbolic benefits

Martini for example managed to create a **symbol** after James Bond ordered it because if you want to have a party you must have Martini. They spent a lot of money on this and we consume a symbol.

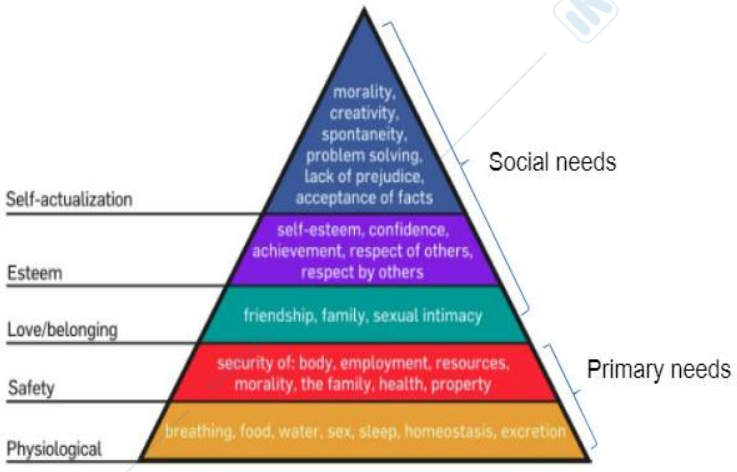
People can also be influenced by a brand what they have to buy a bag. In this case the product becomes a symbol: the function remains the same but the costumers are more attracted by it. So the price is higher because there is a new benefit and another reason for purchasing. A Gucci bag for example is preferred because it's a symbol. For art symbolic benefits are really important.

In a product there can be more benefits but usually one is more important than the others. **Identify and communicative benefits** are also called SYMBOLIC BENEFITS when their value has a symbolic meaning conveyed by the culture, when they symbolize who you are and these meanings are **culturally rooted**. These symbolic value are able to **satisfy social needs**. When products become visible they have communicative benefits (mainly for young people) instead when brands are not visible there are identity benefits. However the **price increases** in both cases.

Each product can assume symbolic meanings and companies can influence this process through communication.

Fashion industries invest a lot in communication to be understandable for the target they want to reach for example young people. The culture of a generation is made of products because they belong to a generational story telling.

People have **individual needs** and there are listed in the **Maslow scale**. There are many needs and people consider them depending on the **age** and the **perception** of **security** or not.



Hedonic benefits

-**Creative products** have hedonic benefits. From creative products there are many hedonic benefits:

- Inner **SATISFACTION**: pleasure;

- Sense of **FREEDOM** and need of escaping from reality;

- **EMOTIONAL** involvement: it's part of the hedonic benefits because it increases the sense of freedom and the satisfaction is deeper and in this way we enter into the story so it's another way to **escape from reality**. At the cinema for example the atmosphere is created working on senses: it's dark and the volume is high.

- Search for **NEWNESS**: something that is **repeated doesn't generate pleasure** so organizations look for innovation and creativity. In creative industries creativity is very important because of the need to try **different experiences**. Instead for the tomato sauce for example there is no need of innovation. Every time

that there is an innovation there is the risk that costumers don't like it because pleasure has an important role. When the manager tries to control the creation of the artist there is the risk of replicating the past instead **creators want to create something new** and **creativity is the real engine of the business**. Innovation is needed every season for the creative industries.

The concept of market

-Within an industry the place where supply and demand meet one the other is called MARKET.

The market is the institutionalized place the different parts get resources:

- **Costumers** get the product to solve their needs;
- **Volunteers** work and help without being paid;
- **Organization** gets revenues in return for their offer

Costumers

Costumer is associated with the idea of the counterpart of the exchange → the person who bears the sacrifice to obtain the availability of the product. Costumers have **different behaviors** and perform **different activities**. The costumer can be defined as the person targeted by the organization's offer.

The concept of costumer is complex because they have **different roles** that **impact on the design** of the organization's offerings:

- DECISION MAKER: they **decide which product** to purchase;
- BUYER: they **bear the cost** of the product;
- USER: they **use** the product;
- INFLUENCER: they **influence the decision process** giving information using their own specific skills. The **specifiers** are a type of influencers that **define the costumer's purchases**.

An organization choose to make use of distribution intermediaries to reach the costumers in order to reduce the complexity of the marketing processes.

Business models

-The organization obtain revenue from the sale of a product to a costumers →sometimes the revenues are not obtained from the sale of the main product but from a series of additional elements relating to that

-A company can receive money from different sources → **Two-sided market:** the earnings can be obtained by the **public** that pays for the product and the **companies** which want to talk to the public

-The users are the most important costumers because without them there wouldn't be visibility for business customers. **Revenues so depend on users**. The **aim is increasing the number of users** because **more advertisers are willing to pay higher prices to be advertised**.
-Social media can help and address the advertisers to those who are in target by looking at the quarries? so they know very well the profiles of the accounts. **The more information I have the best algorithms will work**.
-There are **different types of business models**:

- **Selling products;**

- **Selling attention** and the effectiveness of the message because you access to a target audience. You can the possibility to test the result of an advertisement.

- **Brokerage** when we create links between the supply and the demand.

4.5 THE OFFER SYSTEM

-The offer system is thus the result of a **set of choices** that the organization has made with reference to:

1. The target and the expected benefits
2. Perceive of the offer
3. Tangible and intangible features of the product
4. The methods of use and distribution
5. The price

-The outcome of these choices is a system because each one must be consistent with all the others.
1. The first decision to be made is about the **specific benefits** that the organization wants to offer. They can add also symbolic meanings to offer hedonic and communicative benefits.

-The expected benefits define the target so the offer system should be defined basing on their features. Indeed there are **different expectations and different targets**.
Every group of costumers has different expectations and they are called SEGMENTS.

-There are **two different approaches** in managing the offer system:

- In the first one the **target is chosen before** and the **product is created basing on their needs** and the satisfied benefits follow. The product is made according to the consumers I want to satisfy.
- In the second the **product comes first** and it's **given by an innovation** that drives the research of a specific market segment. So **then I find the target**. This happens for example in **creative industries**.

In **creative and cultural industries** there is the **need of creativity** and then they focus on **promotion**. The creative act remains separate from the industrialization processes.
In addition there are some **roles of creative intermediaries** to reconcile the creative moment and the market that have both artistic and managerial skills. So they are able to **influence the creative activity moving it towards the public's tastes**.
However newness includes also **risks and uncertainty** so for this reason companies **offer several products** increasing the possibility of having a successful product. As a consequence a **product must cover the failure of another product** and moreover the companies get bigger and they have to **invest in different products at the same time**. Another way to avoid risks is to **use** FORMATS to **exploiting some successful elements**.
The main 3 exploited elements are: **stars** (the construction of a personality that is liked by the public), **genres** (notify the public of the type of product) and **serialization** (the use a successful storyline for many stories).

2.The offer of a product is a promise that the organization offers to potential customers
-what counts in designing the features of the product is not just the technical performance but to become in the costumer's head the ideal alternative→ acting on the perception that the costumer target must have the product and it's perceived as the best one → the process is called **POSITIONING** (because it concerns the place that the organization's offer has in the head of the costumer segment)
- **COMUNICATION** is a particularly important positioning lever as it has a dual aim:

- Creating the **awareness** of the existence of the product

- Creating the **perception** of the features of the offer in line with expectation (positioning)

3. Product

-The **product** is the central element of the offer system as a tool to transfer the benefits to a costumer → a product can be seen as a bundle of **attributes** that distinguish the products and have two function:

- Make the product able to create the benefits that it's promised
- Contribute to generating the perception (give the product a symbolic meaning)

➔ They allow both functional and symbolic, identity and social benefits

-The **attributes** (characteristics) are of 2 types:

- **Tangible** (professors and technology) **and intangible** (students graduated) attributes: that are for example the material, the shape and the color.
- **Functional and symbolic attributes:** such as the set of services guaranteed.

- **Products can be distinguished** according to:

- The **possibility to evaluate in advance the quality** of the product so before using it. This is based on **search, experience and credence**. Not all products can be evaluated in advance.
- The **ways the product is produced and used** so if they are goods or services.

The first aspect refers to the difference based on assessment criteria and distinguishes:

- SEARCH GOODS: information for evaluating how satisfactory is the product can be gathered **even before using it**. So the **tangible attributes** and performances are relevant and can be **tried in advance**. For example a car.
- EXPERIENCE GOODS: information for evaluating how satisfactory is the product can be obtained **only after using the product**. so the **product attributes are quality clues** for example when a brand is the most important one. In addition **brand and influencers** are very relevant in **impacting the choice**. For example a film or an holiday.
- CREDENCE GOODS: information on how satisfactory is the product **cannot be objectively evaluated even after using it**. Only **reputation and trust** are the most important assets and attract. A person can never be sure that the advice was really what was expected. So the **credibility that the person offering the product is able to gain and maintain is essential**.

-Search products are susceptible to **rational** choice processes , while experience and credence are more closely linked to **emotional criteria**.

-Cultural products are typically considered **experience and credence products** because the artistic value cannot be objectively measured. TRUST in these cases is an **essential element** and it's created in the **interaction that the costumer has had with the organization in the past** so the costumers **feels a lower risk**. → The offeror's reputation is the element able to capitalize trust (sometimes reputation can be associated with a brand)

The BRAND is **an attribute and it can be the real benefit that the costumer is looking for**→ It is relevant due to the associations it is able to elicit in costumer's mind. His functions are:

- Limits the perception of risk connected to an offer
- Convey symbolic meaning constructed through communications effort.

A LOGO is different to a brand because it is **everything that is able to identify**. The **brand is a matter of elicited associations**. For example thinking about Ferrari in our mind there is speed, tradition, exclusivity and passion instead thinking about Toyota we have functionality and cars.

GOODS AND SERVICES

The **products are like containers of all the skills and the knowledge of the ones that have designed and produced them**. So they are a sets of specialized of skills and knowledge that the company offers to a costumer **in order to make the costumer able to create an outcome** that is considered as valuable.
Companies give customers the resources they need to create value.
Skills and knowledge of the organization **can be embodied**:

- **Into a good** (the way it is designed helps to use it);

- **Into a process** (service);

- Into **both**.

The **potential of a good depends also on the costumers instead the ability to use depends on the company**. An example could be the phone or a course (there is the professor but the result and the potential of the course depend on the study and on interactions).
The difference between goods and services is based on the extraction of potential.

GOODS are **products made available to customers without any interaction between the producer and costumers**. The **producer** limits its activity to **designing, producing, promoting and distributing the good**. The **user instead is in charge for the right use of the product in order to extract benefits**. They can be simple use goods or repeated use products (durable use). SERVICES require **interaction between producer and user in order to create benefits**. The **service is a process** made of one or more activities during which **producer and user interact** in order **to exchange information and to act accordingly**. Both user and provider interact in order to extract benefits so the service is **different each time**. The **value is carried out by the costumer with the help of the product or of the organization** so the value is COCREATED.

4. Distribution

The difference between goods and services stays in the ways of distributing and using a product i.e. the ways the product is made available:

- Goods: simply **availability** enable the customer to use them → so it must be able to reach the costumer in order to be used in store or online(and know how to be used); it's not necessary to own a durable goods because by its nature it enables repeated use with pay-per-use formulas
- Service: are available through **distributors** or the right can be acquired through **agents;** they can differentiate:

➔ people intensive: provider is a human that has a time limited, they are more expensive Ex. Lawyer
➔ machine intensive: the provider is a machine (the cost decrease a lot→ that's why we are substituting people with machine)
➔ reliever: the service substitute the user in something
➔ skill enabler or outcome improver: something that the user cannot do by himself

Distribution choices respond to three criteria:

- reach the costumer (logistic function)

- offer the costumer a series of services that enable him to choose (information function)
- exploit the contact with costumers which occurs at a distribution point to contribute to the construction of the positioning (positioning function)

-in services you receive feedbacks (or data in digital environment) during the interaction

-it's important to dedicate some time to select the workers and the employers of the service because they're the one who's going to make the interaction with the users and decide on the satisfaction

5. Price

-The price is the **sacrifice** that the costumer is asked to make so it must be commensurate based on the target economic availability and the value he gives

-the price impact the costumer's **perception** of the product (too low → poor quality), but on the other hand it gives an important **exclusion function** (as the price rises the fewer can buy it) → The exclusion ability is one of the most important benefit because it gives the product a sense of luxury and pride to afford it

4.6 the consumption of artistic and cultural product

-cultural products are consumed in **free time**, and benefits are given by **the understanding of content** that may have a greater or lesser degree of difficulty to access, requiring the user to have adequate **cultural capital** to make it intelligible

- this has two consequences in relation to:

- **volumes of consumption**: the growth of free time available to the public increases the demand for artistic and cultural products (luckily compared to the previous century a higher amount of time was generated:
- **consumption alternatives**: competition occurs among different uses of spare time and the growth in free time does not necessarily mean that the consumption of these product will increase at the same rate

-this products are **experiential**: they need an **involvement** process and **emotions** matter

-they are consumed mostly for private benefits but their consumption have **positive consequences** both at **individual** level **and social level**, that's why governments are encouraging artists and cultural consumption

Functional benefits	Better performance	Better ability in understanding, learning, social participation, health	Social capital Economic growth
	Private benefits	Private benefits with social spill-over	Public benefits
Intrinsic benefits	Involvement Pleasure	Improve empathy Improve knowledge	More social ties More shared ties

-They divide in:

- Popular Arts: **low complex** contents (process of gradual simplification by removing cognitive access's obstacles), **higher** amount of units **consumed**, main objective is **entertaining**,

sometimes it leads to considerable investments in the design and promotion for the product, it doesn't require interaction

- Heritage, Visual and Fine Arts: **high complex** contents, **lower** amount of units **consumed**, main objective: **the sense of life**, so maintaining the creative content unaltered but facilitate the understanding (care for services to leverage the consumption)

-A critical element of the offer of Popular art is found balancing between the artistic creativity and the aim of addressing the public (which are not only experts)→ the people who create and offer works of art have the task of knowing how to look beyond without ignoring what exists

-management of **creative industries**: both **copyrights** and **distribution** and **promotion** are the main fields, since economies of scale (=cover operating costs) can be exploited due to the larger audience organizations involved in these products are usually for-profit companies

-they manage the risk because they have to be innovative (they most of the time repropose old ideas) → but they have to be very good in understanding the tastes of people (know the market) in order to select the right product; purchase copyrights of the promising things; promote → they are in the middle between artist and content producer, and audience → THEY SELECT IDEAS

-if I am consuming a content I'm not excluding someone to do it → so why I have to pay? COPYRIGHT → being the owner of the idea; ensuring the new culture product will be produced in the future (so to protect the content creator → otherwise he could not survive alone on that); it has to do with the production → that's why the copyright is sold to someone that is not the artist, because he can concentrate on producing new ideas and not promoting the old one also the copyright permits the company to operate because it gives them the money to promote all artist even the one that will not make it

-management of **heritage, visual and fine arts**: cognitive access to the cultural product as the main problem management needs to solve, service management with the aim of increasing the accessibility, they are non-profit so they receive public resources for supporting own missions

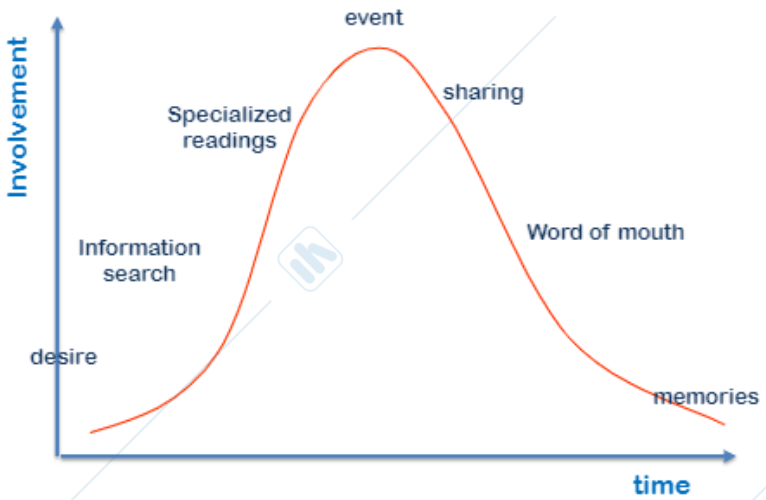
-in **managing** these products you need to focus on:

1. the problem of access to the product and its contents
2. path-dependency in consumption (involvement and understanding)
3. the experiential nature of consumption (physical, cognitive and emotional accessibility)

1.Since its essence it's pure content an artistic and cultural product presents its users with critical aspect of **understanding it in order to fulfill its primarily communicative function** → very important issue for both profit-oriented company which sell less, and non-profit which fail in the mission of promotion of art.

2.The pleasure linked to the consumption increase with the accumulated experiences made in the past with similar product. This explain why people who have been used to consuming these product from a young age will consume and enjoy them more as adults → it's connected to: **Families values, education, past experiences, practices**

3.The consumption is marked by a strong **experiential connotations** (multi-dimensional exp. → senses) rather than just fulfilling a function. The involvement shows the user's interest which is an emotional state that decreases with time involving an ascendant stage and a descendant one which outline the **INVOLVEMENT CYCLE:**



Managers can influence this cycle in order to increase the involvement. Higher involvement better prepares people to get contents that can be even harder and more complex. Involvement impacts on emotions and willingness to interact, and makes learning even better. Involvement helps remebering and spreading among friends.

<u>Before the event</u>:

-create awareness and impact the first perception

-create expectations

-help to begin the cycle of involvement

<u>After the event</u>:

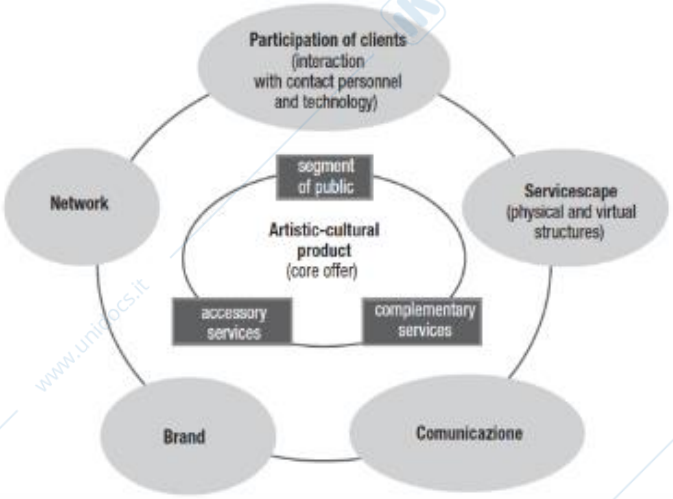
-impact the descending phase

-contribute to strengthen the brand

-nurture the relationship with the audience

"The aim of management of cultural companies and institutions is not only to make the offer available but above all to facilitate access to the contents of the artistic and cultural product in both cognitive terms (understanding the contents) and emotional terms (acceptance of the contents), also trying to stimulate involvement within a process that may have strong experiential connotations."

-The service management:



→**concept of the offer**: what we offer to the audience (the **main benefit** the audience can get from our offer) → benefits can be declared or implicit

→Different expected benefits identify different **customer segments**

→**costumer participation**

→**servicescape** (physical and virtual structures): the characteristic of the place where the interaction takes place affect the understanding

→**network**: players outside the organization → through networks it is possible to offer more customized experiences; their perspective includes sponsorship (to fund, increase the effort in communication and open the organization to target not reached yet)

→ **brand**: element with an impact

→**communication**: all the action developed to inform and attract the public

-Kinds of service:

- core: the main product
- complementary: increase the products' performances
- accessory: enrich the offer with peripherals (=nice to have)

➔ complementary and accessory services are important levers of personalization in the cultural sector because they offer the possibility to design different experiences to different targets even

for the same core product (based on their ability to understand the content, but they should challenge the target without making him uncomfortable) → interaction with the offeror

-Another difference is between:

- Mitigating service: replacing the effort of the public by providing the service needed (mainly accessory services)
- Ability services: increase the ability and skills of the public with a positive interaction between producer and public (mainly complementary services)

CAPITOLO 5

Organizations must take into consideration what happens around them and the market on which they operate. There are **forces that put pressure and that can influence their actions**. These can be **opportunities** to exploit or **threats** to neutralize. Their decisions must **guarantee business continuity in a context of change** and this defines the organization' strategy.

The case of napster

Before internet there were a few organization that controlled the music industry and they decided everything. Then when internet appeared software to download music for free from one pc to another were created (Napster). In this way music could be shared in the logic of gift-giving becoming the antagonist. This changed the environment of the music industry because the cd sales fell down, retailing faced huge difficulties and for what concerns the copyright the artists couldn't be feed. It became illegal.

Figure 1: US Album Sales (incl dig singles)

In 1999 Napster was born and the name came from the nickname of Fanning, one of his founders. It made the activity of copying faster and this created many consequences because people started having lots of downloaded files and the only limit was the speed of the connection. The amount of music grew out of all proportion and this was considered as a new form of piracy. This led to the falling down of CD sales. Then in 2011 Rhapsody bought it for 70mln$ and turned it into a music streaming service but the results weren't excellent. → on the other hand apple iTunes took advantage by selling songs for 0.99$ for a small portable device to be used any time

The case of Napster is important to understand the existence of forces that organizations are not able to control. Digital technology has been combined with two essential cultural aspects: a culture open to sharing and a critical orientation of the costumers towards the majors.

At the beginning there were technological forces when music became digitalized with MP3 files that could run only on authorized devices. Then social and cultural forces came into action when Internet became the place for a new era of free access. New players too offered a solution to the need of music so there are competitive forces too. With Napster music was for free (economic forces) and there was no longer need for available income but the reaction of the political forces was the prosecution of piracy and finally thanks to legal forces the copyright was revised and the penalty was stronger.

The forces that influence the environment

Organizations operated in a **complex context** that represents the **environment** whose elements are strictly connected and **determined by the interactions**. So the relationship with the environment is essential for the organization because it takes the **resources** from it and it directs the offer towards it. In the environment there are also **competitors** that aim to satisfy the same needs. This led to continuous changes that can be opportunities for growing or threats. In order to monitor these changes (to anticipate them) and fully exploit them it is important to discover the **forces that determine this environment**. These are

called ENVIRONMENTAL FORCES that **are beyond the full control of the company** and the interaction between the forces causes phenomena of significant importance to occur. **Each force is driven by specific factors** and they are very different.

TECHNOLOGICAL FORCES

These forces are typically the **results of applications of scientific researches** conducted with private or public research centers. Technology needs infrastructures and imposes **changes** at level **of individual skills and also in the organization of work.**

SOCIO-CULTURAL FORCES

An **organization is surrounded by people** with values, expectations and skills that shape their conduct. **Their needs** are strongly **influenced by the culture and the society**. Culture and society are strictly correlated and indeed social forms can be explained through culture. Inside the **society** there are constant **changes that modify how an organization acts**. Most of all the **sectors** of art and creativity **are involved in the cultural dynamics of the society.**

REGULATORY FORCES

Social harmony is **regulated by laws** that **define** where the **relationships** between people and entities take place. The laws aim at **protecting shareholders' right** since are the ones who impact the general economic context. Organizations can also promote regulations that favor protection and development of their products.

ECONOMIC FORCES

The economic forces consist in the **wealth** and in the **income** of a country and the expectations of the future performances. It is important to distinguish DISPOSABLE income, the **income** that remains **after paying taxes**, and the DISCRETIONARY income, the **income** that remains **after having sustained the expenses** necessary **for survival**.

COMPETITIVE FORCES

In the environment there are many competitors and **competition generates dynamism on the market**. As a consequence there is a **reduction of the profit margins** of single organizations that are pushed to **improve their offer and to create innovations**. These forces come from also the supply relationships between supply chains and distribution channels

The competitors

The **competitors** are **defined from the point of view of the costumer** because he thinks about the possible alternatives and substitutes of a particular offer.

There are different kinds of competitors:

-**INTRA-TYPE**: they are **within the same industry** that use the same solutions and have the **same costumers,** so they compete one against the other

-**INTER-TYPE**: (cross industry) they **cross different industries** like Netflix and cinema. Distributors give to Netflix the movies after in order to attract costumers also at the cinema .

The distinction highlight two aspects:

-**Similar competitors share the same technologies** and **live the same constraints** and the same **opportunities**. **Inter-type** competition is **instead** more difficult to identify because they have **different technologies, process and solutions to satisfy the needs**.

-In the **sectors of art** and culture **inter type competition** is important because each costumer has **numerous alternatives to spend his free time**. These are called SUBSTITUTES.

The concept of sector

The **environment** is **based on the choice that the organization makes** in terms of what to who the target will be and how to keep the promise of certain benefits.

This is a complex choice and these **represent the 3 dimensions** that define a sector:

-**WHAT**: the **functions of the product** that satisfy creation needs

-**WHO**: the **category of clients** who can be find a solution to their needs

-**HOW**: the **technology** that allows a certain function

The sector can be defined with more or less detail and **as the details increase the perimeter of the sector is restricted**. The sector **is an important instrument to analyze and make decisions** . The ABELL MODEL is *useful to define the sector of operations, to identify the intra type competitive context and to analyze the possibilities for development.*

Intra type competition

The intra type perspective identifies the competitors and in order to analyze the sector is important the concept of competitive pressure and of strategic group.

COMPETITIVE PRESSURE

The competitive pressure **depends on many factors**:

-The **structure of the market**: the **number of competitors and their dimensions**

→The **NUMBER** of organizations: with the **growth** of the number of organizations also the competitive **pressure increases**. If there is just **one organization** in a market there is no competitive pressure, it decides the price (it is the price maker) and this is a MONOPOLY. When there are **few big organizations** there are high barriers to entry and a high competitive pressure and this is a COMPETITIVE OLIGOPOLY. There is instead a PERFECT COMPETITION when **several similar organizations are into the same market** and there are **no high barriers to entry**. In this case the organizations are price takers, the costumers face no switching costs and the profits tend to zero.

→The **DIMENSIONS** of the organizations: organizations of **similar dimensions compete in a more heated way.**

-The existence of **BARRIERS**:

→**ENTRY** barriers: **limit the entry of new organizations** and they **decrease the competitive pressure**. They **derive from the existence of economies of scale**, this means that it is necessary to have a certain **minimum size in order to compete** in a market, and from the control of a key resource. Indeed without having the key resource it is not possible to start the activity on the market.

→**MOVEMENT** barriers**: limit the possibility for clients to shift from one offer to another**. Indeed restricting them the competitive pressure is reduced. These barriers are **represented by the costs** and by the **needs to change standards**.

→**EXIT** barriers: **limit the possibility to leave the market without harm** and this increases the competitive pressure. Organizations are forced to continue activity within a market and for this reason they are pushed to reduce the price of their products. The main reason of these barriers are sunk costs, costs that cannot be retrieved.

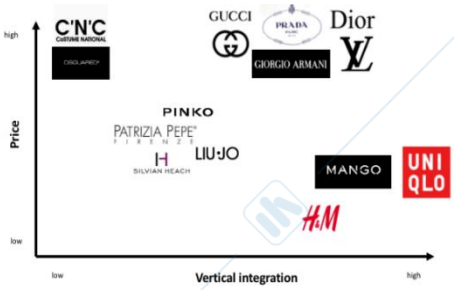
-The **GROWTH** rate of **DEMAND**: *the higher is the market potential the lower is the competitive pressure*. A sector has a **SATURATED MARKET** when there is a **high competitive pressure**, all the clients purchase the

product on **maximum doses** and an organization can **grow only through conquering competitors' costumers**. A **GROWING MARKET** instead has a **lower competitive pressure** and an organization can grow **conquering totally new costumers**. The latter is the easiest way to find someone willing to try the product out.

-Potential to **DIFFERENTIATE the products**: **offers** can be **perceived** by the clients **as replaceable**→ *the greater the replaceability the higher the competitive pressure*. The higher is the potential to differentiate the product the lower is the competitive pressure. The design products that are close to the costumers' expectations push costumers to prefer those products and to strengthen the relationship with the organization. **Differentiate** means **offering a product** that is very **different from the competitors' ones**. They try to be closer to the ideal product that relies into costumers' mind. Products can be differentiated **according to the FUNCTION** they perform (why) **and the SITUATION they are used** in (when). Each function and **each** situation **can create the potential for designing the product** that **better** performs that function or better fits with that situation.

The principle of **MARKETING**: **earn the preference of** those who feed the market, **the clients**.

STRATEGIC GROUPS



Not all **direct competitors** are the same and **equally threatening**. **Distinguishing** competitors **is needed** to monitor the more threatening *because the more is threatening the higher is the need to imitate.* **Imitation can limit the advantage the competitor** could have due to the success of a choice. The more similar organizations appear the fiercer they are such as organizations who target the same costumers for the same needs with the same technologies. **SIMILARITY** is at the **basis of the concept of strategic group**, a group of competitors that pursue similar strategies. For example the vertical integration and price level are the most relevant strategic variables in fashion.

THE PORTER MODEL

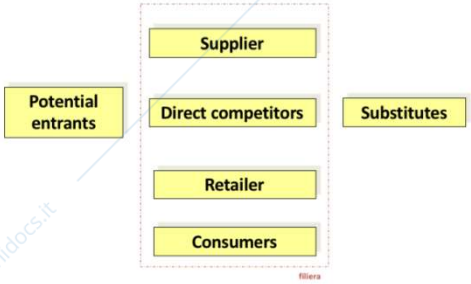
The **Abell model** is important to identify **different types of competitors**:

- The **DIRECT COMPETITORS** are organizations that **compete to satisfy the same needs** for the **same group of clients** using the **same technology**.

- The **POTENTIAL NEW COMPETITORS** (potential entrants) are the organizations that offer the **same solution but** there operate in **different sectors**. They can serve the **same clients for different needs**, can satisfy the same needs for different clients, can serve different clients with the same technology or can satisfy the same need with different technologies.

- The **SUBSTITUTE PRODUCTS**: are **alternative solutions** offered by organizations to the same clients to satisfy the same need.

The **Porter's five competitive forces** is a model that makes understand the fact that **organizations are affected by forces that come from different organizations**. Organizations have to take into account along the direct competitors also the providers of substitute products and the potential entrants. The competition with substitute products is an inter type competition. Instead potential entrants can easily exploit their position to enter the same market and they can be present both upstream and downstream in the supply chain. They are the suppliers and the retailers, the intermediate clients (are distributors such as



Spotify). For this reason some organizations decide to invest new roles internalizing activities becoming in this way direct competitors. For example Intel, the supplier of chips for most of the computers, could easily exploit its popularity to offer computers under its own brand. This would mean becoming a direct competitor of its clients.

Along the **VALUE CHAIN every actor sells its products to the costumer that follows**. **What is spent by** the **costumers is split** between all the actors. So the price that the costumers pay is allocated along the value chain and the channel through the exchange prices between counterparts (buyer and seller). **The strongest is the one who obtains the highest prices possible** compared to the average of his sector that is the average of the exchange prices that characterize the same phase of the value chain. This competition doesn't regard the end costumer. There is a competition also among value chains that target the same costumers and the **supplier**, who is the **most important in influencing the costumer's choice**, has the greatest power and margin.

Competitive advantage

The existence of competitors requires **organizations** to **pursue strategies** in order to reach their aims. The competitive strategy is **the plan aimed at resisting pressure from competitors and from environmental forces**. This is based on the COMPETITIVE ADVANTAGE, a **condition that allows for survival**. In the competitive arena the organization that has a competitive advantage **wins over the others**. The competitive advantage is the source of long term and sustainable **higher profits**. The competitive advantage has to be: **long term sustainable**, unique, not easily imitable and resilient (**flexible enough for adapting** to a changing environment without losing its strengths.)

Competitive advances **can be placed into** 3 categories:

- **OPERATIONAL EFFICIENCY**: it is the **ability to use the lowest quantity of inputs in the process for realizing the free system**. The more efficient the organization is, the lower its costs are so they also reduce sales prices. An example can be low-cost airlines that reconfigured their processes and aimed at maximizing profits.

- **CONTROL OF A KEY RESOURCE**: **controlling a resource** can be an important **advantage**. An example can be copyright because when a book is successful the copyright is an important competitive resource. The control of **distribution** is important: distribution is a **strategic resource** because it is the condition to reach the client.

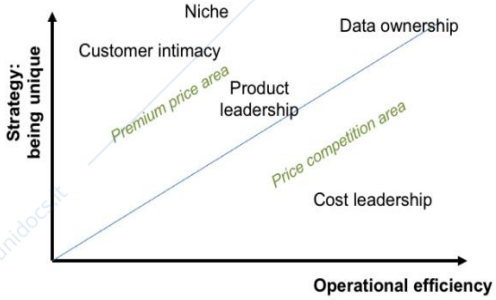
- **RELATIONSHIP WITH THE CLIENT**: the organization has to establish a connection with the clients and the client in this case has an active role. In order to satisfy his needs and reach a **situation of loyalty** the organization has to take them into consideration. The brand for example can be the center of this relationship.

Everything is based on data ownership and the **competitive advantages can be**:

- **COST** leadership: being **more efficient on exploiting resources** it is possible to get **lower prices** on supply chain. It allows to reduce prices when needed.

- **PRODUCT** leadership: there is a better performance than competitors' products and they are at **the edge of innovation**. It allows to set a premium price.

- **COSTUMER** intimacy: costumers prefer an organization to another when they **perceive the organization as a reliable** partner. It is the ability to maintain **over time** an intense and significant relationship with the costumers. It allows to set a premium price.



- **NICHE** strategy: when an **organization is the leader into a small market** segment (a niche). The costumer is willing to pay high prices for a product with peculiar features so **specific skills are needed**. It allows to set a premium price.

The cost leadership is part of the operational efficiency instead the product leadership, the costumer intimacy and the niche strategy are part of the strategy.

CAPITOLO 6

6.1The relationship between volumes, costs and results

There is a **relationship between specialization and size** and between **specialization and profitability**: specialization impacts the cost structure of the firm but what is the optimal size of a firm? Is it better to grow manufacturing one product only or offering a wide range of products? Size of companies matters.

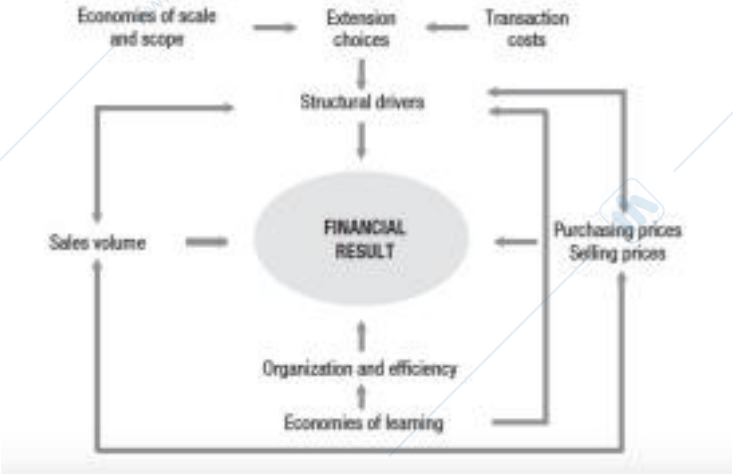
Looking at the company's financial results there are different drivers of economic performance that are connected: structural drivers, volume, organization and prices. This is the interplay of every company and after having understood this firms can improve profitability and best pursue their goals.

STRUCTURAL DRIVERS

Companies can grow in many different ways:

- Grow by **SCALE**: **optimization of capacity** (increasing the number of seats) can affect revenues (ticketing in a theatre).

- Grow with **SCOPE**: if there is a limit to grow by scale and a firm can still **grow in variety** (such as Gucci).



- **MAKE/BUY**: another way to grow is to **internalize or outsource some activities** because this determines a structural change in how results are generated. There is a theory according to which, for any activity firms can decide to make (produce inside) or buy (outsource). In both cases costs occur.

TRANSACTION is a shift among two separate activities (within the firm or outside the firm. MAKE implies a higher level of internal coordination but also the possibility to exploit capacity, use internal resources, develop skills and reduce control costs. BUY shifts competences to the supplier so there could be cost advantages if he manufactures for several competitors but this requires coordination costs. This is the TRANSACTION THEORY of Willmson Masten. There are different elements that affects transaction costs:

- Information complexity;

- Specificity of resources;

- Possibility of opportunistic inappropriate behavior.

PRICE LEVELS

Purchasing and selling prices determine the level of revenues and costs. If purchasing prices go up the profitability goes down but if the selling prices grow it is important to control the impact on volumes. If you increase the price the demand could decrease.

PRICE ELASTICITY is very important and it can change over time. However sometimes even if the price goes up there could be a higher demand.

Prices levied or paid are affected in part by the company's bargaining power and in part are driven by external factors. Internal elements can be pricing policy of the company and external factors can be technological evolution and competitors. For example Ryanair and Alitalia operate in the same business but they have very different pricing strategies.

VOLUMES

Volumes are both drivers and consequences of other choices.

Companies with the same cost and price structure will show a difference in profitability due to volumes produced.

Then for a given capacity different levels of utilization will determine a change in profitability. So volumes depends also on utilization of capacity.

ORGANIZATION

Considering the same choices about extension, prices and volumes there could be different profits due to efficiency. You improve performance by modifying how processes are structured and how we assign tasks.

By repeating an activity we learn by doing and in this way we can become more efficient. So efficiency drives cost savings.

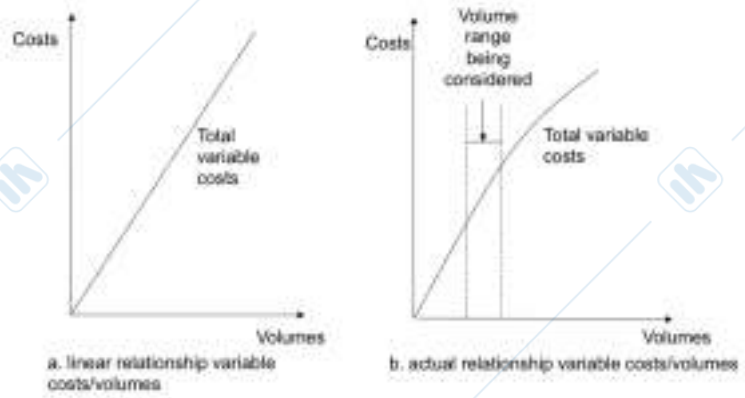
6.2 Break-even analysis

COST STRUCTURE

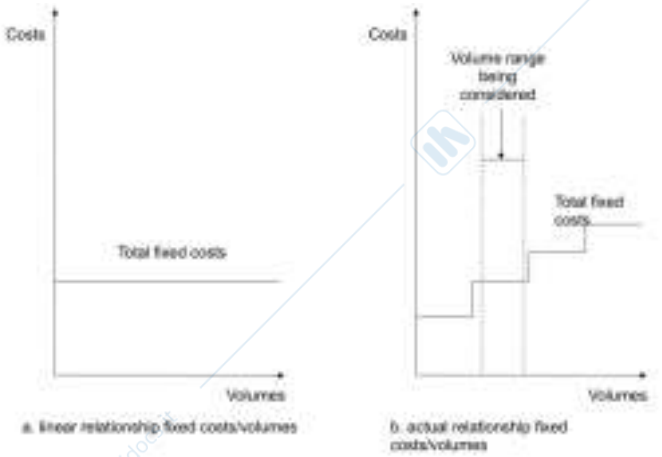
There is a relationship between the volumes of goods actually produced and sold by a company and the operating profits earned by the same. The structural configuration is the result of how I decided to configure my activities and it affects cost structure which affects profitability.

We focus on core operations, the decisions about the activities of a company. We can identify two categories of costs:

- VARIABLE costs: they grow basing on the volumes. The higher the volumes produced, the higher the total variable costs because the more I produce the more raw materials I need. These are for example fuel, packaging and raw materials. The relationship between variable costs and volumes is not linear but it is a curve since there can be discounts on purchases of goods and services or increases in efficiency that can bring a reduction of the variable cost unit.
The higher the incidence (= occorrenza) of variable costs, the steeper (= più ripido) the total variable costs curve. A linear function can be used when unit variable costs remain unchanged.



- FIXED costs: they don't vary within a given interval of production. They don't depend on the actual volumes produced but on the production capacity available. These are for example advertising campaign, website maintenance, rent, R&D. Fixed costs are not completely fixed but they increase by steps each time actual volumes reach the limit of production capacity. However fixed costs can be constant since production capacity is fixed by definition. If the actual volumes increase fixed costs don't necessarily increase and if the actual volumes decrease fixed costs don't decrease automatically. There are also fixed development costs that are independent of actual volumes, are upfront costs (are sustained even well before the period in which they start to give benefits), are sunk costs (cannot be recovered), allow the development of intangible resources (they have no limits on production capacity) and are discretionary costs (the amount spent can be easily modified).

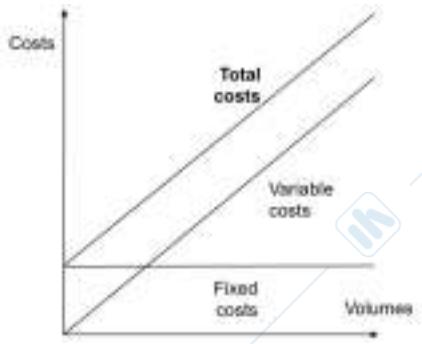


Cost structures dominated by variable costs are defined as FLEXIBLE because they adapt easily to changes in volumes, instead structures dominated by fixed costs are RIGID because they have difficulties in adapting to changes in volumes so they are more risky. This distinction is very evident but in practice it is not. Labor can be a fixed or a variable cost. If labor can be easily increased or decreased or reallocated across business units then it would be a variable cost (such as direct labor, assembly line). Actually labor is regulated and labor laws set limits to the possibility of considering labor costs as variable costs. So labor costs are variable but include some fixed cost component.

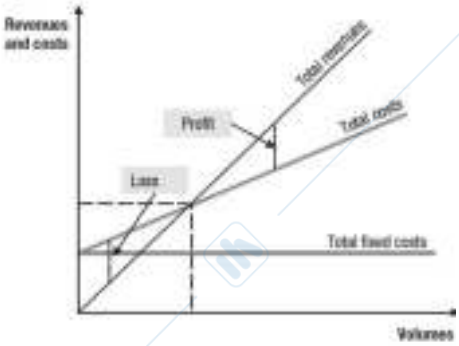
For example the hours of direct labor increase with the increase of actual volumes but sometimes workers are paid regardless of the number of hours actually worked so it turns into a fixed cost. In home parties direct employees are a variable costs if they are paid basing on hours worked and they are a fixed cost if they have a fixed remuneration regardless of the number of parties. Paying regardless of the number of parties increases the risk but there could be better results.

Instead supervisory costs and management costs tend to be fixed costs.

The TOTAL OPERATING COSTS are equal to the fixed costs + (variable costs x volumes produced). They have consequences on income and on finances. Then there are also NON OPERATING COSTS that include passive financial operations (coverage of financial needs), active financial operations (decisions on the investment of liquidity), tax management and extraordinary events.



For a cost structure the total operating profits are determined basing on volumes. If I increase the volumes produced I will have an impact on total costs and revenues and this will imply price elasticity.



In the graph below fixed costs are constant, total costs coincide with fixed costs when the actual volume is equal to zero and they increase linearly with the increase of variable costs. Revenues start form zero and they can increase more rapidly than variable costs if the unit price exceeds the unit variable costs. The graph shows the portion of fixed costs that have to be covered. However the breakeven point is the same since it shows an operating loss before and an operating profits after. Loss and profit are measured by the distance between the revenue line and total costs line.

BREAK-EVEN POINT

The BREAK-EVEN POINT (BEP) makes us understand the impact of cost structure on profitability. It is defined as the amount of revenues needed to cover the firm's operating costs.

The relationship between volumes and operating profits is important to measure the break-even point and the degree of flexibility too.

The break-even point is the volume (Q) at which Total revenues (TR) are equal to Total costs (TC). It gives me an idea, basing on the cost structure, on how much I have to grow in order to be profitable.

uR = revenues per unit (unit price).

uVC = variable costs per unit produced.

FC = fixed costs.

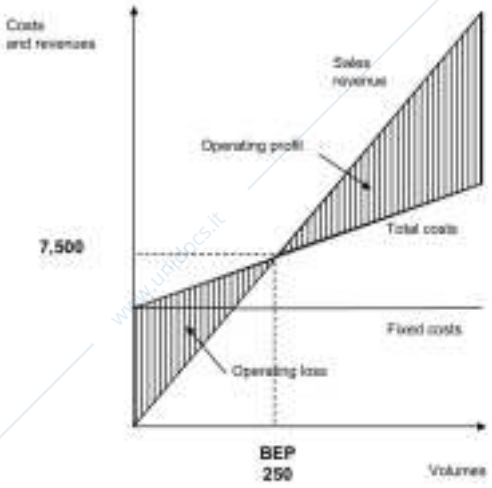
uR x Q = Total revenues (TR).

uVC x Q = Variable costs (VC).

So uR x Q = (uVC x Q) + FC -> (uR x Q) - (uVC x Q) =

FC -> Q x (uR - uVC) = FC -> Q break-even = FC/

(uR - uVC).



uR - uVC = unit contribution margin (uCM) and it is the contribution that the sale of each unit brings to the coverage of fixed costs in order to form incomes.

For example let's suppose I am organizing a party. I have to understand my charge. I have a hall, deejay, light, decorations, security, cleaning, audio system and barman. But there are also the variable costs that are sparkling wine, spirits, soft drinks and panettone. The price fixed per person is 30€. The fixed cost is 4000€ and the unit contribution margin is 30 -14 and this is the margin that contributes to the fixed costs. The BEP is fixed costs/unit contribution margin and is 250. In order to make money I have to sell 250 tickets so I have to understand if the venue has the capacity to have 250 people. If I reduce the price of 25€ I have to look for more people but probably I can attract more people because the price is lower.

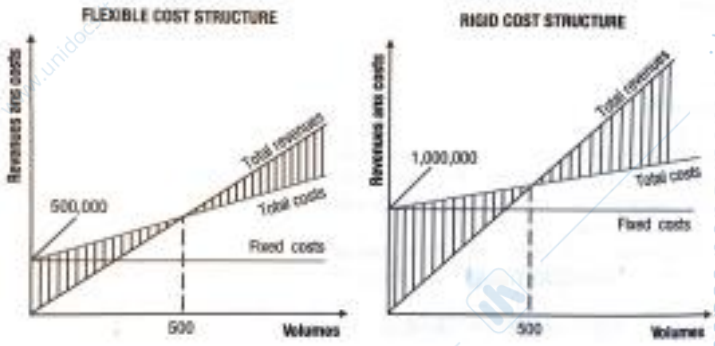
Often the contribution margin is expressed as a percentage of total revenues: uCM (%) = uCM/uR. The BEP revenues are FC/uCM (%).

The PROFIT POINT is the turnover to be reached in order to earn profits. The profit volume is = FC + Target Operating Income / (uR-uVC). The target operating income is the operating income I want to obtain. The profit turnover is = FC + Target Operating Income / uCM%.

Managers have to make decision in order to maximize profits. The higher the growth the higher the profitability.

The break-even point also indicates the degree of FLEXIBILITY/OPERATING ELASTICITY of a company's cost structure. The cost structure impacts profits variation before and after the break-even point and indeed at equal break-even there can be different situations. The flexibility index can be calculated in the break-even point and is = VC/FC. The higher the ratio, the greater the flexibility of the cost structure and the lower the loss if the break-even point is not reached.

A FLEXIBLE structure has a low break -even point so it is less risky but since the gap is symmetrical before and after break-even this structure implies limited losses before break-even and limited profits after break-even. Instead RIDIG cost structures are more risky but the profits increase rapidly after break-even. For this reason flexible structure should be preferred only if there is the fear of not reaching the break-even point. So the distinction is reflected into the gap between the lines of total revenues and costs: the higher the operating elasticity the narrow the space of the gap and the lower the risk instead the wider the wedge between the lines, the higher the risk.



For example if there are changes in volumes. If a firm has a rigid cost structure (high ratio of fixed costs to total costs), the firm will lose money if there is a drop in volumes (less possibility to spread fixed costs over units produced). But at the same time the firm will have profits when it increases volumes. Instead considering a firm has a flexible cost structure (low ratio of fixed costs to total costs) if the volumes drop the firm can easily reduce costs instead if volumes increase the firm experiences also an increase in costs.

For example Ryanair if the plane is not full it won't fly. It is super-efficient in managing the cost structure however the business model require the plane to be full every time. It works only if there is a strong demand so it is based on fixed costs.

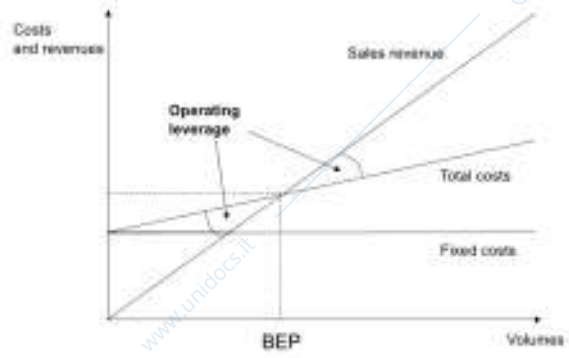
If we outsource the production of an activity the fixed costs are lower and variable costs are higher so flexibility increases and the cost structure changes. It is important to understand the situation before break-even point in different situations.

It is important to consider also the OPERATING RISK. The operating leverage is the magnitude of the difference between revenues and total costs above and below the break-even point. The higher the leverage, the higher the operating risk.

The operating risk is determined by two elements:

- How far you are from break-even: the more you are above break-even point the less risky you are. The higher the break-even point the higher the risk.

- The operating elasticity: the extent to which the demand reacts to variation in price. The higher the elasticity, the lower the risk.



Operating risks is not necessarily a bad thing: it amplifies losses, when we move left to the BEP, but it amplifies profits when we move right to the BEP. So considering two plants with same BEP but with different operating risk, the choice depends on our estimate of how much volumes sold would exceed the BEP and on the manager's degree of risk aversion.

A startup is under break-even point and the higher the incidence of fixed costs the higher is the break-even point and you reach it earlier. However the profits will be slower per unit. Startups however are encouraged to have a high incidence of variable costs, so as to reach BEP as soon as possible.

Volume and scale economies

CAPACITY

The cost structure affects the possibility to grow and size matters. The increase of actual volumes has an impact on average unit costs and revenues.

Some sectors are characterized by big size such as chemical, pharma, banking, insurance but also digital platforms and industries consolidate (industries buy small competitors). In some industries size pays off (= ripaga) more than in others. But at the same time there are also seven small firms.

MAXIMUM PRODUCTION CAPACITY (MPC) = the maximum units of output that can be produced in a given time interval (in theaters it is the number of seats).

CURRENT PRODUCTION CAPACITY (CPC) = the units of output that are produced in a given time interval (is what we are currently producing). It is lower than the maximum production capacity (CPC < MPC) because companies build plants with bigger capacity than the current needs since economic downturns (= crisi) determine lower production levels or because of scraps (= scarti), interruptions and quality control issues.

DEGREE OF UTILIZATION (of production capacity) = is the ratio of CPC to MPC. A company has a MPC of 10000 washing machines a year but it's CPC is 7000 so the degree of utilization is 70%.

In order to measure capacity there are different ways basing on the typology of firm. In manufacturing firms the increased capacity is measured in terms of number of units produced (shoes, cars…).

In retail companies (such as a supermarket) the increased capacity is measured in terms of size of the store, which translates in higher number of aisles/shelves and goods displayed. In airline companies the indicator of capacity is the seats. Indeed the company sells the service of transporting people. The output is measured as number of available seats and miles flown. Increasing capacity means increasing the number of flights of each plane or reducing legroom to increase the number of seats.

In law firms the indicator of capacity is the number of days/person invoiced to costumers. In theaters the indicator of capacity is the number of seats/number of performances per show.

VOLUME ECONOMIES

In a shirt manufacturer the fixed costs include the rent and general expenses that is of 25.000€. Variable costs per unit (1 shirt) is €12 (1,5 mt of fabric and €8 per mt) + €8 for external laboratories + sales commissions of 8,9% so of €4 so they are 24€. The price per shirt is of €45. The income is calculated with the difference between the revenues per unit (uR), the fixed costs (FC) and the unit variable costs (uVC). The revenues and the costs change basing on volumes and the Average Unit costs (AUC).

AUC = total costs (TC)/volumes produced but also AUC = unit variable costs (uVC) + (fixed costs/volumes).

It is important to improve the utilization of capacity and this concept is called ECONOMIES OF VOLUMES. There can be an important economic advantage from a greater use of a given capacity. The absence of limits on production capacity makes the absorption of fixed costs significant.

Volume economies (or fixed-cost absorption) are cost savings generated by increasing the rate of utilization for a given MPC. They originate by the fact that fixed costs are spread over a higher number of units produced, leading to an average unit cost reduction. These economies are higher the higher the incidence of fixed costs over total costs. Total costs increase because total variable costs increase but fixed costs remain at the same level. The limit of volume economies is full capacity exploitation.

This kind of economy is linked to the volumes actually sold and not to the benefits that derive from the increase of production capacity because these are economies of scale.

SCALE ECONOMIES

Scale economies are costs savings associated to an increasing production capacity but at the same level of utilization of capacity. When the production capacity increases and there is a reduction of average unit costs there is the presence of ECONOMIES OF SCALE. The cost advantage (savings) can be obtained by reaching the MINIMUM OPTIMAL DIMENSION. The higher the production capacity and the dimension of the firm the lower the average unit cost. In this way it's easier to get lower prices from suppliers because the contractual power increases.

For example plant A can produce 100.000 pieces per year and comparing with plant B with a capacity of 200.000 pieces there are economies of scale if the AUC of A > AUC of B at the same utilization rate in A and B.

This type of economy can be found in all type of businesses, only the minimum level of production capacity necessary to achieve the lowest possible average costs changes. In the theatre sector there are economies of scale since the average unit costs per audience member in a theatre with only 100 seats is higher than the average unit costs in a theater with 1000 seats with the same utilization rate. The minimum optimal dimension can be obtained very quickly since excessive production capacity (5000 seats) may not be attractive for users and this could generate diseconomies of scale. In other sectors instead the minimum optimal dimension is very high.

If I want to build a classroom and I want to double the capacity. Then variable costs increase proportionally and fixed costs increase too but less than proportionally. So total costs increase but you are doubling the capacity not the total costs then average unit costs decrease.

In order to understand whether to increase capacity or volumes sometimes companies try to presell, which means that they collect preorders to understand how big the market is and then they start to sell.

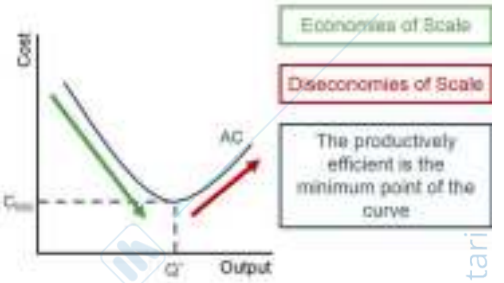
Economies of scale come from:

- INDIVISIBILITY OF INPUTS = some inputs cannot be brought in sub-units. So some assets are underutilized at lower production levels (volumes economies). In a classroom some elements are indivisible such as the teacher, the desk, the computer.

- SPECIALIZATION = larger size means that resources can be employed in a more specialized way (a R&D department allocates people to specific projects).

- BARGAINING POWER = higher volumes of production require higher volumes of factors of production, this means that they can get price discounts from suppliers. The contractual power increases with respect to suppliers.

- GREATER TECHNOLOGICAL EFFICIENCY = some production plants becomes more efficient as their scale increases. For example if you double the size of an engine power the fuel consumption increases less than proportionally (it doesn't correspond to a doubling of energy consumption).



- GEOMETRIC PROPERTIES OF CONTAINERS = when production capacity relates to volumes, the increase in capacity grows by the 3rd power with respect to is linear dimension. But costs are often expressed in terms of the square surface area, which grows by the 2nd power.

Economies of scale are not infinite (are very limited) because the cost advantages are not sufficient to push the smaller companies out of the market and the sector will continue to remain very fragmented.

When operating activities are combined with significant activities the level of economies of scale rises a lot and so there is an increase in the minimal optimal dimension. However the concentration of the offer is higher so the size grow implies more disadvantages than advantages. Indeed the curve of economies of scale is U shaped. The increase of production capacity implies a greater operational complexity and this causes an increase in average costs and thus DISECONOMIES OF SCALE. Diseconomies of scale depend on the size of the market, the incidence of transportation costs, coordination and control costs and on quality (in the classroom as the size increases the quality of teaching may decrease due to limited interactions). For this reason the decision on increasing capacity is a very delicate decision to make.

In a sector where development activities dominate they generate immaterial resources that don't have limits on production capacity. So these kind of economies are very high absorption economies and limited diseconomies of scale since the increase of volumes doesn't require the increase of resources used. So this structure is INFINITELY SCALABLE. An example can be for information goods. Technological evolution has provided the basis for dematerialization of information goods and this leads to a reduction of activities. As a consequence the ratio between costs and volumes changes.

VOLUME ECONOMIES	SCALE ECONOMIES
Volume economies are cost savings generated by **increasing the rate of utilization** for a given MPC	Scale economies are cost savings at the **same utilization rate** generated by **increasing production capacity**
AUC decreases because fixed costs are spread over a higher number of units produced	Sources of economies: indivisibility of inputs - specialization - bargaining power - technological efficiency - geometric properties of containers
The **limit** of volume economies is **full capacity**	The curve of economies of scale is **U shaped**

In **volume economies** there is a **greater use of a given production capacity** that is measured thought the utilization rate. If you reduce the unit cost of goods by using the 100% of the plant instead of using just the 80% then you have volume economies. Instead in **scale economies** there is a **greater production capacity** (a bigger plant) but **the utilization rate is the same** as before. Comparing the performance of the smaller and the bigger plant (at 100% of utilization) if the bigger plant allows for economic savings then you have economies of scale.

We have DISECONOMIES OF SCALE when, comparing two plants at 100% utilization rate, the **bigger plant has a higher average unit cost than the smaller**, due to the complexity of managing such a great production capacity. However **it is not inevitable that unit costs fall** so sometimes a business can get too big.
Instead DISECONOMIES OF VOLUME are associated with the **reduction of the utilization rate and with the increase of the average unit cost.** They are calculated by doing the difference between the AUCs: if the **utilization rate increases** and the **AUC has decreased** the difference is positive (we have **economies of volume**), instead if the **utilization rate decreases** and the **AUC has increased** the difference is negative (we have **diseconomies of volume**).

Scaltrini case

The **Scaltrini case makes understand the impact of economies of scale on the company's revenues**. This firm produces the compressor for industrial refrigerators.
The production manager has to **choose the most suitable size for the company and as a consequence the average unit cost will change**.
Should he invest in a **bigger plant**?
Should he build a **smaller plant and outsource extra production**?
Should he **drop the price** in the hope of fully exploiting the bigger plant?
Which choice minimizes AUC? Which maximizes operating profit?

	Plant A
Number of compressors per hour 1	435
Hours per year 2	1.760
Maximum production capacity (MPC) 3= 1*2	765.600
Utilisation 4	80%
Current production (CPC) 5=3*4	612.480
Variable costs	
Direct workers at full capacity 6	196
Direct workers at current capacity 7 =6*4	157
cost per year per direct worker 8	20.660
*total cost of direct workers 9=8*7*	*3.239.488*
Raw materials per compressor 10	0,8
Energy per compressor 11	0,5
Cost of extra compressors 11a	
Number of compressors purchased	
Total variable costs 12= 9+(10+11)*5	***4.035.712***
Fixed costs	
Indirect workers 13	18
Cost per year per indirect worker 14	33.570
Maintenance costs 15	1.550.000
Service costs 16	2.580.000
Overhead costs 17	3.100.000
Total investment 18	31.500.000
depreciation (years) 19	15
Depreciation per year 20=18/19	2.100.000
Total fixed costs 21=13*14+15+16+17+20	**9.934.260**
Total costs 22=12+21	**13.969.972**
Average unit cost 23=22/5	22,81

	Plant A
Current production (CPC) 5=3*4	612.480
Variable costs	
Total variable costs 12= 9+(10+11)*5	***4.035.712***
Fixed costs	
Total fixed costs 21=13*14+15+16+17+20	**9.934.260**
Total costs 22=12+21	**13.969.972**
Average unit cost 23=22/5	22,81
Unit price 24	28,5
Total revenues 25=24*5	17.455.680
Total variable costs 12	4.035.712
Total fixed costs 21	9.934.260
Totl costs 22	13.969.972
Operating income 26=25-22	3.485.708

This is a sector with growing economies of scale.
There are **economies of scale so the price changes but not necessarily this is translated in a higher profitability** because if we change the price we are not sure about this.

The logical flow is:
- **Calculate AUC** for the two options
- **Verify the existence of economies of scale**
- Calculate which **option maximizes operating profit**

MAKING SENSE OF AVERAGE UNIT COST

The MPC is obtained by multiplying the number of compressors per hour with hours per year. The current production (CPC) is based on **utilization** that is **80%**. Also the workers are not all used (always 80% of utilization). The variable costs consist in the direct workers and in the variable unit cost. The **variable unit costs is the cost to spend to produce the compressor** (raw material + energy) this has to be **added to the costs of the direct workers** and everything is **multiplied for the volumes produced**. In order to calculate the total costs the variable costs have to be summed to the fixed costs. **The average unit cost is the ratio of the total costs and the current production** (CPC).
The revenues of the company are calculated multiplying the unit price and the current production. The **operating income is the difference between total revenues and total costs**.
The **BEP** is fixed costs/[unit price - (total direct workers/current production) - costs to produce a compressor] = 9934260/(28,5-5,29-1,3) = 453.412. So **we are actually making profit after having produced 453.412 compressors**.

ARE THERE ECONOMIES OF SCALE?

Building a **Plant B at the same level of utilization** (80% of capacity) the current production (CPC) would be 1.232.000. When **we are increasing capacity as a consequence total variable costs increase and total fixed costs increase too**, even if **there is a cost saving at unit level**, because we are manufacturing more and we are investing more. The total costs are higher and the AUC (total costs/current production) is 17,79. **The amount of savings per unit is 5,02 and it is an economy of scale**: this is calculated with the difference between the AUC of A and the AUC of B

that has to be positive so if **AUC of B < AUC of A**.
If we are exploiting the economy of scale then calculating **the operating income** we can see that **is higher comparing to Plant A**. However the problem is that we don't expect to sell 985k compressors at this price.
What if the market is not able to absorb all the compressors produced?

	Plant A	Plant B
Maximum production capacity (MPC) 3= 1*2	765.600	1.232.000
Utilisation 4	80%	80%
Current production (CPC) 5=3*4	612.480	985.600
Variable costs		
Total variable costs 12= 9+(10+11)*5	***4.035.712***	***6.008.896***
Fixed costs		
Total fixed costs 21=13*14+15+16+17+20	**9.934.260**	**11.526.400**
Total costs 22=12+21	**13.969.972**	**17.535.296**
Average unit cost 23=22/5	22,81	17,79
Economies of scale per compressor produced		5,02
Unit price 24	28,5	28,5
Total revenues 25=24*5	17.455.680	28.089.600
Total variable costs 12	4.035.712	6.008.896
Total fixed costs 21	9.934.260	11.526.400
Totl costs 22	13.969.972	17.535.296
Operating income 26=25-22	3.485.708	10.554.304

WHICH OPTION MAXIMIZES OPERATING PROFTS?

Question 1

In the **big plant** (B) the **expected sales are 790k with the same price**. In this case the **maximum production capacity is the same of plant B**. If the **utilization rate** of plant B decreases to **64%** then the current production decreases, the total variable costs decrease, the fixed costs remain the same and the total costs decrease. The **total revenues will be lower because we are selling less since we are producing less**. In this case we don't have an economy of scale but a DISECONOMY OF VOLUME (-2,9) since the **amount of savings per unit**, namely the **difference** between the AUC of Plant B with 80% of utilization and the AUC of Plant B with 64% of utilization, **is negative**. In order to have a volume economy AUC of case 1 > AUC of case 2 but actually AUC of case 2 > AUC of case 1. Moreover a **bigger size** seem to be better but it is **risky because we cannot say that they are able to sell so much compressors**.

	Plant A	Plant B	Question 1
Maximum production capacity (MPC) 3= 1*2	765.600	1.232.000	1.232.000
Utilisation 4	80%	80%	64%
Current production (CPC) 5=3*4	612.480	985.600	790.000
Variable costs			
Total variable costs 12= 9+(10+11)*5	***4.035.712***	***6.008.896***	***4.816.384***
Fixed costs			
Total fixed costs 21=13*14+15+16+17+20	**9.934.260**	**11.526.400**	**11.526.400**
Total costs 22=12+21	**13.969.972**	**17.535.296**	**16.342.784**
Average unit cost 23=22/5	22,81	17,79	20,69
Economies of scale per compressor produced		5,02	
Volume economies			- 2,9
Extra cost per unit			
Unit price 24	28,5	28,5	28,5
Total revenues 25=24*5	17.455.680	28.089.600	22.515.000
Total variable costs 12	4.035.712	6.008.896	4.816.384
Total fixed costs 21	9.934.260	11.526.400	11.526.400
Totl costs 22	13.969.972	17.535.296	16.342.784
Operating income 26=25-22	3.485.708	10.554.304	6.172.216

Question 2

In the **small plant** (A) we can **outsource extra sales and keep the same price**. In this case the maximum production capacity is the same of plant A. If the **utilization rate of plant A increases to 100%**, the **CPC = MPC** since we use it at **full capacity**. In addition they **purchase 24.400 compressors** at

	Plant A	Plant B	Question 2
Maximum production capacity (MPC) 3= 1*2	765.600	1.232.000	765.600
Utilisation 4	80%	80%	100%
Current production (CPC) 5=3*4	612.480	985.600	765.600
Variable costs			
Cost of extra compressors 11a			24
Number of compressors purchased			24.400
Total variable costs 12= 9+(10+11)*5	***4.035.712***	***6.008.896***	***5.630.240***
Fixed costs			
Total fixed costs 21=13*14+15+16+17+20	**9.934.260**	**11.526.400**	**9.934.260**
Total costs 22=12+21	**13.969.972**	**17.535.296**	**15.564.500**
Average unit cost 23=22/5	22,81	17,79	20,33
Economies of scale per compressor produced		5,02	
Volume economies			3,2
Extra cost per unit			0,8
Unit price 24	28,5	28,5	28,5
Total revenues 25=24*5	17.455.680	28.089.600	22.515.000
Total variable costs 12	4.035.712	6.008.896	5.630.240
Total fixed costs 21	9.934.260	11.526.400	9.934.260
Totl costs 22	13.969.972	17.535.296	15.564.500
Operating income 26=25-22	3.485.708	10.554.304	6.950.500

the price of 24€ so the **total variable costs increase**. The **fixed costs are the same** of the original plan A but the **total costs increase**. There is a **decrease in average unit cost** because we have an ECONOMY OF VOLUMES. The difference the AUC of case 1 > AUC of case 2 and so **the amount of savings per unit is positive**. **The operating profit are higher because we didn't invest in the bigger plant but we have been more efficient in the small plant**.

Question 3

In a **big plant** (B) there can be a **super drop of price to boost volumes**. The unit price becomes **22€** and the **utilization is 100% of plant B**. The **operating income is less** than the operating income of the original plant B. The number of **compressors are doubled and costumers could be attracted by the lower price but however there are lots of compressors**. As a consequence this cannot be the most suitable option. **We invest a lot in the bigger plant but even if the price is lower we are not sure that all the compressors will be sold**.

	Plant A	Plant B	Question 3
Maximum production capacity (MPC) 3= 1*2	765.600	1.232.000	1.232.000
Utilisation 4	80%	80%	100%
Current production (CPC) 5=3*4	612.480	985.600	1.232.000
Variable costs			
Cost of extra compressors 11a			
Number of compressors purchased			
Total variable costs 12= 9+(10+11)*5	***4.035.712***	***6.008.896***	***7.511.120***
Fixed costs			
Total fixed costs 21=13*14+15+16+17+20	**9.934.260**	**11.526.400**	**11.526.400**
Total costs 22=12+21	**13.969.972**	**17.535.296**	**19.037.520**
Average unit cost 23=22/5	22,81	17,79	15,45
Unit price 24	28,5	28,5	22,0
Total revenues 25=24*5	17.455.680	28.089.600	27.104.000
Total variable costs 12	4.035.712	6.008.896	7.511.120
Total fixed costs 21	9.934.260	11.526.400	11.526.400
Totl costs 22	13.969.972	17.535.296	19.037.520
Operating income 26=25-22	3.485.708	10.554.304	8.066.480

The **question 2** could be the best option since it is **more safe** and in this way you **avoid risks** (lots of compressors could not be absorbed by the market). Indeed in this option we don't invest in a bigger plant but **the small one is exploited at the maximum of its capacity**.

Network externalities

Network externalities are a type of scale economies and are also called DEMAND SIDE ECONOMIES OF SCALE. **Supply side economies of scale are linked to the size of plants** and imply a **reduction of costs** instead **demand side economies of scale are linked to the size of user's pool** and imply a **greater utility perceived** by the client. The **utility depends on the number of other users** who use the same good or compatible goods. So as a consequence they can also be **negative** (if there are too many users on the same highway it becomes less useful). Network externalities **refer to a good in general** regardless of who the manufacturer is but sometimes they regard a specific supplier.

The **sources of network externalities a**re many:

- They can be generated by the direct effect of the **number of users on the good's capacity to generate value for the client**.
- They can be linked to the **presence of complementary products** that share the **same standards** in order to be compatible.
- They derive from the **complementary of users** (they need to exchange files for example).
- They are linked to the fact that a **service network in a specific territory is important**.

In case of **positive network externalities** companies have to make decisions **affirming their standard** or understanding which standards are the most successful in the sector.

Scope and learning economies

SCOPE ECONOMIES

You could have an impact on profitability by increasing the size but the **size could be increased** not just **leveraging** on one product (volume and scale economies) but **on a mix of products**. You can have a **cost advantage broadening the scope of your activity and increasing the variety of business in which the company operates**. This is called DIVERSIFICATION. There is diversification at **different levels**:

- **Single** business (such as Walmart);
- **Dominant** business (such as Walmart);
- **Related** business (you manufacture leather belts and you start offering leather bags);
- **Unrelated** business (such as Disney): the business in which the companies operate have little things in common and the nature of the business are completely different.
- **Conglomerates**: one company operates in different businesses.

In the **1960s-70s there has been the emergence of conglomerates and a diversification into related sectors**. In the 80s there was a refocusing on the core business and diversified firms were avoided. From the 90s until **now diversification became important again**, there were synergies and core competencies but it is hard to realize expected benefits.

Diversification is a strategy that firms adopt in order **to**:

- **Reduce risks**;
- Make use of available cash **investing**;
- Enter into **attractive market segments**;
- Generate new strategic **know how**;
- **Limit unit costs**;
- Enjoy **cost advantages** (scope economies).

In scope economies **you can have a reduction in costs if the combined production of 2 or more products is lower that the sum of the costs associated with their separate production**. Scope economies can be calculated with the **difference between the total costs** paid for producing X units **without sharing resources and the total costs** paid for producing X units **sharing resources**.
In this case the advantages are a **share of storage, costumer service facilities, a joint production and cooking techniques**. The costs of the combined production are lower because there are **resources and factors of production that are underutilized** (capacity) or they can be **exploited on different products**. They share both the production structures and the administrative and commercial structures.

There are some sectors that exploit economies of scope significantly that doesn't always come from the fact that resources are underutilized. An example can be the **fashion industry** (Armani): **every brand has many different products** and economies of scope come from the possibility of utilize IMMATERIAL **assets** so there are **no constraints with capacity**. This sector indeed is dominated by activities aimed at supporting the brand image and so they **decide to enter into**

compatible sectors. An immaterial/intangible asset can be a brand, technological skills, a software but also contents and characters. Instead others economies of scope can come from a MATERIAL **asset** (shared distribution networks and costumer care) however the sharing of material resources can be **limited by the production capacity**. An example can be **Poste Italiane**: they offer **postal services but also retail and financial products and services**. Indeed it uses a **wide network of local branches to sell many different services and products**. Not always the strategy works for example in the case of **books** the **investments were discontinued and weren't justified by the volumes sold because there was a poor assortment and a lack of expertise by employees**. **Amazon** also started as digital bookseller and transferred its know how and logistic infrastructure to **several different sectors** opening up own portals or managing other companies emailing activities. Then it entered the physical retail business through the acquisition of Whole Foods and developed cloud services.

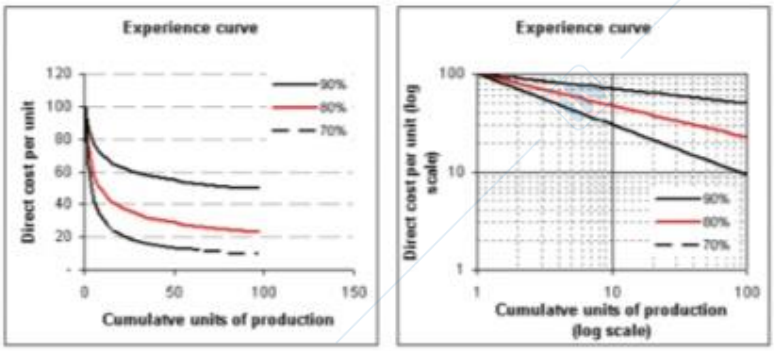
In scope economies there is a **greater integration of systemic goods**, that are goods or services that are complementary, coordinated or correlated. The presence of systemic goods doesn't require a single company to offer multiple elements of the system but **this would uniform design and it would lead to an increase of the level of satisfaction**.
A particular form of systemic goods is present **when different goods are integrated not only on the demand side but also on the supply side**. For example Google offers a search engine to end users but also an advertising service to companies. This business model is know as a TWO-SIDED MARKET.

Another phenomenon of economies of scope is the CROSS SUBSIDIZATION, that is the **fund of activities at a low remuneration with more profitable activities**. In the case of Google the search engine is a free service and the losses are more than offset by the sale of advertising. So these **two services couldn't survive independently**

LEARNING ECONOMIES

Learning economies are **reductions in unit cost and improved output quality** which occur **as additional units of a given output are produced due to the** ACCUMULATION OF EXPERIENCE. The more people learn about how to produce a good, the more they **save time and money**. Learning economies are measured on the cumulative volumes of production and they are **calculated every time you double the cumulative production**.
The **learning effect** is a CONSTANT and brings **regular reductions of the average unit cost**: **when the production doubles the unit cost decreases by a specific percentage**. It has been observed that the percentage of cost savings is the same throughout the learning/experience curve that represents different levels of production. It is relevant because it helps us understand what is the **advantage of the first player** in an industry (the learning curve goes down before the competitors) and because if you keep producing the same products **you can predict the costs at different levels of production and the evolution of profitability**. However this **strategy is very risky** too because it can lead to a banalization of the product. Then it is important for the **learning not to take place only at the individual level but above all at organizational level**. For example in the Cirque du Soleil the learning is organizational indeed the artists don't benefit from personal notoriety and moreover they can be easily replaced so the organization won't be affected.
Then in order to maintain the speed of learning a **constant effort is needed because learning can stop and costs can began rising again and quality can began to deteriorate**.

The existence of this type of economies was **found in airplane manufacturing**. When more **planes where produced the average unit costs were reduced**. It was observed that **the hours of work necessary to build an airplane decreased with the number of planes produced** sequentially and that **the decrease was regular**. To build an airplane 200 hours were needed but to produce 2 airplanes the hours needed were 160 so the hours saved are calculated by (160-200)/200 = 20%. The **cost advantage is very high at the beginning of the production and then progressively reduces**. If 4 airplanes are produced in 128 hours then (128-160)/160 = 20% and this **20% is the cost advantage and what you save by learning for every doubling of output.** Instead **the 80% is the experience curve that indicates that unit cost drops to 80% of their original level**.



Nokia for example **was the market leader of selling cellphones** and in the 90s they keep going down the learning curve in manufacturing doubling the production and reducing the costs. Then **Apple changed completely the cost structure** and the learning curve and it overcame the advantage related to learning.

In the late 1960s **BCG** began to **emphasize the implications of the experience curve for strategy**. Their research observed experience curve effects for various industries. The existence of learning curves explains why some companies characterized by high volumes production of very standardized product **tend to grow significantly and justifies first mover strategies**.

Learning economies **derive from different factors**:

- **Reinforced human skills**: people **improve** their work habits and **perform** assigned **tasks more quickly and better**. This applies to all employees and managers not just those directly involved in production. This regards both manual and intellectual activities.
- **Simplification of products and processes**: when people **gain experience** regarding a certain product or production process they **can also understand possible pathways to simplification** leading to greater efficiency at lower costs.
- **Better selection of materials**: it is possible to understand **which production resources are the most appropriate** for carrying out a given activity.
- **Higher programmability of activities**: events become more predictable and **response-time to non-standard circumstances is quicker**. This makes it possible to plan processes more effectively by timing each operation, optimizing the mix of different production capacities and coordination resources.
- **Higher coordination**: people must interact and utilize different kinds of plants and equipment as they carry out the activities. With experience **individuals get to know one another and learn to work in team and coordinate different processes.**

Different kinds of economies and theirs sources are often observed together.

Scale economies or volume economies are normally associated with learning economies. The higher the capacity installed and the speed of growth, the **higher the possibility to exploit both scale and learning economies**.
The **higher the incidence of fixed costs**, the higher the possibility to **exploit simultaneously a variety of economies.**

Transaction costs

It is important to analyze the **advantages and the disadvantages of the make, but and connect choices** (lead to the formation of inter-company aggregates).

A transaction cost is the **cost involved in making an** EXCHANGE. An exchange can be external or internal to the company. An **external exchange occurs when two separate businesses are involved** (when an activity is outsourced) and the **external transaction costs represent the costs for a company to create and monitor an agreement with another company**. It is important to collect information, prepare a contract, verify compliance and sustain potentially unforeseen greater costs or lower revenues. Instead an **internal exchange occurs when the exchange takes place within the same company** and the **internal transaction costs** (or internal coordination costs) **are the costs to plan and coordinate this internal exchange**. With the growth of a company's size, activities become more complex as well as coordination.

When **purchasing materials costs are very low** however **the use of the market increases them**. **External transaction costs are influenced** by:

- INFORMATION COMPLEXITY: the information of the transaction itself are complex so the **market becomes less transparent and certain**.
- SPECIFICITY OF RESOURCES: **one or more parties to a transaction must sustain costs to change interlocutor.** An example can be the speciality of place for a hotel or the specific of the physical goods.
- Possibility of OPPORTUNIST OR INADEQUATE BEHAVIOR: **transaction costs would be lower if they didn't tend to follow their own interests**. So it is necessary to take precautions with complex contracts against opportunism. Then also an **inadequate behavior** (inability to manage a hotel) can inflict transaction costs. Sometimes companies want to acquire contracts in sectors characterized by information complexity and highly specific resources in order to create a REPUTATION. **The greater the reputation the greater the harm that would derive from an opportunistic behavior**.

The theory of transaction costs assumes that **transaction costs must be considered when deciding if internalizing or externalizing an activity** so when deciding if it is more convenient to make or buy a product. It is not sufficient to compare the production cost of a product with the price of the product on the market because also the amount of transaction costs involved are essential. If **(production costs + costs of internal coordination) < (market price + external transaction costs)** then you MAKE. If **(production costs + costs of internal coordination) > (market price + external transaction costs)** then you BUY.
The **difference** in the cost **resulting from the two calculations** represent a TRANSACTION COST (DIS)ECONOMY.

Interdependence between economies

Multiple economies can emerge in a company and they can influence each other. The descending along the experience curve should accelerate if the production capacity increases but it can also be combined with more sophisticated machines.

It is possible to have diseconomies of volume when we have scale economies but the two concepts are not necessarily interlinked. They have to be **calculated separately and then conclusions are made about their interactions**, depending on the specific case.
Scale and volume economies coexist when you increase both capacity and utilization rate and then the AUC decreases. This can happen when there is a **significant drop in unit price**.
There are **scale economies with diseconomies of volume** when by **increasing the production capacity** (scale economies)it becomes **harder to saturate the production capacity** (volume economies). Then the **AUC can decrease** (the difference is positive) due to **scale economies** but the **AUC can also increase** (the difference is negative) due to **diseconomies of volume**.

There is an **interplay between extension choices and economic theories**.
Choices about the SIZE have to be **made after analyzing the economies of scale and the expected demand** on the relationship between utilization of capacity and absorption of fixed costs. These choices can be also **influenced by positive externalities** that lead to increase the value of the goods for the end clients.
VERTICAL EXTENSION choices have to **take into account transaction costs**. There are **higher fixed costs and lower variable costs** and the cost structure becomes more **rigid**.
HORIZONTAL EXTENSION choices are **linked to the economies of scope**.
Finally GEOGRAPHIC EXTENSION choices are **linked to economies of scale and economies of volume**.