The sources of value creation in buyer-supplier relationships

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Abstract:
The buyer-supplier literature emphasizes that collaborative relationships result in higher value creation. However, few studies had empirically tested the way how this value is created in different types of transactions. Based on qualitative interviews with 28 respondents, this study identified four different sources of value creation in buyer-supplier relationships.

Key words: Buyer-supplier; value creation, qualitative study

Introduction

Value creation in buyer-supplier relationships is an important debate for academics and practitioners, although only recently its concept has been better understood (Lindgreen et al. 2012). One of the difficulties of measuring the value created in the B2B relationships resides in the fact that organizations do not consider only the transaction cost in doing business. In the dyadic interaction, firms consider the cost, but also evaluate other possible sources of gains, such as process efficiency, waste reduction or even opportunities to increase the bargaining power outside the relationship (Lindgreen and Wynstra 2005). Lingreen and Wynstra (2005) provided a literature review about the theme and addressed new opportunities for research. Recently, a special issue of Industrial Marketing Management (vol. 41, issue 1) was dedicated to the subject.

Another important stream of research in Operations and Buyer-Supplier areas discusses the different governance mechanisms adopted by the focal company in its relationships with suppliers. Suppliers should be segmented according to the risk they represent to the business and the impact to the profit and a more strategic relationship should be adopted only when risk and profit impact are higher ((Krajlic 1983). Despite this, the focus on collaborative partnerships has increased over the last two decades, with many empirical research providing evidence that relational governance mechanisms have a positive effect on firm performance (e.g. Autry and Golic 2010; Chen et al, 2004; Nyaga et al. 2010). More recently, however, some studies found out that there is an optimal point for collaboration and both transactional and relational mechanisms should be adopted in dyads (Liu et al. 2009, Poppo and Zenger, 2002, Villena et al 2011).
If value is created in every relationship between two organizations and different mechanisms of governance can be adopted, one can argue that different mechanisms of governance may create value in a different way. Therefore, the present study aimed to answer the following research question: How different governance mechanisms adopted in a buyer-supplier relationship affect the value creation in a buyer-supplier relationship?

This study contributes to the debate by investigating the different sources of value creation in different supply strategies and providing a framework for managers to understand how they can act in different situations to create value.

**Literature review**

**Value creation for a firm and in buyer-supplier relationships**

Value creation is a key concept in the Strategy field, although its definition is still under development (Lepak et al. 2007). One important research stream in the field defines economic value created by the firm in a triad (supplier-firm-customer) as the difference between the customer’s willingness to pay and the supplier’s opportunity cost, as shown in figure 1. (Brandenburger and Stuart, 1996).

To understand this model, it is important to define customer’s willingness to pay and supplier’s opportunity cost. The first construct is defined by the customer’s perceived value of a product or service and can be estimated as the maximum amount a customer is prepared to pay by a product/service. It is important to highlight that is not the effective value of the good, but a superior value that encompasses the benefits the customer perceives in that good, such as innovation or product utility (Bowman and Ambrosini, 2000; Priem 2007). The supplier’s opportunity cost, on the other hand, is incurred when the supplier has to choose between two or more alternatives and can be measured as the benefit obtained in the “best” transaction compared to other alternatives (Victoravich 2010), i.e, when a supplier perceives the benefits he can obtain when transacting with a firm compared to other, it can accept to reduce the transaction cost to that firm compared to the others. The opportunity cost can be defined then as the minimum amount the suppliers accept to sell to the firm (Brandenburger and Stuart, 1996). The economic value created by the firm is then created in each transaction. Both Strategy and the Marketing areas are interested in the surplus created a firm and its customers.

The buyer supplier literature, on the other hand, is more interested in understanding how value is created in the relationships a firm develops with its suppliers. Lindgreen and Wynstra (2005) highlighted that the “relationship value” differs from the economic value, because it
cannot be evaluated only at the transaction level, but also considering other additional aspects, such as reputation, location or innovation capability, that can also be exploited outside the relationship. Terpend et al (2008) also contributes to this debate by analyzing how this relationship value has been studied. According to this authors, initially (until 1980), buyer-supplier value was measured as operational performance. In a second moment (early 90’s), the focus was changed to assess the impact on improving the interaction between companies (collaboration, coordination, knowledge transfer, conflict resolution and opportunism reduction). Subsequently, value also considered the capacity of the suppliers to develop skills of internationalization, technology, new product development and environmental outcomes (late 90s). In the early 2000s, finally this relationship was evaluated in terms of the financial performance of the purchasing companies (Terpend et al. 2008). Another interesting result of this review is that the authors realized that at first, the initiative to develop the relationship was basically assigned to the focal company. More recently, there are mutual initiatives with a common objective (Terpend et al. 2008).

Value is created in any buyer-supplier relationship, although the Operations and Supply Chain Management research has focused primarily on collaborative and strategic partnerships to confirm the positive impact on the firm performance. However, different suppliers require different Supply Strategies, as discussed in the next topic (Krajlic 1983).

**Supply strategy and governance mechanisms**

Two aspects are important for a manager to define the correct supply strategy to adopt with each supplier: the impact to the firm profitability and the risk to the business (Krajlic 1983). According to the product/supplier classification, the buyer can adopt one of the three strategies: exploit (use the bargaining power as much as possible, taking care only to avoid disruptions), diversify (look for alternatives in the market) or balance (in this case, the advice is to forbear the use of the bargaining power and ask for a preferential treatment).

Depending on the type of the strategy, the buyer company may adopt transactional or relational governance mechanisms. The best choice of the governance structure is well documented in the transaction cost theory (TCT): decisions about the best governance structure should be based on transaction volume, uncertainty and asset specificity. The governance arrangement varies between two extremes: markets (no type of integration with other organizations and negotiations are scattered – arm’s length) and hierarchies (vertically fully integrated structured with high management) (Williamson, 1981). Between these two types, there are hybrid forms, based on long-term relationships.

When a long term relationship is set between a buyer and supplier, organizations need to establish safeguards against opportunism. Formal contracts with clauses and obligations, frequent negotiations and unilateral investments characterize a transactional governance structure. On the other hands, trust and social aspects, such as commitment and personal agreements can act as an informal safeguard: in this case a relational structure can be adopted, where both organizations invest in the continuity of the relationship, collaboration and knowledge and information sharing (Li et al, 2009; Poppo and Zenger 2002).

In dynamic relationships, organizations periodically analyze the proper mechanisms of governance for each partner and different mechanisms to be applied (Dyer and Singh, 1998; Poppo and Zenger, 2002). Transactional mechanisms are more effective in controlling opportunism, while relational mechanisms have greater impact on the results of companies (Liu et al., 2009).
Although academics has focused on the collaborative relationship as source of competitive advantage, strategic partnerships should be developed only with key suppliers, and the one of the challenges is to identify the partner and recognize the benefit it can generate in advance (Dyer and Singh, 1998). Therefore, the majority of the buyer-supplier relationships are based more on formal safeguards and long term contracts and few strategic relationships are developed.

Bearing this in mind, it is worthwhile to understand how different governance mechanisms can be used to create different value for both organizations.

Methodology
To achieve the goal of the present study, 28 in-depth interviews were conducted with key respondents of two industries: Personal Care and Cosmetics (PC&C) and Food and Beverage (F&B). The PC&C industry in Brazil is recognized by its high innovation rates and new products developments, therefore the need of constant increase in the value perceived by its customers (ABIHPEC, 2011). Although this industry is fragmented, a few large players are responsible for the majority of the industry results. The focal companies can be grouped in two categories: specialized companies in PC&C (such as Avon) and large organizations that benefit from their economies of scales and efficiency, such as Unilever and Procter & Gamble. Six companies from the leading organizations in the industry participated in the research.

On the other hand, despite of the efforts in the F&B industry to increase the customers’ willingness to pay, the customer surplus is dependent on the price of the final product. Both industries share suppliers among competitors.

Our cases sample consisted of 10 leading buying companies (A to J) and 15 suppliers (1-16). In each company, one or two in-depth interviews were conducted with the responsible for relationships; that is, executives (managers or directors) of the areas of Purchasing or Supply Chain in buying companies, Sales and Supply Chain or the suppliers. In addition, complementary interviews with the representative associations (ABIPHEC, ABIA, ABIFRA) aimed to improve the knowledge about the specificities of each sector. From the initial interviews, new contacts were identified by the snowball method.

We developed a total of 28 semi-structured interviews, with questions on the respondents’ perception about the value creation in dyads, the benefits of the relationship for each party and power and trust in the relation. Most of the interviews were face-to-face (lasting between 1 to 2 hours) and recorded upon agreement. In cases where the recording was not possible, the researcher notes were the source for data analysis. Table 1 and Figure 2 show the respondents profile and the relationships between the companies.

| Table 1– Cases studied |
|-------------------------|------------------|------------------|
| **Number of companies** | **Number of interviews** |
| Buyer                   | 10               | 12               |
| PC&C                    | 6                | 7                |
| F&B                     | 4                | 5                |
| Suppliers               | 15               | 16               |
| Fragrance and Scents    | 2                | 3                |
| Packaging               | 9                | 9                |
| Others                  | 4                | 4                |

Note: PC&C buyers (A to F), F&B Buyers (G to J), Fragrance and Scents suppliers (1 and 2), Packaging suppliers (3 to 11), Other suppliers (12 to 15).
In the current study, the buyers are the focal firms and do have the bargaining power compared to the suppliers. As a supplier strategy, all focal firms had a base of qualified suppliers and, when possible, had at least two suppliers for each raw or packaging material. All organizations had signed contracts for two to five years with regular suppliers and reviewed the requested volume on the basis of frequent bidding processes. Supplier selection process consisted of a new request for quotation, based on an estimated volume. If a new product is required, suppliers are encouraged to present an innovative product, but prices ranges are previously stipulated.

4.1. Data analysis
Data analysis was performed concomitantly to data collection, always confronting evidence and prior literature, which allowed the refinement of issues throughout the study. A deductive approach was adopted as the main goal of the research was to extend the theory using a complementary theoretical perspective (BARRATT; CHOI, 2001)

The analytical procedure (COLLIS; HUSSEY, 2005, p. 247) consisted of the following steps: (i) general analysis of the interview, identifying main ideas; (ii) detailed analysis of the data, identifying the context, conditions, and their agents interactions; (iii) data coding according to previously defined constructs based on the literature and classified according to the power of the evidence provided (weak, moderate and strong); and (iv) analysis of the results to verify patterns, similarities and differences. A discussion of data analysis is presented in the next sections.

As a first step in the analysis, organizations were grouped according to the preponderant behavior they seem to adopt with the suppliers (therefore the prevailing governance mechanism they tend to adopt). In a second step, the analysis of the interview provided evidences of how value is created in each kind of relationship.

Data results
Prevailing governance mechanisms

The interviews were analyzed to identify which were the organizations that were more prone to adopt collaborative relationships with its partners and which companies tend to use more the bargaining power and exploit the relationships. The results are shown in figures 3 and 4.

Figure 3 – Prevailing governance mechanisms (Buyers)

Figure 4 – Prevailing governance mechanisms (Suppliers)

The analysis of the predominant governance mechanisms resulted in five major findings summarized in Table 2.

Table 2 – Main findings of the governance mechanisms analysis

| The main driver for a collaborative relationship is the risk of scarce resources and the possible impact to the company image | When the raw or packaging material is a scarce resource or when there is a threat of opportunism of current suppliers, buyers are willing to develop current or new supplier to avoid disruptions. In the investigated firms, buyers were willing to engage in such collaborative only if the supplier is smaller and dependent on the focal company. |
| Suppliers are more willing to collaborate than buyers organizations. | Although suppliers work to offer initiatives to buyers in a proactive manner, buyers are resistant to such relationship. Buyers are afraid of dependency and opportunism. |
| The size of the other organization impact the collaboration. | The presence of trust in its two dimensions (benevolence and credibility) seems to occur when the relationship is captive (ie, there is greater reliance on one of the parties in relation to a larger company). The size would have a negative impact to the relational mechanism. Large organizations are recognized more by its credibility than benevolence. Smaller companies require dedicated treatment, but are more flexible and adapt quickly to changes requested by customers. |
| The continuity of the relationship does not | According to the suppliers’ perspective, there |
Governance mechanisms and its impact on relationship value creation

Although in the previous topic, all studied organizations were classified in terms of their preferred governance mechanism, this does not mean that they operate using an exclusive type of relationship. All companies investigated, regardless of the segment or if it is a buyer or a supplier, confirmed that they segregate suppliers (customers) and have relationships governed by contracts, with different levels of flexibility. Respondents were unanimous in terms of different mechanisms with suppliers (or customers) according to their dependence, their criteria for choosing a supplier (or customer), their representation in financial terms and availability of alternatives. It was also possible to identify three different supply strategies: transactional (use of bargaining power and based on the minimum price), long term relationships with suppliers, with at least two providers for each material (in this case, although there are alternative suppliers, the product is important and the supplier base is already developed. The buyer still has the bargaining power, but a long term relationship is preferable than an arm’s length structure. Both transactional and relational governance mechanisms are adopted) and strategic partnerships. In the last strategy, a long term relationship can be developed with key suppliers based on trust or an episodic collaboration can be established. In both cases, although formal agreements are required, the relationship is grounded on reputation, benevolence, credibility and past experience.

The analysis of in-depth interviews also allowed to identify four possible classifications for value creation in relationships: transactional value, incremental value, situational value, and relational value. Each of these classifications is discussed in details.

Transactional value – When a arm’s length relationship is adopted, both companies are looking to exploit only economic benefits of the transaction. As highlighted by Lindgreen and Wynstra (2005, p. 736): “customers become valuable to the firm only when the firm has something of value to offer to them.” In this case, although there is a value creation in the transaction, there is no relationship value created. Value is created only by the individuals that participate in the transaction but no value is created by the complementarity and the joint efforts of both companies. This value is created when the strategy is completely based on exploitation.

Incremental value creation - Value created is solely by the action of one member of the relationship. Buyers companies use their bargaining power to request that suppliers provide processes innovation, design, new products and logistics projects. In these cases there are no mutual projects, but the relationship value is dependent on the investments each supplier makes. As the buyer company does not reciprocate to the supplier with the expected loyalty and commitment, the value created is not unique and specific to the relationship and is rapidly offered to other customers. Incremental value is the response of the supplier to the pressure of the buyer company and is used to maintain the relationship. The focal company, in these cases, uses both relational and transactional mechanisms to promote the relationship. Although negotiations and contracts negotiations are frequent and suppliers are pressured to reduce costs and offer new benefits, when contracts are firmed, a new initiative is paid with volume and opportunity to participate in new biddings processes.

Situational value – Occasionally organizations engage in an episodic collaboration with specific suppliers, that is a temporary collaboration focused on a specific initiative that will last during a
given period (Zacharia et al. 2011). In this case, buyer and supplier sign a formal agreement to invest in a common project which will last for a finite period and will result in mutual benefits that would not be achieved without the relationship. Although the relationship is based on formal safeguards, such as contracts and obligations, this value is only created because of the efforts of both companies and the past experience they have.

Relational value - Occurs when both parties invest in the relationship as a whole and not just in a situation. In this case, the relationship is based on benevolence, trust and there is an agreement on profit sharing. This value is rare and valuable in the long term, however, more difficult to be generated. Among the interviews, few companies consider the relationship as a common strategy and although there were some buyers organization that does recognize the importance of such strategic relationship, no evidence of the relational value was provided in the interviews.

CONCLUSIONS
The results provided evidence that, in the studied segments, suppliers are willing to adopt a more collaborative behavior that buyers, but that this commitment does not assure exclusivity or increased participation in the relationship. Buyers are more motivated to choose relational governance mechanisms in situations involving risk to acquirers and when there is asymmetry in size and power between the parties. One possible explanation for this finding is the lack of absorptive capacity and the ability to manage collaboration. The company does not recognize the value of knowledge of the other party and therefore, does not appropriate this to have superior results compared to its competitors (Zacharia et al. 2011).

The qualitative study also provided evidence that different governance mechanisms result in different value creation in the relationship. A 100% transactional relationship results only in economic value, that is created by each company and is not result of the synergy between firms. When a long term relationship is established, three scales of value creation were identified: incremental value, situational value and relational value. The present study contributes to the buyer-supplier debate by explaining how different supply strategies can be used to maximize the value created.

At this moment, it is important to highlight the limitations of the current research. First of all, although interviews allow an in-depth analysis of a phenomenon, the results are limited to the individuals and organizations studied. Even in the industries studied, the research focused on large organizations, that have the bargaining power and their relationship with its suppliers. Future research should extend the present study by replicating it in different contexts, such as other industries, other types of power balance relationships or where dependencies differ from the present scenario.

REFERENCES
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