[SAMPLE] Lecture Five: Partner Selection & Governance

Today we consider the link between partner selection/characteristics box with the governance and structure box [including relational governance] in the ISA framework.

Note on ISA: CSD is the core critical sociological dimension, it is the trust element that glues everything together and allows us to reduce transaction cost, and maybe substitute or complement for contract. Also, better your governance, the better the stability/performance of the alliance!

Motivation
Issues in Joint Ventures and Strategic Alliances https://www.youtube.com/watch?v=OMXQ91AVWi8

- There is a difference between M&A and alliances - and if you're good at both, you will be the leaders of tomorrow. The approach and mentality is different.
- M&A - you have control - "my way or high way", you can change course (change culture, management, strategic direction etc.)
- JV / alliance - have to collaborate, if you go cross-border it is quite different, requiring meeting of minds for goals and objectives, management and culture. You need to consider how long you are going to run the JV for, have a mentality of sharing, learning and benefiting from JV activities, and also, before closing/signing completing alliance, issues and flexibilities need to built-in to the design so that key stakeholders have anticipated challenges, making the framework of alliance and decision-making the more successful.
    - Summary: Figuring out what is going to happen in the relationship and sorting all this before signing contract [governance and structure] relates to partner selection (and is about trust)! We explore this today!

Formal governance and all contracts are inherently incomplete; therefore, we need to ensure that we have good **relational governance** (essentially, trust so that w/o going to court you can solve problems)

Partner Selection x Governance

- May be about searching for complementary resources (RBV)
- May be about **mitigating appropriation concerns** (TCE)
    - You can do this by contractually securing an investment to reduce costs, but it increases monitoring costs!
    - Selection process is an alternative to control - that is, you can find a good partner that you can *trust as a substitute to long contracts*.
        - More time/costs on selection, less time/costs on contract and monitoring - reducing need for governance!
        - ***Generally, longer contract means less trust and less effort put into finding right partner.***
        - Therefore, search effort should increase with risk!
        - Better understanding of outcomes help dictate what governance is needed e.g. motives and goals shared

Contract Functions (type of control):

- Safeguarding and incentives (TCE)
    - Under what conditions will you choose one contractual agreement over another (licencing, JEV, etc.)
        - Relates to coordination cost, monitoring cost, appropriation costs, etc.
- Coordination, adaptation and communication

- Knowledge repositories
- Signalling commitment
    - More you write into contract, the more equity involved, the more you signal long-term agreement to marketplace
    - Contractual clauses / dimensions relate to different functions - for example:
        - Should be task-related and specify which part of the value chain is part of the agreement, what isn't part of the agreement
        - Litigation clauses e.g. settle in International court and not a Chinese court; arbitrage first, etc.
        - Geographically related: e.g. JV can only sell in China

Other Control Mechanisms:

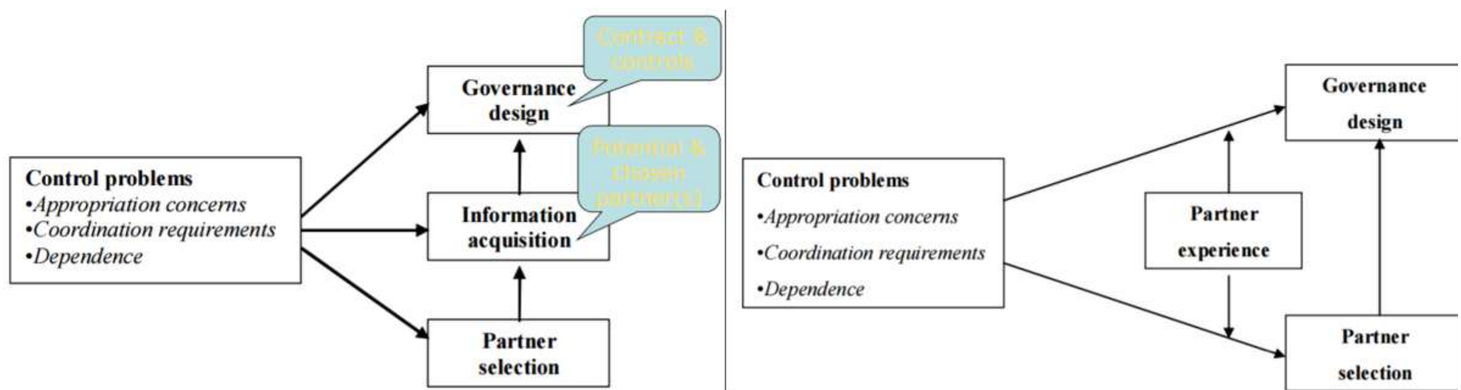
- *Rotation of mid/top management teams*
- *Build in specific alliance units* - e.g. cross-functional, etc.
- *Relational Governance* - determines what happens day to day so that you don't need to keep going to contract [trust]
- Therefore, these control mechanisms allow for day-to-day basis of monitor and control without the need to rely on contract
    - Generally, relational governance is about building common commitment and being on the same page
    - Relational contracting is very loose as doesn't have clauses, but more important than contract
        - Related to partner selection so you can select partner you know enough about in terms of similarity and complementarity
        - Example: **reputation** is a good mechanism - this is a signal that firm in past has done something very good (linked to brand) - if it stands more to lose from breaching alliance, then good signal they won't do that - e.g. Microsoft and IBM will be good partners!
    - Case study: look at what other mechanisms are in place:
        - Are they building trust and/or relationship
        - Mutual commitments e.g. in terms of financial resources, etc.

Control Problems in Alliances:

- They are the drivers of governance choices.
- Role of trust is important in relational risk and performance risk.
- Think of this as a continuum from market transactions to hierarchy (M&A with full control) - and anywhere in between, you won't have full control and need to trust each other (goodwill to do what they promise) with chance of opportunism leading to concerns below:

- *Appropriation concerns (goodwill):*
    - ***TCE tells us when to go for more hierarchy and governance - i.e. when risks/uncertainties are higher, you want higher hierarchy and more governance.***
    - Value appropriation (who gets what) vs. value creation
    - ***If outcome is learning and exploration, then rigid contractual governance structure is not conducive because the more rigid the controls of the contract is, the less flexibility there is to go above and beyond / innovate***.

- Contracts reduce flexibility!
- *Coordination requirements (capabilities):*
  - ***Task interdependencies***: how complex are tasks to coordinate and manage, how many value chains are we organising.
  - Alliance structure, management and monitoring
  - ***Longer the contract, the more you need to contract. However, if contract is clear then perhaps no need for coordination.***
- *(Inter)Dependence:*
  - Power asymmetry issues (beyond the transaction)
  - e.g. large firm vs. small firm; critical supplier
    - Power related to importance, not size!

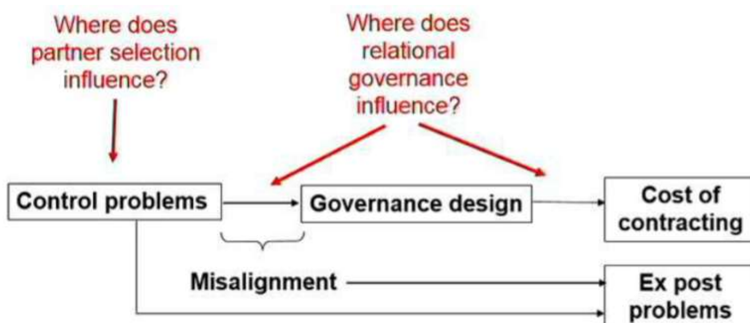


Notes from these diagrams:
- **Uncertainty here is key:** how can partner selection reduce need for governance by reducing uncertainty?
  - Argument is about information [between governance design and partner selection] as per diagram to reduce uncertainty!
- *If we know appropriate concerns is low, then uncertainty may be low [we can attach some probability to it based off reputation and repeated repetition as well as other info we know]. We can match tasks that then reduces coordination requirements and so we don't worry so much about building in securities through equity. We can also be unafraid of dependence if we are in long-term relationship stipulated in contract.*
  - Example: If dependence is so high, we are making specific investments for Toyota, so make contract to be long term focussed, such as 40% equity stake in company. Invested in them, so won't drop them
  - **Asymmetrical information issues** e.g. don't know anything about company in Laos - then might choose higher equity stake [assume high uncertainty].
- **How does selection process affect governance?**
  - **Information acquisition**: on partners [resources, HR, financial assets, marketing potential, ownership structure, value chains, low to high scale in favour of me trusting me more]
  - **Confidence generation**: rate whether info. is reliable from 1 to 5.
  - Based on criteria, information and uncertainty, develop governance choice!

- Sometimes you have multiple good partners then question becomes matter of which uncertainty is most important to me (appropriate or dependency, etc.) then link to information you have and look at its reliability etc.

- **Prior Experience Diagram:**
  - Gives information that could reduce a lot of uncertainties but just because something happened in the past does not necessarily mean it will affect future!
  - Example: many biotech and pharma firm do JV where biotech develop drug and pharma distributes worldwide. Pharma may then know them well and want to do more strategic alliance in R&D. But then while biotech knows pharma very well and trust them in marketing new drug, they can't trust them in R&D sharing and as a result this often leads to M&A instead.
  - Implications:
    - Searching pool with people you know and limiting your pool means search cost reduction and increase search efficiency
    - Less governance for appropriation concerns (with prior experience), but more governance for coordination (more complexity with prior experience) --> **no clear link between prior experience and governance**!
    - More **Trust & Ties** - *but is trust always good*?
      - How much do you trust '**weak ties**' (higher degree friendships / referrals) because you really know nothing about previous tasks completed (e.g. your babysitter may be good at babysitting problem child but not good at babysitting your child). BUT, it expands your network greatly!
      - **Implications of Trust on ISA**:
        - Overconfidence in firms or people
        - Trust becomes a liability - too much trust builds in inertia, lack of innovation, lack of incentive to do something extra
        - But trust and governance links to more information and decreases uncertainty on partner and their intention!

Performance Effects of Governance

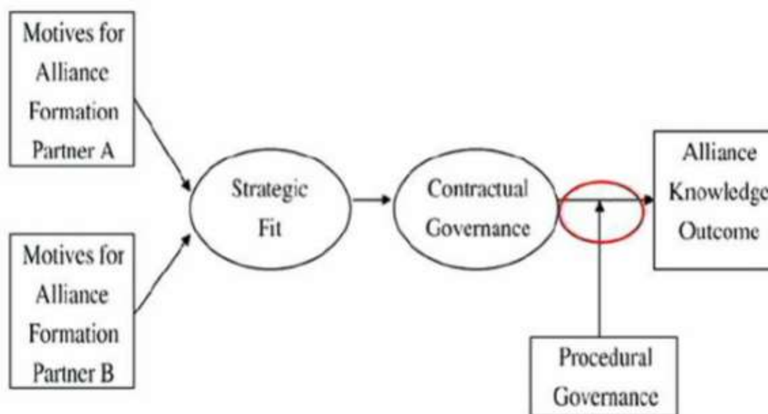


- Ex-post alliance problems affects stability of alliance and performance of alliance
- Lesser governance seen as trust or have contract then build trust so there's less monitoring costs later
  - Look for signals of mistrust in cases - e.g. benefiting themselves in certain ways, culturally not on same page on, misalignment, M&A down the line - as this increase cost of monitoring contract
- *Evidence from IT services sector (see readings)*:

- Are contracts complementary to relational governance/trust (i.e. reinforce performance) or substitute (so if there is lack of trust then need more contracts)?
- Findings: Increasing customised contracts is coupled with increasing relational governance
- **Complementary governance fosters performance**

Relational Governance

- How are governance and selection choices affected by informal (relational) controls? Trust.
- How to maximise success from forming alliance? PwC https://www.youtube.com/watch?v=quro-XmK-n0
  - Due diligence: understand motives and goals of partners even though they be different, understand why they are different, building trust, e.g. up/down integration enhances economies of scale/scope or creates barriers to entry, if it is entry to market then looking at culture or discipline, etc.
  - Moving faster and thinking differently
  - You want partners who are not the same, but complementary - and the core element bounding partnership together is trust
  - Trust connects the four boxes of ISA framework together as there is a lot of information asymmetry
    - Picking partner from existing ecosystem - search cost, monitoring costs, risk reduction, etc.
  - Note: as amount of differences grow, more trust is needed - since it is correlated with uncertainty - size, nationality, etc.



Source: Nielsen, 2010

- Framework above link motives to strategic fit, shows how strategic fit influences contractual governance, and how outcome is moderated by procedural governance / relational governance!
- Note: the red circle is where trust plays in, and is also the CSD in ISA framework!

Repeated Exchanges and Trust

- Development of **relational trust comes from** the promotion of social norms and values, routines, prior ties, social embeddedness, partner experience / reliability / competence.
- **Effect of Trust on Selection and Governance Choices**: economising on or improving control, information availability, moderating influence on control problems [basically all addressed above already]
- TCE does not talk about repeated ties and assumes each transaction unique, which is clearly not true - therefore, **relational governance reduces a lot of transaction cost**.

- Under which conditions are trust and control *substitutes or complements*? It depends on where you are and the magnitude of investment, etc.
- *Cost of trust*: setting up control, what does it cost to maintain and build trust, **hard to build, easy to break**
- **The type of trust at play in picking partners is different to that at early stages of partnership and different to that in the monitoring stages!**
    - Types of trust below - note, in future, need to identify specific type of trust and not just 'trust' in case study! *Hence, this article is extremely important.* **SOURCE: NIELSEN 2008**

Table 1. Types and roles of trust in alliance research.

Type of trust	Theoretical grounding	Definition	Dynamic role of trust		
			Antecedent	Moderator	Outcome
Cognitive-based or fragile trust	*Rational prediction* sociology/ psychology	Assessment of reliability is based on past behaviour and cognitive reasoning (Lewis & Wiegert, 1985)	Partner selection as function of prior (positive/negative) experiences	Reduces reliance on formal (contractual) control and monitoring mechanisms	Procedural governance leads to sharing of broad-based, explicit knowledge; reinforces cognitive-based trust and may lead to affect-based trust
Calculus-based trust	*Rational choice* economics	Trust emerges when the trustor perceives that the trustee intends to perform an action that is beneficial (cost/benefit) (Lane, 1996)	Partner selection as function of perceived cost/benefits of alliance to partner	Increases reliance on formal (contractual) provisions and monitoring mechanisms	Contractual governance leads to sharing of narrow, predefined codified knowledge; reinforces calculus-based trust and may lead to deterrence-based trust
Deterrence-based trust	*Utilitarian* economics	Enables one party to believe that another will be trustworthy; cost of breach of trust exceeds any potential benefits from opportunistic behavior (Ring & Van de Ven, 1992, 1994)	Partner selection as function of fear of defection and sanctions	Increases reliance on formal (contractual) provisions and monitoring mechanisms	Contractual governance leads to sharing of narrow, predefined codified knowledge; reinforces deterrence-based trust
Affect-based trust or resilient trust	*Emotional prediction –* sociology/ psychology	Non-calculative reliance on the moral integrity, or goodwill, of others based on emotional bonds between individual and social interaction (Lewis & Wiegert, 1985)	Partner selection as function of individual ties (often among top managers)	Reduces reliance on formal (contractual) control and monitoring mechanisms	Relational capital leads to sharing of broad-based, explicit knowledge; reinforces affect-based trust and may lead to cognitive-based trust
Competence-based trust	*Rational choice* economics/ RBV	Trust emerges as a function of the partners ability and expertise to perform certain tasks (Mayer *et al.*, 1995)	Partner selection as function of assessment of task- and partner-related criteria	Adaptive coordinating mechanisms may replace contractual controls; formal monitoring mechanisms remain in use	Competence-based trust may emerge as an outcome of successful transfer of knowledge
Institution-based trust	*Conditional* institutional economics and sociology	Institutional factors act as conditions that sustain further risk-taking and trust behaviour (Globerman & Nielsen, 2007; Gulati, 1995)	Partner selection as function of assessment of (formal and informal) institutional risks	Decreases reliance on formal (contractual) provisions and monitoring mechanisms	Institution-based trust may emerge as an outcome of successful collaboration in a particular national (regional) context

- Extra Notes on Types of Trust:
    - Cognitive - past behaviour, *less contractual, more relational*
    - Calculus - based on TCE, cost-benefit approach, not gaining benefits, but reducing risk, *high contract and more monitoring* to see if you are actually getting financial benefit
    - Deterrence - building barriers from distrustful activities
    - Institutional-based trust: e.g. you trust dentist based off university institution they graduated from (maybe should do some due diligence to know whether they are a dentist!) or government

Differences in Partner Selection Criteria Based on Culture

- Traditionally we look at Western vs Asian approach, but this is now outdated stereotypes as there are many countries there, and within those countries, regions and cities that all have very different cultures.
- ***Generally, concept of trust may differ esp. as strategic rationales (motives) differ from place to place due to culture. The culture then impacts partner selection criteria, which then impacts governance structure.***
- <u>Example</u>: US (very TCE focussed) vs. Korea (exploration and learnings focussed)

Partner Selection Criteria Used by Korean and U.S. Executives
(In Order of Importance)

Korean Executives	U.S. Executives
1. Technical Capabilities	1. Financial Assets
2. Industry Attractiveness	2. Managerial Capabilities
3. Special Skills You Can Learn from Partner	3. Capabilities to Provide Quality Products/Services
4. Willingness to Share Expertise	4. Complementarity of Capabilities
5. Capabilities to Provide Quality	5. Unique Competencies Products/Services

Alliance Negotiation Strategies and Tactics

	The Power Game	The Trust Game
Modus Operandi:	Create fear	Create trust
Guiding Principle:	Pursue self-interest	Pursue what's fair
Negotiating Strategy:	Avoid dependence by playing multiple partners off against each other.	Create interdependence by limiting the number of partnerships.
	Retain flexibility for self but lock in partners by raising their switching costs.	Both parties signal commitment through specialized investments.
	Primarily unilateral	Bilateral
Communication:	Through coercion	Through expertise
Influence:	"Closed," or formal, detailed, and short-term	"Open," or informal and long-term
Contracts:	Use competitive bidding frequently	Check market prices occasionally
	Reduce conflict potential through contracts	Reduce potential by selecting partners with similar values
Conflict Management:	Resolve conflicts through the legal system	Resolve through mediation or arbitration

- **Clearly, negotiation strategies change from different countries as influenced by culture as well as industry environment - e.g. in case above, to create fear vs. trust**
- *LT relationship focus means trust is important, ST gains focussed [manager assessed every 3 months for quarterly earnings require ST gains] then relationship with ST benefits is more important so you monitor and control partner to extract/appropriate as much value as possible.*
- *LT: build in equity and co-own (e.g. Toyota) so it will be stupid to take them (yourself) to court)*
- *ST: go to court, JV is over, no more trust. The minute you wrong, I assume bad intentions!*
- This all points to the role of culture in negotiation strategies (see below), all of which either have creation vs. appropriation focus, and impact the governance mode!

TABLE 4.1 Negotiation strategies and tactics

	Description	*Tactics*	*Implications*
Collaborating	Primary concern for individual and partners' interests; focus on problem solving	Primary focus on soft tactics to build high quality working relationship; hard tactics only employed to defend interests	Strengthening of preexisting relationships; preventing conflict escalation
Competing	Primary concern for individual interests; focus on imposing outcomes on counterpart	Focus on hard tactics to exploit power advantage and obtain compliance	Jeopardizing long-term relationships; conflicts that are costly to resolve
Avoiding	Limited concern for individual and partners' interests; focus on neglecting negotiation	Limited use of tactics	Integrative solution is not achieved, likelihood of premature dissolution
Accommodating	Primary concern for partners' interests; focus on compliance with counterpart's demands	Primary focus on hard and rational tactics to deal pre-emptively with counterpart's demand	Short-term success, but risk of exploitation remains because an integrative outcome is not achieved
Compromising	Moderate concern for individual and partners' interests; focus on quick consensus solutions	Primary focus on rational tactics to obtain compliance	Short-term success, but fundamental issues persist as the alliance progresses

Sources: Das and Kumar (2010); Lax and Sebenius (1986); Rao and Schmidt (1998).

Who should negotiate?

- Generally, top management teams (CEO/CFO), corporate lawyers, alliance management, experts, get involved. *Problem is when people doing most of the operational work (e.g. marketing alliance would be marketers) are not involved in the negotiation process*.
- Therefore, depending on the task of job, **you want to involve different people that can produce an appropriate alliance design and contract around the task that needs to be done**. Iron out from beginning what actually needs to take place based off tasks and not actually lawyer type stuff!
- Example: science firm + GE Medical proposed JV. First meeting, GM Medical brings four lawyers who talk about reduction of risk, clauses [if and when XYZ goes wrong, how do we litigate], and disallowed anyone from science firm going to GE Medical to learn about stuff. This immediately took away trust and JV did not go ahead as all they wanted to do was appropriate technologies of science firm.

READINGS SAMPLE

Week 3: Global Strategy, Competence-Building and Strategic Alliances

Lei, D. & Slocum, J.W. 1992, "Global strategy, competence-building and strategic alliances", California Management Review, 35(1), pp. 81-97.

Companies must learn to:

- Utilise strategic alliances as vehicles for learning new technologies and skills from their partners
- Protect themselves from being deskilled / hollowed out
    - *Deskilling*: external dependence for components, supplies, new designs and technologies
- Collaboration within alliances → competition in learning new skills and refining firm capabilities in other products and processes

Alliances, learning and new sources of competition:

- Technological Interrelationships
    - Intended to share costs, reduce risks, obtain economies of scale, gain access to new markets
    - **BUT costs of sharing technology/skills outweighs potential benefits**
    - Sharing risks/improving cost position → both partners share knowledge and technological skills, BUT there are few products, designs or processes that are limited to a narrow product/market scope
- Faster Learning
    - Difficult to seal off unforseen opportunities for a partner to learn about a firm's technologies in an alliance
    - Tacit information and knowledge that can't be easily expressed in writing is passed on in day to day contact
    - **Greatest potential for fast learning is at the plant/design site where the employees of the two firms interact daily**
    - Every alliance mechanism gives an opportunity for partner to learn core competencies and skill sets
- Outsourcing and Supply Arrangements
    - Alliances may be creating new competitors as firms depend on their partners for production / technologies that are important sources of organisational learning
- Collaboration as Competition
    - In many instances, alliances are not intended to survive for more than a few years
    - Core competencies and knowledge will deteriorate in the host firm and grow in the alliance partner

Building Initiative: Core competencies and the indirect approach:

- Building *initiative*: Firm's ability to direct resources that build and refine core competencies, skills and capabilities in a way that creates competitive advantage. Initiative allow firms to choose its own growth path and free to manoeuvre in fast-changing environment.
- Elements of *initiative*:
    - Continuous organisational learning focussed on core competencies
    - Develop multiple, overlapping technologies & skills into future gen of new products
    - Redirecting corporate focus away from product/performance characteristics and towards upstream activities and skills
- Stages of surrender *initiative* (or growing dependency):
    - Stage 1 & 2: firms seek to reduce costs look to outsource simple assembly and low-value added, labour intensive tasks/components into other countries
    - Stage 3: Manufacturing/assembly of key components abroad (including core components/items representing the essence of product)

- Stage 4: Turning point. Domestic firm loses initiative and foreign partner ascends into commanding position in technology and manufacturing (have the skills)
- Stage 5 &6: growing disarray – firm has lost its initiative to learn
- Stage 7: complete exit/divestiture of business

Strategic Control:

- Some strategic tools create the *illusion of building a competitive advantage*, but actually encourage managers to enter into alliances too quickly → *undermine corporate efforts to focus on and renew core competencies*, discourage careful thinking and strategizing of prospective partners' intentions
- Separating design from manufacturing and marketing:
  - Fallacy in outsource decision thinking design, manuf. & marketing are separate tasks
  - In many products, design and manufacturing have become so tightly interwoven that development and commercialisation happen in one seamless value chain
  - Organising value-added tasks allows the firm to engage in faster learning, if you outsource some activities you may give your partner insight into the firm's operations somewhere else in the value chain
- Product Portfolio Matrices (e.g. BCG):
  - Competitor analysis tools may damage corporate efforts to rebuild competitiveness
    - Does not account for converging technologies and growing interrelationships
    - Direct attention to products sold by firm, not necessarily those manufactured
    - Dependency on alliance, weaken strategic position, ST-results/cash flows
- Divisional and SBU Organisational Lines
  - Firms that organise themselves along SBU lines often encounter greater difficulty in building the necessary critical mass to justify investments in converging/related tech
  - Corporate organisation design for SBU may encourage managers to partner with alternative divisions/headquarters.
  - Each division of the corporation becomes vulnerable to predatory alliance partners willing to exchange financing/markets for learning/technology

Using Alliances to Renew Competitive Advantage

- Defining core business:
  - Alliances represent a temporary alignment of interests at that moment
  - Value of partners' contribution is relative, not absolute
  - Successful alliances: companies who understand their core competencies and how a particular alliance might extend this
  - Over time, should be able to detect a future partners' willingness/determination to learn. The more willing → the more intent to eventually enter and seize the initiative from the original firm
  - Alliances can limit the firm's future strategic discretion
- Human Resource Practices:
  - Boost short term financial results by hiring less people and for a shorter time period
    - Shorter corporate memory, no base for sustained learning
  - Shorter time frame limits ability to learn tacit knowledge only learnt through continuous exposure and practice
  - Key competitive advantage to attract talent from anywhere in the world
    - Systematic international management development system is vital
  - Ignorance and lack of experience → root of alliance problems/failures
    - Having 51% = having legal control, but if managers do not have a deep understanding of their alliance partners' dreams/or own → irrelevant
- Lean superstructures
  - Global headquarters become meaningless once an alliance has been formed.
  - More about the managers in the alliance responsible for the specific strategy and coordination with responsible departments
  - Value-driven super structures should oversee day to day operation

    - <u>Shared resources</u> should be organised as profit/cost centres
    - Horizontal structure replacing traditional functional based form. Work is structured around business processes (e.g. new product development, manufacturing technologies, integrated logistics etc. rather than functional expertise)

Summary:

- Successful alliances → identifying core competencies of both partners, developing strong interpersonal skills and values needed to mange them
- Need to see alliance as an integral part of corporate strategy, a long-term initiative, focus on learning from alliance partner about the industry or how to successfully build a competitive advantage → collaboration to competition
- Successful companies → alliance partner can help achieve company goals in long-term by being focused, know specifically how to contribute and learn from alliance → clearly knowing this before structuring alliance and reward system

<u>Week 3: When to think alliance</u> :

Ernst, D., & Halevy, T. (2000). When to think alliance. McKinsey Quarterly, (4), 46-55

- Large alliances move share price, market capitalisation and create shareholder value
    - Big deals attract more scrutiny in the market
    - Companies are more likely to invest significant management resources in thinking through strategic alliance (strategy & communicating purpose of deal to public)
    - Managers involved in big alliances are more likely to follow lessons / literature advice
- Alliances are better received than M&A in fast moving, highly uncertain industries (electronics, mass media, software) – *share price move up more probably than in M&As*
    - Vast majority of alliances are either win-win or lose-lose
    - Alliances allow media companies to leverage content, enter new geographies, place several bets rapidly I alliances are simpler, less costly and reduce risk
- Alliance for growth: alliances are preferred for companies trying to build new business, enter new geographies, or access new distribution channels
    - New business → new capabilities: products, customer relationships, tech, etc.
    - Alliances can help expand sales through new distribution channels
    - Alliances can help expand sales by entering new geographies
- *<u>Contractual alliances</u> (simple, flexible) are **better received** than <u>equity joint ventures</u> (more complicated – see below)*
- Network and consortium: Multi-partner alliances tend to be well received
    - Not necessarily disadvantageous to any party
    - Can give parties targeted access to specific assets of the firms
        - M&A can be impractical if 3+ partners want to combine some of their assets as transaction costs are huge, disruptive to operations
    - Attractive for setting standards (e.g. getting system adopted by industry)
- Many successful companies use alliances to <u>position themselves at the centre of a network</u> → leverage intangible capital (e.g. R&D, distribution) w/o owning many expensive assets
- Market prefers simpler and more flexible deal structures – KEY TAKEAWAY!!!
- Joint ventures are *less popular* / less well-received than alliances
    - Take longer to start as it is a completely new company
    - Requires complex governance structures, commitment/time from senior management
    - Don't last forever and exit costs can be high
    - Analysts are often sceptical of deals that complicate firm's future strategic options
- Too many managers approach deals with an acquisition mindset, should be more open to alliances