

Co-evolution of firm's capability and environment: a multinational hotel case study

I. Introduction

Over the past two decades, several calls have been made for close engagement between history and management and organization studies (Clark & Rowlinson, 2004; Jones & Khanna, 2006; Kieser, 1994; Kipping & Üsdiken, 2008; O'Sullivan & Graham, 2010; van Baalen & Bogenrieder, 2008). It was observed that the close relationship between business history and management studies, evinced by Chandler's book *Strategy and Structure* (1962), which had a profound influence on both areas of study, has not pushed this relationship further over the years (Kipping & Üsdiken, 2008). In response to this observation, this paper employs the co-evolutionary and dynamic capabilities concepts to evaluate the historical evolution of a multinational hotel firm.

The co-evolution concept addresses the long-term interactive patterns between companies and their environment, capturing both adaptation to environmental change and the importance of interdependence between these and managerial decisions (Millar et al. 2009; Dieleman & Sachs, 2008; Porter, 2006). Similarly, dynamic capabilities, such as distinct skills, knowledge and tacit understandings gained through experience within a firm, are argued to enable firms to combine and redeploy resources in order to address changing environments (Teece et al, 1997). In a similar vein, business history has been defined as '*systematic* historical studies of business behaviour and structures and politics, and of their consequences for the economy as a whole' (Supple, 1977: 1). These three areas of study share a common domain of interactions between firms and their external environments.

Moreover, Leblebici and Shah (2004: 374) argue that the integration of history and management theories is achievable by using analytical explanation that integrates a succession of historical events to expound a 'meaningful and temporal process' and identify questions that are commonly relevant to both areas of study. What causes concern for firms during the overseas expansion that leads up to capability-building? How are the patterns of mutual influence between firms and

industries acted out over time? The next section briefly discusses the co-evolutionary and dynamic capabilities concepts and section III presents the discussion. Section IV concludes and identifies the limitations of this paper.

II. Co-evolution and Dynamic Capabilities

According to Porter (2006), the co-evolution concept is based on the premise of organizations evolving in relation to their environments while, at the same time, these environments evolve in relation to them. Similarly, Levinthal and March (1993: 105) argued that the survival of the firm is dependent upon the firm's capability to 'engage in enough exploitation to insure the organization current viability and engage in enough exploration to insure its future viability'. According to Helfat and Peteraf (2009), it is argued that competitive advantage is created in the process of exploration for new opportunities and exploitation of a firm's existing capabilities.

Exploitation is associated with increasing the productivity of employed capital and assets by improving and refining existing capabilities such as technologies, routinization and cost reduction (Koza & Lewin, 1998). Similarly, Zettinig and Benson-Rea (2008) posit that exploitation is a behavior associated with systematic reasoning, efficiency seeking, performance measuring, risk-avoidance, incremental improvement of capabilities, processes and technologies. Whether exploitation leads to profit or loss for an organization, it is advocated that exploitation should be complemented by exploration (March, 1991). Exploration involves experimenting with ideas, technologies, new business models, strategies and systems and it is concerned with long term returns rather than current contributions to the business (Zettinig & Benson-Rea, 2008). The strategic intent of exploration is the discovery of new opportunities, which may have remarkable effects on a firm's performance (Koza & Lewin, 1998). This paper argues that these interactions between firm and environment lead to mechanism change and the dynamic capabilities concept becomes relevant, in that it underpins managerial decision-making processes.

Wang & Ahmed (2007: 35) define dynamic capability as 'a firm's behavioral orientation constantly to integrate, reconfigure, renew and recreate its resources and capabilities and, most importantly, upgrade and reconstruct its core capabilities in response to the changing

environment in order to attain and sustain competitive advantage'. This argument concurs with Teece et al. (1997), who consider the management as the driver for enabling the combination of resources and coordination of activities to generate dynamic capability. In the same way, managers may consider the reassessment of strategy process and content and organizational routines to address any environmental change and create or renew capability-based advantage in the context of environmental change (Helfat & Peteraf, 2009). Thus, organization evolutionary change is the joint outcome of both managerial adaptation and environment selection (Lewin & Volberda, 1999; Madhok & Liu, 2006).

III. Discussion

This section discusses the genesis and performance of Hilton Hotel International (HHI) to illustrate the co-evolution between the firm and its environments and dynamic capabilities building in this process after the Second World War. HHI has been used as the case study, based on the fact it was the first US hotel chain to enter Europe and remains a leading international chain at present. Archival documents and secondary data were collected to conduct this study.

The beginning of Hilton Hotel Corporation's (HHC) international expansion was an exploratory activity motivated by foreign policies. After WWII, Conrad N. Hilton, (Conrad Hilton), the founder of HHC, was approached by the US government to explore the possibility of creating a chain of Hilton Hotels in Europe as part of the Marshall Plan also known as the European Recovery Plan (ERP) (Maximaxims, 1951). The ERP set the goals of generating \$2 and \$2.5 billion through tourist receipts from Americans travelling to Europe in 1950 and 1954 (Friedlander, 1949). The Economic Cooperation Administration (ECA), created by the Marshall Plan was to oversee the economic and technical assistance programmes extended to help a few selected European countries re-generate their economies. These programmes included an ECA fund allocated for European hotel development, contributed by the US State department, which required a repayment rate of 2% below market rate (Pearson, 1949).

Presented with the pull from business opportunities arising in Europe due to the need to repair buildings in anticipation of the arrival of American tourists (Friedlander, 1949) and the push

exerted by US foreign policy, Conrad Hilton created Hilton Hotel International (HHI) to explore the opportunity of creating a long-term return. Conrad Hilton believed that the business opportunities available in Europe were beneficial for HHC's growth and persuaded his Board of Directors to expand into the region despite their reluctance to commit because of their worries about 'war', 'revolution' and 'inflation' (Hilton, 1957: 234). The Board provided Conrad Hilton with \$500,000 to create HHI as a subsidiary of HHC. Between 1953 and 1966, HHI operated 31 hotels. HHI's first international hotel was built in Spain in 1953 and subsequent hotels were established in Latin America, North America (Canada), the Caribbean and Middle East regions.

The extensive hotel operating experience held by Conrad Hilton, arguably forms a major capability possessed by HHI in the foray into the internationalization process. The lease model which HHI used was a '2/3 and 1/3' lease contract, meaning the hotel owner(s) received 2/3 of generated profit and HHI got 1/3 of it (Hilton, 1959b). This model demonstrates a typical exploitation trait where existing capabilities such as knowledge and tacit understandings gained through experience by management (Teece et al, 1997) are adopted in a new venture. HHI's first expansion beyond the North American continent - the Caribe Hilton Puerto Rico - had successfully generated \$102,963 in net profit in the first year of operation (1949 -1950) and continued to show positive returns in subsequent years. HHI's subsequent international hotel expansion saw a robust financial performance stemming from the clearly outlined lease model to which the company adhered for many years. Although Conrad Hilton was enthusiastic about hotel internationalisation, he was cautious not to commit huge capital investments and risk. HHI's financial commitment was limited to the provision of operating capital, and local government or private companies invested in individual hotel properties.

Similarly, the power held by Conrad Hilton was equally important in the advent of HHI's internationalization process. During the exploratory process, Conrad Hilton, who was also the President of HHC and HHI, formed a special Operating Committee, comprising three senior executives and headed by himself, to make important decisions about its development (Hilton, 1947a). Conrad Hilton's correspondence further shows his authoritative management style, forming an important capability in his firm. He asserted to an executive that 'Also, the acquisition of new properties, I have been the chief factor in all of this at all time so it is proper

that they be handled under me' (Hilton, 1947a), and another letter sent to his top managers, indicating that 'I have assigned myself and to Mr Binns [Joe Binns] the duties of the expansion program and the riddance of certain properties (Hilton, 1947b) reveals a centralized control and management style, Conrad Hilton's management style combined with his experience, contributed to HHI's profitable performance, but the insistence on a lease model also contributed to its loss, evinced in late 1958.

The weakness of HHI's lease model first came to light during the 1958 political unrest in Cuba. Habana Hilton was opened in March 1958, and before HHI could recover its investment in the hotel, Fidel Castrol took over Cuba in December 1958. The political unrest drove away visitors from Cuba and increased HHI's financial loss. This was HHI's first recorded loss in its international expansion (Hilton, 1958b). In 1960, American owned or operated businesses were expropriated, including Habana Hilton. The new Cuban government seized the hotel on the grounds that the American operator (HHI) failed to stimulate growth despite its close connection with the US market and caused employment and economic problems (Phillips, 1960).

The loss led to HHI's critical review of its operation which showed that the firm should re-define and revise the concept, principles and the policies guiding foreign expansion strategies. It was pointed out that HHI's existing form of contract (lease contract using 2/3 and 1/3 model) was too rigid. HHI was at a disadvantage particularly in deals where HHI guaranteed the owner a minimum return whilst bearing all operational losses (Hilton, 1959b). Thus, the review team proposed for HHI the use of management contracting in deals that were known to have high financial risk because leasing incurred a higher amount of cash investment on HHI's part (Hilton, 1958a). Management contracting enabled a minimum to null equity investment, and was thus able to reduce capital investment risk, at the same time, enabling HHI to retain control over its operations and reputation. It is apparent that the development of HHI's internationalization strategy, like any other business development, encountered the need for adjustment of practice through management learning as the business grew, illuminating the interdependence between the environment and managerial decisions (Millar et al. 2009; Dieleman & Sachs, 2008; Porter, 2006). The Cuba crisis also highlighted a key concern of strategic management and organization studies, particularly regarding how capabilities were built during the internationalization process,

which furthers the understanding of how firms can sustain a competitive advantage by responding to and creating environmental change (Teece, 2007).

By extending the theoretical concepts to a historical analysis of a multinational hotel firm, the co-evolutionary process between airline and global hotel industry development became apparent. From the late 1940s, technology in the airline industry advanced rapidly, contributing to shorter flight times. For example, the new high speed planes developed enabled a tourist to have a two-week vacation by using a 12-hour crossing of the Atlantic Ocean between America and Europe (Friedlander, 1949). In 1948, the introduction of a tourist class ticket made it affordable for more consumers, particularly those of the middle income population, to travel. HHI's strategy for location selection also co-evolved with airline industry. For example, the type of location HHI initially identified concentrated on capital cities (Hilton, 1947b) because of the availability of human traffic, essential for generating and sustaining business (Hilton, 1959a). However, with the advent of jet airplanes and an exponential international tourism growth rate, HHI extended its projects out of capital cities, to include metropolitan cities. For instance, in 1959, projects in Germany under consideration and negotiation included metropolitan cities such as Cologne and Munich (Hilton, 1959b). In the early 1960s, hotel expansion extended to non-metropolitan locations such as Alexandria in Egypt and airport hotels.

The emergence of the jet engine in the 1960s also propelled the demand for air travel, which saw a succession of mergers between airlines and hotel chains, or the creation of new hotel chains by airlines. Examples include the acquisitions of HHI by TWA in 1967, the merger of United Airlines and the Westin hotel group (previously known as Western International Hotels) in 1970 and the creation of Le Meridien Hotels by Air France and Nikko hotel group by Japan Airlines in the 1970s (Gee, 1994). These activities further illuminate the co-evolution phenomenon between multinational hotel firms and airline industry.

The co-evolution process of airline and global hotel industries, if delving deeply into their genesis, presents a political issue as the first push for international hotel evolution. In this study, it is found that multinational hotel firm started at the instigation of the US government, who wanted to build good relationships and extend trade aid to war-torn European countries at the end

of WWII. Moreover, the timing of a shortage of foreign currency amongst these countries, specifically of US dollars, and their being in need of US dollars to facilitate imports, presented the US government with the opportunity to improve its international social and economic relationship with them, and form a symbiotic relationship. In addition, the US government saw the encouragement of Americans traveling abroad as the quickest way to help produce foreign currency in dollars for these countries, in turn helping to generate hard currency in dollars to facilitate international trading with the US (Dow, 1998; New York Times, 1947a; 1947b).

IV. Conclusion

In sum, this paper argues that management and their accumulated experience underpin a firm's capability to exploit internal resources and explore external opportunities to enable a firm to grow and survive. This interdependency between firms and environment becomes more apparent over time. By examining HHI's international development, this paper illuminates how the international hotel and airline industries co-evolved, in turn highlighting how hotel firms developed capabilities through a dynamic environment and organizational changes that 'feed on each other through time' (Djelic and Ainamo, 1999: 623).

This is a preliminary attempt to integrate co-evolutionary and dynamic capabilities concepts with a historical analysis. Therefore, further evaluation of theoretical concepts could contribute to more in-depth insight into the applicability of theories that benefit business historians, whilst historical analysis of organizational past could highlight conceptual issues in cross-sectional variation in business studies and contribute to the refinement of theoretical arguments in management and organizational studies (Jones & Khanna, 2006; Kipping & Üsdiken, 2008; Üsdiken & Kieser, 2004).

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