Small firms face unique renegotiation challenges

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Strategic alliances are vital to almost every type of organization, but what about small firms?

One thing is certain: alliances are critical for small firms. A new paper on this subject affirms that alliances allow small firms to "tap into new markets, access scale economies, obtain complementary resources in underdeveloped value chain activities, respond to environmental uncertainties and receive endorsements from reputable incumbents." Such benefits are essential to small firms' growth and success, say the authors.

In "Alliance Dynamics for Small Firms," Africa Ariño, IESE professor of strategic management, together with professors Roberto Ragozzino and Jeffrey J. Reuer, examine the nature of small firms' strategic alliances and evaluate the benefits, challenges and obstacles small firms face in making sure that alliances serve them effectively.

While researchers have tended to focus on the implementation and termination of alliances, these authors are more interested in following the alliances' evolution and dynamics. Alliances change, just as companies do, and such changes in small firms are quite different from those in large firms. Alliances are neither easy to manage nor unequivocally positive, and small firms must overcome a unique set of challenges, they say.

Hazards for small firms

It's worth examining why an alliance might face contractual changes. Small firms are often inexperienced, have limited resources and may be prone to misrepresenting their abilities

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when establishing the collaboration - all of which suggest that ex post adjustments will be very necessary for small firms.

But small firms do not always have the desire, or the ability, to make such adjustments.

The authors highlight two main transaction cost arguments that influence contractual renegotiations, which they say are imperative to a study of renegotiations.

First, "firms may renegotiate an alliance to alleviate inefficiencies stemming from the initial design of the collaborate agreement." In short, governance misalignment.

Second, "a firm may be willing to renegotiate an alliance when it has made significant transaction-specific investment in an alliance and its partner recognizes the opportunity to hold up the firm and appropriate this value."

Governance alignment is a tricky area, since there is no universal governance structure that will suit all alliances all the time. Transaction cost theory offers two possibilities for choosing a governance structure: discriminating alignment, which means that "the efficiency of a transaction will be positively related to the alignment between the chosen governance structure... and the fundamental attributes of the transaction"; and selection approach, in which "efficiency implications are drawn from reduced-form models of firms' governance choices."

An ideal governance structure is hard to come by on the first try, which can lead to the need for renegotiations. For example, excessive governance may impede a simple alliance, while insufficient governance may complicate a complex relationship still further.

Small firms may also face the need for renegotiations because they find that changes are being forced upon them. In this case, renegotiation is "a manifestation of hold-up behavior."

If a small firm has made transaction-specific investments, its partner may stand to benefit from renegotiations. In this case, "the gap between these assets' first and second best use values provides motivation to incur ex post costs to renegotiate the alliance's terms rather than lose the difference in value for resources deployed to the alliance."

If a partner sees the chance to capture value from increased assets, he or she will likely push a small firm to renegotiate. Hold-up and opportunism are, therefore, hazards of strategic alliances for small firms.

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Similar rates yet different experiences

These reasons for contractual renegotiation lead to a few questions:
Will small firms recognize governance misalignment when it occurs, and understand the need to renegotiate? How susceptible are small firms to alliance hazards such as opportunism and hold-up, and how willing or able are they to handle the related renegotiations? And how does the behavior of small firms on these issues differ from the behavior of large firms - if at all?

Two main hypotheses shape this research: that "the positive effect of governance misalignment on the likelihood of contractual renegotiation will be lower for small firms than others." And that "the positive effect of asset specificity on the likelihood of contractual renegotiation will be higher for small firms than others."

In both cases, the research shows that small firms and large firms are more or less similar in how they experience strategic alliances, and they tend to engage in renegotiations at a similar rate.

Yet what also emerges is that small firms do face unique experiences in forging strategic alliances. The results emphasize the importance of transaction cost theory when evaluating governance decisions. And transaction-specific investments do stand out as an important element in alliance dynamics.

This research on small firms, alliance dynamics and contractual renegotiations paves the way for more extensive research in this field. No matter what direction future research takes, a thorough understanding of strategic alliance dynamics will help small firms navigate these potentially fraught waters - and will give them the ability to manage alliances in a way that will serve them fairly, lucratively and successfully in the future.

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