Private Equity-Backed Firms' Corporate Strategy: An Explorative Study from a Dynamic Capability Perspective

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Abstract— **This paper explores the case of Toys "R" Us in order to understand the strategy of private equity-backed firms. It is a first attempt to investigate the target firm's strategy from a dynamic capability perspective. The paper shows that the acquired firm mobilizes resources after acquisition in order to improve its competitive strategy within the traditional business. The paper confirms that the concerns about leverage buyouts are exaggerated because the acquired firm mobilizes resources to generate long-term growth. Moreover, the paper discusses possible improvements of the corporate strategy implemented by private equity-backed firms. After acquisition, private equity management could help push the target firms into developing the resource potentialities in the direction of their diversification. Future quantitative researches could verify the results of this qualitative work on a larger sample.**

Keywords - Strategy, Strategic Change, Dynamic Capability, Private Equity

I. INTRODUCTION

Dynamic capabilities are the processes which change resources (Teece, Pisano, Shuen, 1997). According to the media, when an organization is acquired by a private equity firm, it ceases to generate resources for its growth (Weinberg, Vardi, 2006). Private equities erode the firm's development because dynamic capabilities stop operating. This paper aims to understand whether or not the dynamic capabilities continue to work in a private equity setting and, if so, to explore how the dynamic capabilities continue to operate in that particular setting. The results suggest that dynamic capabilities continue to expand the firm's resources and growth following acquisition. In addition, this paper suggests that the firm's growth could be incentivized more according to the 'principles' of the Resource-based View. Actually, the growth occurs within the original market, dynamic capabilities could exploit the original resources and they could create new ones to expand the target firms within new markets populated by new clients.

This paper is a first attempt to analyze the target firm's corporate strategies from the perspectives of the resource-based view (Wernerfelt, 1984; Barney, 1991) and the dynamic capability theory (Teece, Pisano, Shuen, 1997). While it has all the limitations of a single-case study, future works could test the results of this paper on a larger sample.

II. THEORETICAL BACKGROUND

According to the resource-based view, a firm is a bundle of resources. These resources can generate a competitive advantage if they hold certain characteristics, such as being valuable, rare, inimitable, and sustainable (Barney, 1991).

In concrete terms, resources are factors which are combined in order to be transformed into products. They can be financial resources, devices, raw materials, licenses, software, human resources, and so on. The literature identifies the capabilities, which differ as they are related to each resource. These are intangible abilities developed by firms over time to coordinate their resources at any organizational level, such as at the corporate or the functional level (Amit, Shoemaker, 1993). From a resource-based view, scholars and practitioners see corporate strategy and multibusiness firms in a novel way. Traditionally they are analyzed through the portfolio matrix. Managers and scholars represent multibusiness firms as a group of products which are sold in different markets. Corporate strategy should invest in the products which will be more remunerative in the future, while investing the cash flows generated by the products that are more remunerative in the present. Ultimately, it should eliminate the less remunerative products. From the new perspective, multibusiness firms are seen as a complex of resources which are used to generate cash flows in different markets. Corporate strategy should use the available resources to enter the new markets that will generate cash in the future, and invest in these resources to develop them in a way that makes them suitable for meeting the needs of new groups of clients (Wernerfelt, 1984).

An extension of the resource-based view is the dynamic capability theory (Amit, Zott, 2001). The theory points out that in environments where changes happen very quickly, firms can generate wealth if they hold capabilities that can dynamically reconfigure, integrate, and adapt resources located both inside and outside the firm (Teece, Pisano, Shuen, 1997). Teece, Pisano, and Shuen's (1997) paper made strategy scholars aware that dynamic capabilities are relevant units of analysis. Since

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the paper was published some scholars have tried to understand what dynamic capabilities are and how they work. Eisenhardt and Martin (2000) explain that dynamic capabilities are well-known processes such as product development or alliance creation. On the one hand, firms have some similar dynamic capabilities which correspond to the diffused "best practices." On the other hand, dynamic capabilities can have different characteristics in heterogeneous environments. In the most static ones they correspond to routines; these are procedures which allow organizations to automatically react to external inputs. In the most dynamic environments they are idiosyncratic and interactive learning processes, which generate resources and capabilities when reinventing the firm's actions (Eisenhardt, Martin, 2000).

Erwin Danneels' investigation of Smith Corona identified four ways by which dynamic capabilities work. First, Smith Corona uses its available resources to penetrate into new markets. Second, it generates new resources internally and integrates the old resources with the new ones. Third, the firm creates alliances by looking for new resources externally, to complete their available resources and the resources which cannot be created internally. Fourth, the management's mental models represent the available resources, the lack of resources, and the possible path to fill the resources gap. They are important dynamic capabilities which shape the other ones (Danneels, 2011).

Literature has moved a step forward in the comprehension of dynamic capabilities by trying to understand their sources. Scholars highlight how the evolution of organizational forms affects dynamic capabilities. When management supports this evolution through flexible organizational principles, dynamic capabilities emerge (Rindova, Kotha, 2001). Moreover, the literature identifies the "microfoundations" of dynamic capabilities—"distinct skills, processes, procedures, organizational structures, decision rules, and disciplines" (Teece, 2007: 1319) —which are the drivers of dynamic capabilities at the micro-level. Additionally, scholars highlight the relevance of the emotions which are the origins of such dynamic capabilities (Hodgkinson, Healey, 2011).

Dynamic capabilities are also investigated in particular contexts, such as in: a firm's political strategy that affects a government's actions (Oliver, Holzinger, 2008); penetration into new technological niches (King, Tucci, 2002); entry into foreign markets (Luo, 2000; Weerawardena, Mort, Liesch, Knight, 2007); processes which lead to continuous innovation of products (Verona, Ravasi, 2003); and investment processes activated by venture capitalists (Arthurs, Busenitz, 2006).

These investigations of dynamic capabilities are carried out in depth within the different firm contexts. Despite the huge amount of analysis of the theme, dynamic capabilities have not been analyzed in a private equity context; that is, a setting where a firm is acquired by an investor or a group of investors. With regard to the resources dynamic, this setting seems to generate a significant practical problem; it seems that private equities are just speculating by acquiring and selling firms' assets. They do not aim to develop their resources. In an article titled "Private Inequity," two *Forbes* journalists wrote: "There would be no reason to begrudge the financiers their take if they were building enterprises and creating jobs. But they do not make their fortunes by discovering new drugs, writing software, or creating retail chains. They are making all this money by trading existing assets" (Weinberg, Vardi, 2006). The supposition in the media is that private equity acquisitions do not allow for the creation of new resources for a firm's growth, which could generate benefits for its stakeholders. The claim is that these acquisitions do not respect the corporate strategy principle, according to which resources should be developed for growing the firm in the long run (Wernerfelt, 1984). This problem is related to the recent financial crisis apparently generated by the banks' financial perspective, which aims to create cash in the short term without caring about a long-term growth of the economic system. This paper aims to investigate dynamic capabilities in a private equity setting to understand whether or not they operate in that setting in generating and reconfiguring resources. Moreover, the paper aims to understand how they would work in that setting. The objective is to answer the following research questions:

- Do dynamic capabilities work within firms acquired by private equities?
- How do they work?

Any qualitative research should have a protagonist whose story is told by the paper (Pratt, 2009). This paper tells the story of dynamic capabilities operating in a special setting: the context of firms acquired by private equity.

III. Method

This paper tries to answer the research questions through an inductive analysis, which is the most suitable for the unexplored theme of the "dynamic capability within a private equity setting." Qualitative research can help to develop a theory showing:

- Whether or not dynamic capabilities work when private equities acquire firms.
- How dynamic capabilities work in a private equity setting.

A. Case Selection

This paper is a single-case study. A large operation was chosen because these should be "extreme" cases which would better demonstrate the features of the dynamic capabilities within a private equity setting. A larger investment ensures that the efforts to manage it should be more evident. In addition, investigating major operations allows for a focus on the most significant phenomena related to the problem which activated this research. The bigger the investment, the more negative and significant are the effects of a speculative management on society. An acquisition realized by private equities more than five years ago was selected; it seemed compelling to choose such an operation because this period of time allows one to observe dynamic capabilities in the short run and in the long run. This could help develop a theory, which includes both periods of time, showing the effects of private equity on a firm's resources in both time ranges (short term and long term). The case under study is Toys "R" Us.

B. Data Sources and Analysis

The company's annual reports were used. They are available online and data reported by the business section of the annual report were selected. This section discusses the firm's strategy and includes the main investments in the firm's resources. Attention was focused on the data supported by numbers, such as the number of employees or the number of new trademarks. This selection allows for fairer work on the data because they can be verified by the possible stakeholders and, above all, by audit companies. Then, this kind of data seems to be more solid from the research perspective. Numbers allow for identification of the dynamics of the resources: when they become larger over time it is possible to believe that the resources are also increasing; when they become smaller it is possible to believe that the resources are being eroded.

A private equity acquired Toys "R" Us in 2005. Data collection occurred over seven years, from 2003 to 2009. These data allowed analysis of the scenarios before and after the acquisition, in order to understand the changes caused by the private equity entry into the firm's capital. Moreover, the long-term private equity effects can be seen because the data include the firm's strategy over the five years following acquisition. "First-order codes" and "theoretical categories" were identified, with the latter brought together to elaborate the "theoretical dimensions" (Pratt. Rockmann, Kaufmann, 2006: 240-241; Gioia, Chittipeddi, 1991; Strauss, 1987). Data was codified through first-order codes (Strauss, 1987; Emerson, Fretz, Shaw, 1995; Lofland, Snow, Anderson, Lofland, 2006). The codification process is presented in an appendix (available from the author upon request). It identified six codes: Stores, Websites, Employees, Relations with Vendors, Distribution Centers, Employees, and Trademarks. These correspond to a theoretical category of "a bundle of resources and capabilities"—that is, a group of resources and capabilities embedded in an entity such as an employee or a store. Analysis of the six codes occurred over seven years, and is represented in the graphs included in the findings. These graphs show the evolution of the codes over time, which correspond to another theoretical category: the dynamic capabilities. The two theoretical categories generate a theoretical dimension: the corporate strategy. The nature of the resources/competences dynamically defines the corporate strategy in the private equity setting, and this theoretical dimension is evaluated in the discussion section. Figure 1 shows the first-order codes, the theoretical categories, and the theoretical dimension.

IV. FINDINGS

A Toys "R" Us is a "worldwide specialty retailer of toys, baby products, and children's apparel" (TOYS "R", annual report, 2003: 1). A group of investors acquired Toys "R" Us on July 21, 2005. The group consisted of several players: Bain Capital Partners, Kohlberg Kravis Roberts & Co., Vornado Realty Trust, and GB Holdings (TOYS "R", annual report, 2004). The company's unsatisfactory performance in 2003 pushed its management to conduct a strategic analysis

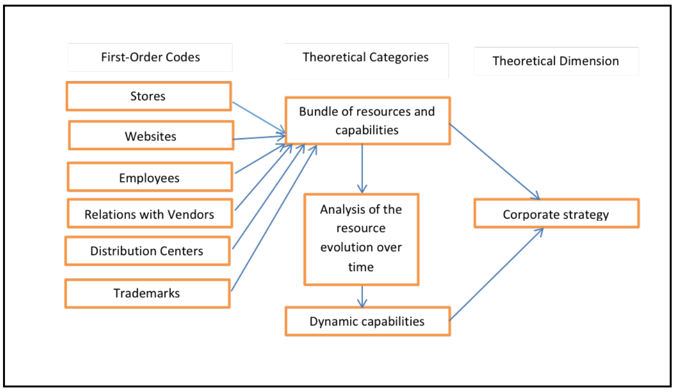

Figure 1. Codes

involving all the businesses of the company. In January 2014 the management began to communicate the analysis to its stakeholders. It led to the important decision of selling the company to the investor group in 2005 (TOYS "R", annual report, 2004). The investors decided to keep driving for reconstruction of the business, the aim of which was to grow the most promising business areas and to reduce the less productive parts:

On April 6, 2005, the Company and Parent each filed a pre-merger notification and report form under the Hart-Scott-Rodino Antitrust Improvement Act of 1976, as amended, and the rules and regulations promulgated thereunder, with the Federal Trade Commission and the Department of Justice. On April 15, 2005, we were notified by the Federal Trade Commission that we were granted early termination of the waiting period.

After the closing of the proposed merger, the Sponsors may direct us to make significant changes in our business operations and strategy, including with respect to, among other things, store openings and closings, new product and service offerings, sales of real estate and other assets, employee headcount levels and initiatives to reduce cost and expenses (TOYS "R", annual report, 2004: 6).

The year 2005 was a "transaction year": the company was managed within a nonprivate equity setting over the first half of 2005, followed by a private equity setting in the second. The whole of the previous year was considered a "preacquisition" year, and 2006 was the first entire "postacquisition" year.

Since 2005 many resources have been mobilized. The business section of the annual reports shows that there was a huge mobilization of the resources and competences embedded in the stores, databases, websites, employees, vendor services, distribution centers, and trademarks.

Table I shows the number of stores per year, and is divided into two store categories: domestic stores located in the U.S. and international stores located abroad. Figure 2 shows the trends of both the domestic stores and international stores. Domestic stores increased by three in 2005 and then significantly increased in 2006 (by 64 stores). In 2007 they increased again, by eight stores. Afterwards the numbers remained more stable, while the international stores increased by 40 in 2005, by 37 in 2006, and by 37 in 2007, before stabilizing.

TABLE I. STORES

Year	*Number of*		
	Domestic Stores	***International Stores***	***Total***
2003	927	574	1,501
2004	898	601	1,499
2005	901	641	1,542
2006	837	678	1,515
2007	845	715	1,560
2008	846	713	1,559
2009	849	717	1,566

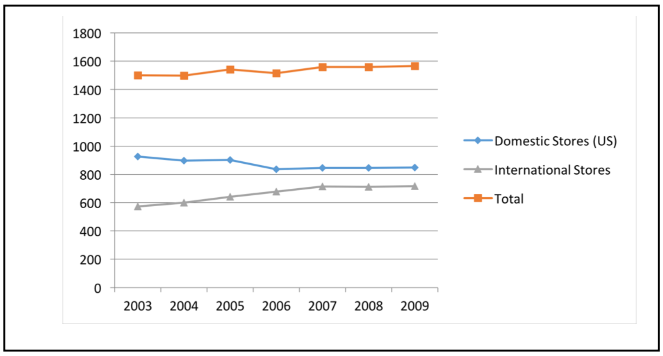

Figure 2. Store Trend

As Toys "R" Us is a retailer, the stores are made up of a bundle of particular resources that are key for the firm's business. In the context of private equity, Toys "R" Us has worked hard on the resources embedded in its stores during the first period of the post-acquisition (2005 to 2007). Over this period, there was a higher level of dynamicity within the stores' resources, this dynamicity decreased afterwards. This dynamicity was not displayed by just one sign; resources do not only decrease, and neither do they only increase. While they were reduced in the domestic market, they did increase in the international one. The company put in major efforts in this first period, during which the store's resources were mobilized with the highest intensity. Afterwards, the number of stores became more static. This does not necessarily mean that the dynamic capability was not working; stores were also transformed internally, changing from one kind of store to another. This happened in the first and last periods (2005 to 2007 and 2008 to 2009, respectively). The 2008 annual report stated:

Over the past three years, we have converted 111 existing stores into side-by-side formats and have constructed 27 new side-by-side and "R" superstores. We expect that our side-by-side and "R" superstore formats will continue to be our focus going forward and will eventually become the standard for all of our stores (TOYS "R", annul report 2008: 1).

This statement shows that dynamic capabilities continuously operate over time, changing the shape of the resources during the entire analyzed period. Nevertheless, they operated with a higher intensity in the first period, during which the largest amount of resources were built or destroyed, either in shutting down established stores or in starting new ones.

Websites constitute another unit that assembles several resources and capabilities which are core for a retail company. They have as much importance as the stores for selling in the current business environment. Table II shows the names of the websites used by the company to sell in the U.S. The table reports the websites for each year, while Figure 3 shows the number of websites available in each year.

The number of websites changed in 2006. During the year after acquisition, the company reduced the resources embedded in its websites. The number of websites remained the same in the following two years and increased again during 2009. Dynamic capabilities increased their intensity, generating resources embedded in the websites. These dynamic capabilities correspond to acquisitions of firms. According to the 2009 annual report (p. 19), "Commencing in fiscal 2009, we sell merchandise through our newly acquired eToys.com, FAO.com and babyuniverse.com Internet sites." The "acquisition dynamic capability" operates in the long run. In the last year of the study period, the company built new websites. In the context of private equity, it was compressing the resources embedded in the old websites, but then reconstructed other resources through the acquisition of other websites for the long term.

TABLE II. WEBSITES

Year	***Brand of the Websites***
2003	www.toysrus.com www.babiesrus.com www.imaginarium.com www.sportsrus.com www.personalizedbyrus.com
2004	www.toysrus.com www.babiesrus.com www.imaginarium.com www.sportsrus.com www.personalizedbyrus.com www.toysrus.ca
2005	www.toysrus.com www.babiesrus.com www.imaginarium.com www.sportsrus.com www.personalizedbyrus.com www.toysrus.ca
2006	www.toysrus.com www.babiesrus.com
2007	www.toysrus.com www.babiesrus.com
2008	www.toysrus.com www.babiesrus.com
2009	www.toysrus.com www.babiesrus.com eToys.com FAO.com babyuniverse.com

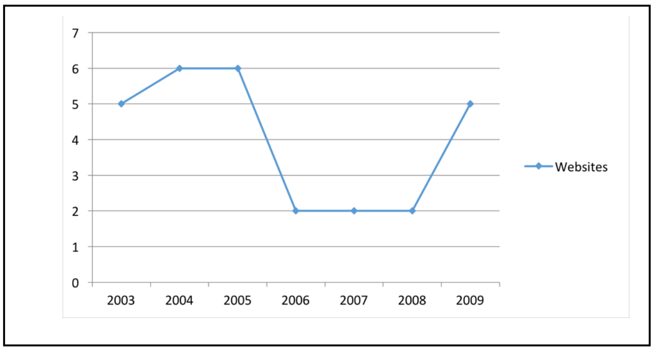

Figure 3. Website Trend

In any industry, many capabilities are embedded in the employees. As yet, human resources cannot be substituted by devices, as these cannot guarantee human flexibility and versatility. Data show that Toys "R" Us employs more workers in the holiday season, as shown in Table III and Figure 4, which compare these numbers with the "regular" employees.

TABLE III. EMPLOYEES

Year	*Number of*	
	Regular Employees	***Holiday Season Employees***
2003	65,000	113,000
2004	60,000	97,000
2005	59,000	90,000
2006	59,000	95,000
2007	72,000	110,000
2008	69,000	107,000
2009	68,000	114,000

The company reduced the number of its regular employees by 1.7% in the year during which it was acquired by the private equity. The holiday season employees decreased by 7.2 %. The company did not reduce by as much those employees having more competences, such as the regular employees, who are more familiar with the firm's routines. In the year after the acquisition, the number of regular employees did not change, so the firm did not lose the competences of its more skilled employees. Moreover, it increased the resources supplied by the second category of employees, who increased from 90,000 to 95,000. In 2007 the company empowered the competences embedded in the workers by hiring 13,000 regular employees and 15,000 holiday season employees. However, in the last two years, regular employees were reduced. Dynamic capabilities work in a way that generates new human resources in the first stages of the acquisition. The human resource policy aims to grow the firm's competences in the short run (2005 to 2007); it does not try to reduce the costs. The regular employees were reduced in the last years, but their reduction was not a priority

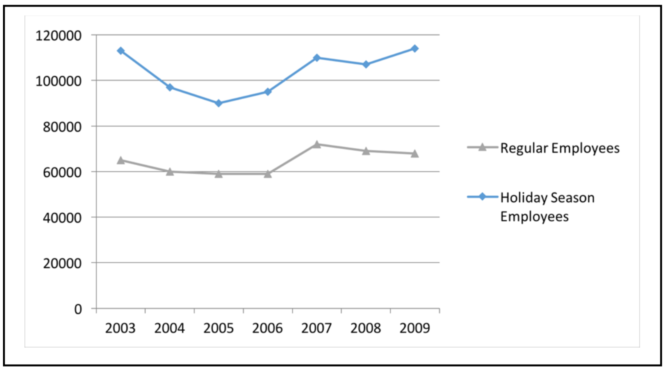

Figure 4. Employees trend

from the beginning. It is a policy oriented to the firm's growth rather than because of cost cutting.

From the data another resource emerges. It is the vendor service, consisting of a bundle of relations with vendors that sell the Toys "R" Us merchandise. This appears to be a central channel for selling products, and completes the resources embedded in the stores and websites in order to realize the firm's mission. Table IV shows the number of relations with vendors per year, while Figure 5 shows the trend of these relations over time.

TABLE IV. VENDORS

Year	*Relations with Vendors*
2003	2,000
2004	2,000
2005	1,400
2006	1,600
2007	2,100
2008	3,400
2009	3,700

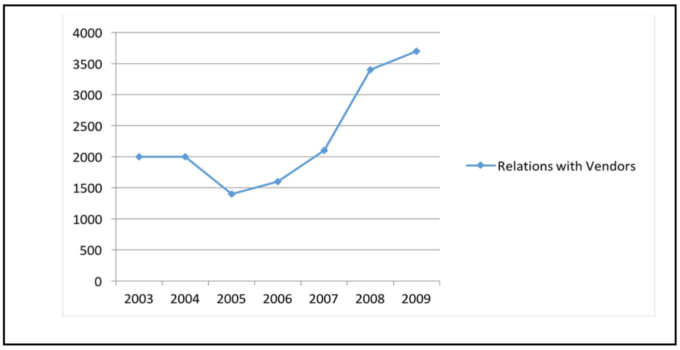

Figure 5. Vendor Trend

The relations with vendors were reduced in the year of the acquisition (2005); afterwards they increased every year and continued to increase in the long run. In the private equity context, the firm enlarged the bundle of resources enabled by the vendor relations.

There is an intermediate step between the buying process and the selling one generated by stores, websites, or vendor relations. This intermediate step is controlled through the distribution centers. They collect resources which are important for retail firms because they affect the value chain costs, which in turn affect the firm's competitiveness. The annual reports show the number of distribution centers in both the U.S. and foreign countries, which is illustrated in Table V, with Figure 6 representing the trends of the distribution centers in both markets.

TABLE V. DISTRIBUTION CENTERS

Year	Number of	
	Distribution Centers (U.S.)	***Distribution Centers (Foreign Markets)***
2003	12	8
2004	12	8
2005	12	8
2006	12	9
2007	10	9
2008	9	9
2009	9	9

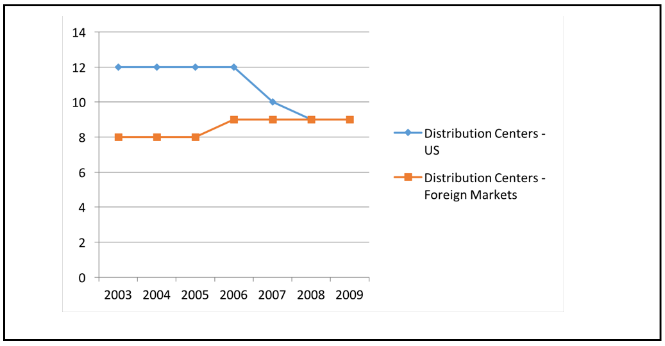

Figure 6. Distribution Center Trend

The number of distribution centers did not change up to the year of the acquisition (2005). Later, U.S. centers were reduced, while foreign distribution centers increased. On the one hand, the strategy formulation had been oriented to reduce resources in order to leave the most productive resources and eliminate the less productive ones. The company buys the services supplied by the eliminated resources, while outsourcing some other services: "During the fiscal 2007, we closed two distribution centers in the United States and have outsourced these functions" (TOYS "R", annual report, 2007: 12). On the other hand, the strategy formulation is oriented to potentiate the resources when they are allowed to improve the firm's performance. In the case of the distribution center, the dynamic capabilities operate in opposite directions in different markets. In the U.S. market the resources which are not useful are eliminated; in foreign markets, new resources are accumulated.

The data analysis also highlights trademarks as central resources for retail companies. They allow the customers to recognize the firm's products. These resources embed other intangible resources, such as advertisements or the quality of the products sold over time. Table VI shows the names of the company-owned trademarks per year, with the numbers and trend over time illustrated in Figure 7.

TABLE VI. TRADEMARKS

Year	***Number of Trademarks***
2003	Toys "R" Us® Babies "R" Us® Imaginarium® Geoffrey®
2004	Toys "R" Us® Babies "R" Us® Imaginarium® Geoffrey® Toysrus.com®
2005	Toys "R" Us® Babies "R" Us® Imaginarium® Geoffrey® Toysrus.com®
2006	Toys "R" Us® Babies "R" Us® Imaginarium® Geoffrey® Toysrus.com® Babiesrus.com®
2007	Toys "R" Us® Babies "R" Us® Imaginarium® Geoffrey® Koala Baby® The reverse "R" monogram logo The Geoffrey character logo
2008	Toys "R" Us® Babies "R" Us® Imaginarium® Geoffrey® Koala Baby® The reverse "R" monogram logo The Geoffrey character logo Animal Alley® Fast Lane® Dream Dazzlers® Especially For Baby® You & Me®
2009	Toys "R" Us® Babies "R" Us® Imaginarium® Geoffrey® Koala Baby® The reverse "R" monogram logo The Geoffrey character logo Animal Alley® Fast Lane® Dream Dazzlers® Especially For Baby® You & Me® eToys.com babyuniverse.come ePregnancy.com KB Toys

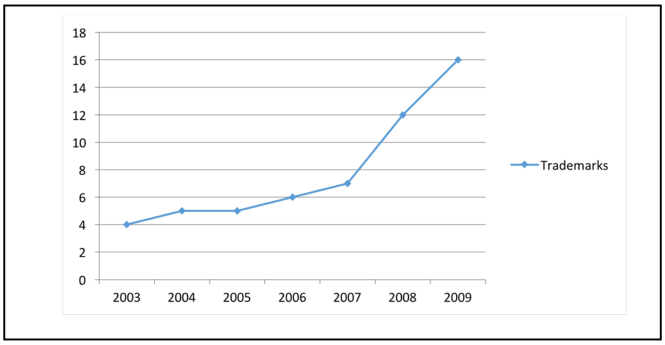

Figure 7. Distribution Center Trend

Toys "R" Us invests in trademarks within the context of private equity. Dynamic capabilities operate mobilizing resources, which generate new trademarks. One trademark (Babiesrus.com®) was added in the year after the private equity acquisition. In 2007, Toysrus.com® and Babiesrus.com® disappeared, but Koala Baby®, the reverse "R" monogram logo, and the Geoffrey character logo appeared. The number of trademarks increased, but two of them were cancelled. With regard to trademark resources, the dynamic capabilities improved their intensity in 2006, but they operated in two directions. In the first direction they worked "negatively," by eliminating some trademarks. In the second direction, they operated positively, by generating new trademarks. The strategy formulation mobilized the resources and reallocated them from one trademark to another, in expectation of a supposed higher productivity of the latter. The intensity of the positive force is stronger than the second one because Toys "R" Us generated more trademarks than those which were cancelled. The intensity of dynamic capabilities again improved in 2008: Animal Alley®, Fast Lane®, Dream Dazzlers®, Especially For Baby®, and You & Me® enrich the brand portfolio of the firm. It increased again in 2009.

V. Discussion

According to the resource-based view, firms build competitive advantage if they hold resources which: (i) are able to generate value for the customers; and (ii) cannot be reproduced easily by competitors (Barney, 1991). According to the dynamic capabilities theory, only if a firm holds dynamic capabilities can it sustain competitive advantages over time. Dynamic capabilities are processes which reconfigure the old resources or generate new ones (Teece, Pisano, Shuen, 1997). Resource-based view and dynamic capabilities are interrelated for several reasons. One of them is that the seminal paper on the resource-based view suggests that corporate strategy should develop the available resources invested in them. The investment should use the resources' potentialities to push the firm to enter new market segments to gain new business opportunities (Wernerfelt, 1984). As entrepreneurship is the process of discovering and generating business opportunities (Shane, Venkataraman, 2000), the media criticize private equities because they do not otherwise generate entrepreneurial development based on the creation of new products. According to the media, acquisition of target firms cannot feed the long-term growth which creates advantages for all the stakeholders (Weinberg, Vardi, 2006).

Nevertheless, the literature shows that private equities produce economic value and they will continue to play a central role in economic systems thanks to their operational engineering (Kaplan, Strömberg, 2009), which increases productivity (Davis, Haltiwanger, Handley, Jarmin, Lerner, Miranda, 2014). Operational engineering guarantees that the resources are used in a more efficient way, so productivity increases. The literature suggests that dynamic capabilities mobilize resources to improve competitive advantage. This paper's findings confirm that when private equities enter a firm's capital, strategy activates dynamic capabilities which mobilize resources. It is not possible to state that in a private equity setting the strategy operates without modifications and development of resources. Dynamic capabilities work, both in the short and long run—they actually try to generate long-term growth. Dynamic capabilities develop the original resources for expanding firms within the original market. The findings confirm that the worries about private equities' acquisitions are exaggerated. Actually, they encourage the development of the resources and the target firm's growth. At the same time, the findings suggest that corporate strategy could exploit the resources more. It could analyze the resources of the target firms and try to discover their potentialities, which could be used in other markets, thereby increasing value creation. Dynamic capabilities could use the old resources and they could integrate old resources with new ones in order to enter new markets populated by clients having different needs.

This paper is a first attempt to explore private equity-backed firms from the resource-based view and the dynamic capability perspective. As a single-case study, it has all the limitations of qualitative research. The case study's results could be tested on a larger sample by using quantitative methods, and future research could try to understand the target firm's corporate strategy more extensively.

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