

## Overcoming Exit Barriers

### 1.1 Abstract

Adverse strategic and economic factors prevent managers from making rational repositioning, downsizing or exit decisions, especially within mature or declining demand industries. Instead of avoiding irreversible commitments that could provide temporary competitive advantage, the power of exit barriers can be reduced by investing in flexibility when resources are first committed. If not, then activities akin to radical surgery may be required during the industry's endgame.

### 1.2 Definition

Porter (1976) identified exit barriers as being economic, strategic and/ or emotional factors that keep companies competing in businesses even though they may be earning low or even negative returns on investment. The presence of exit barriers contributes to an adverse industry structure where excess capacity is not retired (so price cutting becomes the prevailing competitive behavior as each firm that faces exit barriers tries to fill their respective plant to breakeven levels).

### 1.3 exit barriers

When exit barriers are high in an industry, distressed firms do not exit (so large firms that could invest in economically-sized assets are never created and smaller, local firms with old assets are handicapped vis-à-vis global competitors). Due to exit barriers, technological progress is impeded as old-fashioned technologies do not give way to newer ones. Exit barriers may also impede appropriate shifts in a firm's strategic posture (which often results in lost market share from a shrinking pool of customers willing to pay premium prices for increasingly less-desirable goods). Unless investments are made in anticipation of their devastating power, exit barriers can sap economic resources and managerial energies from a firm's more remunerative lines of business as trapped assets are being wound down and liquidated.

What creates an exit barrier?

Economic exit barriers can be associated with irreversible assets – e.g., specialized equipment for making paper – that cannot be easily converted to other uses or sold to competitors, except at scrap-metal salvage values (Hozl, 2005; Rosenbaum & Lamort, 1992; Shaanan, 1994). Their true economic value is zero, or very nearly so. They could in fact be negative if, for instance, plant closure required environmental clean-up which could otherwise be delayed or avoided. The exit barriers arise from the accounting losses that would be reported upon asset disposal. (Although write-off losses are typically tolerated by investors who want a turnaround to occur, managers often harm inherently-attractive operations through their reactions to exit barriers.) Economic exit barriers can also be “legacy costs” (e.g., pension and healthcare obligations that are owed to retirees, but unfunded-- as in the examples of firms in the steel, petrochemical and automotive industries), “remedial costs” (e.g., already mentioned clean-up costs associated with closing a facility that are mandated by environmental regulations -- as in the examples of the metals- or chemicals-processing industries) or “redundancy costs” associated with downsizing operations (e.g., labor expenses like the job-bank programs created for laid-off automotive workers). In cases where exit seems to be the profit-maximizing decision -- until the impact of associated exit costs is considered – exit costs can become exit barriers that are difficult to overcome because firms seeking to downsize or exit from distressed businesses may be unable to fund the costs of exit.

Governmental policies intended to maintain employment levels -- such as state ownership of facilities or state-level anti-closing laws -- can be exit barriers. Seeing that in the state of New Jersey, for example, redundant electronics workers were granted excessively rich medical stipends for alleged damage to their eyesight from doing close work, competitors calculated that they would report better performance results if they continued to run plants making obsolete generations of active electronic components that nobody wanted until all of their workers retired of old age (Harrigan, 1980b; 2003). Conversely government policies can force layoffs and capacity reductions as in the case of BAE Systems PLC when the Harrier and Nimrod were abandoned.

The height of a firm's strategic exit barriers will differ according to how particular firms have competed in the past. For some firms, exit barriers are uneconomic, long-term contracts that force them to provide goods and services that they would have preferred to eliminate from their product lines as in the example of insurance firms that are not permitted to abandon customers. Similarly, AT&T's obligation to support many, older generations of communications links (including, until recently, the analog systems that operated in parallel with digital telecommunications systems) was an exit barrier that harmed its performance. For other firms, strategic exit barriers are linkages between two or more businesses whereby reputational harm would be incurred to the ongoing business if capacity or services were reduced (or retired) within their distressed business. Vertical integration can be an exit barrier -- as in the situation where upstream exit from oil production was contemplated, but oil refineries could not obtain acceptable crude oil inputs elsewhere (Harrigan, 1985). Sometimes customers shared with other businesses within the corporate family can inhibit downsizing and exit (unless the needs of the shared customers can somehow be serviced even after the firm's uneconomic resources are retired). In non-declining industries, the apparent future attractiveness of an industry can act as an exit barrier because firms delay their exit -- hoping conditions will improve for them (Harrigan, 1982).

Emotional exit barriers originate with top management's rationalizations and ambitions and could constitute a form of agency costs, as in the example of Marks & Spencer closing stores across continental Europe. A particular product line may have been the firm's founding business and given the firm its name, e.g., General Mills from flour, Singer from sewing machines, or National Distillers & Chemicals from whisky distilling. In such cases, the founder and firm's Board often procrastinate when divesting that business. A CEO who may have ascended to power within a firm through the introduction of a particular product creates an exit barrier by preventing its deletion, e.g., a small appliance firm could not remove a waffle-baker product that homemakers no longer purchased from their product line until their CEO retired. Because disposing of a particular facility may require the employment of disliked family members in locations closer to the president's office, emotional exit barriers can make such changes be delayed indefinitely. In the face of emotionally-charged exit barriers, decisions to postpone the decision to downsize or exit must be refuted by clear and persistent evidence of recurring losses, as in the example of Renault's closing of its Belgian factory.

Who faces exit barriers?

Harrigan (1980a; 1980b) tested the effects of exit barriers using a sample of firms from industries facing declining demand (because competitors facing losses in that universe would be most likely to downsize, divest resources or exit outright). Losses encouraged exit, but firms possessing strategic traits that increased customers' willingness to pay premiums for their products -- characteristics like large market share, strong brand images, and reputation for high quality -- faced the highest exit barriers. In tests using industries facing slow-growth (or no-growth) demand, expectations of future industry growth was the strongest exit barrier (Harrigan, 1982). Faced with evidence that downsizing negatively affects

firms' performance, managers may procrastinate instead of shrinking excess capacity (Munozbullon, et al, 2010).

Mature firms operating within post-industrial economies are more likely to face exit barriers than are young firms – especially young competitors based in emerging economies with underdeveloped infrastructures. Older firms support more retired employees than active ones; past negotiated promises regarding pensions, healthcare insurance and other retirement amenities may cripple the competitive viability of mature firms facing spirited challenges from younger firms that have fewer retirees to support. Unless they have been relieved of their legacy costs via the bankruptcy court, older firms carrying such impediments to downsizing are typically be found in the steel, chemical, farm and industrial equipment, automotive and other older and often-unionized industries.

Firms that must support older generations of technology due to demand from laggard customers are more likely to face strategic exit barriers than do competitors who can continually migrate their customers to new technological systems for providing the same goods and services. For example, incumbent local exchange carriers (ILECs) must support wire-line telecommunications services even as the majority of telephone calls are being placed via wireless communications devices. By contrast, firms that lease their products and services to customers – firms like Cisco Systems – can overcome perceived exit barriers associated with product quality and customer service by migrating their installed base of customers to the latest generation of technological products that they offer.

Distressed firms of all ages face exit barriers when the burden of servicing excessive debt makes them insolvent and a thin market for selling their assets exists. Increasingly, economic exit barriers to corporate restructurings are overcome by using Form 363 acquisitions out of Chapter 11 bankruptcy filings to confront management's past inefficiencies and expedite the recovery process (Ayotte & Skeel, 2006). For example, the 2009 reorganization of General Motors facilitated the closing of six automotive factories, idling of thirteen additional plants, divesting of several parts businesses and elimination of several brands. (Ownership of GMAC was partially divested to Cerberus Capital in that restructuring.)

### Overcoming exit barriers

In anticipation of the harmful effects of exit barriers, firms can take proactive steps to increase their subsequent strategic flexibility (Harrigan & Porter, 1983). Competitors can be encouraged to retire redundant resources by purchasing their excess capacity and destroying it (to avoid its re-sale to would-be, offshore entrants). Obligations to supply long-term customers can be satisfied via private brand manufacturing arrangements with ongoing firms that will allow downsizing competitors to maintain a market presence for their brand (while reducing excess capacity pressures to engage in price wars). If the business unit is healthy, as in the case of Rexam's closures business, outright divestiture may be possible. Incremental divestitures can be accomplished using fade-out joint ventures that operate until the demand faced by both owners is no longer large enough to fill the remaining facilities to breakeven levels of operation.

Future strategic exit barriers can be reduced by de-integrating vertically-related businesses and requiring both business units to sell (or buy) increasing proportions of the products in question on a merchant basis (or as spot purchases) thereafter. Economic exit barriers can be reduced by periodically discussing the sale of germane assets with salvage firms (and taking the impending hit to earnings earlier by revaluing such assets accordingly -- to mitigate the exit barrier-like impact of future write-off losses on disposal). Employee training programs can increase the marketability of workers that would

otherwise incur redundancy costs when their jobs are eliminated, thereby reducing another potential source of exit barriers.

Finally governmental agencies (like the U.S. Pension Benefit Guarantee Corporation in the U.S.) or programs (like the Troubled Asset Relief Program) can assist firms with confronting employee-related or other forms of economic exit barriers – especially where entire industries are trapped by such exit costs and cannot fund them. National policies for dealing with “sunset industries” might develop additional programs for enhancing the competitiveness of leading local firms while expediting the downsizing of weaker ones that are trapped in distressed industries. Results suggest that anticipating and defying exit barriers improves returns on investment, as well as enhancing allocative and technological efficiency.

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