

## **SUPPLY CHAIN**

### **Creating value together**

In buyer-supplier relationships in which both companies depend on one other, performance may improve.

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Conventional wisdom suggests that companies should avoid growing dependent on their business partners. If one company, the thinking goes, grows too dependent on a counterpart by getting the entire input for a particular activity from it and not being able to switch quickly to alternative sources of supply, then the counterpart company gets powerful levers of influence. By threatening to exit the relationship, the supplier may then renegotiate the relationship toward more favorable terms and claim a bigger share of the economic pie. And this bigger share will come at the purchasing company's expense.

Is dependence on another company bad, then? Not necessarily.

While seemingly intuitive, the conventional wisdom fails to realize that there are not one but two critical processes that affect how a company fares in a business partnership. One is indeed value appropriation, in which each company's performance is determined by how much value it captures from the pool of value generated by the partnership. But to capture value companies first need to create it, and this is where the second process comes into play: value creation. In other words, what matters for a company's performance in a buyer-supplier relationship is not just the share of the pie it gets, but also how big the entire pie is.

Our research suggests that, if smartly managed, dependence on one's business partners brings significant benefits to value creation in interorganizational relations; it can boost the overall pool of value to be distributed and, subsequently, the performance of a company. Dependence, therefore, should not be avoided but actively harnessed. We also show that ineffective management of dependence may just as quickly shrink the value in the exchange, hurting all companies' performance in the relationship. In that respect, relying on a tug-of-war – in which the more powerful company is trying to squeeze out the value at the expense of its more dependent partner – is particularly detrimental. It results in the dominant partner claiming a bigger share of a rapidly shrinking pie. Remarkably, in such circumstances, a more powerful business can be left with a net loss.

Our research method was two-pronged: We first conducted 37 interviews with managers and purchasing agents working in the automotive industry. We then analyzed survey data on 151 buyer-supplier relationships in the automotive industry, looking at manufacturers' and suppliers' dependence on each other in terms of a variety of factors. (Our complete study was published in the March 2007 issue of the journal *Administrative Science Quarterly* in an article called "Dependence Asymmetry and Joint Dependence in Interorganizational Relationships: Effects of Embeddedness on a Manufacturer's Performance in Procurement Relationships.")

Among the factors we studied in the manufacturer-supplier partnerships were the magnitude of exchange, the concentration of exchange (measured through both the number of exchange partners each company had and the fraction of business done with a partner), the availability of alternative sources of exchange as reflected in the ease of replacing the incumbent partner, and the magnitude of investments that would result in lost value if redeployed outside the existing partnership. Intuitively, if the dollar value of the exchange is high, a large part of a manufacturer's supply comes from one supplier, the supplier is relatively irreplaceable due to lack of viable alternatives, or if the manufacturer made highly specialized investments for the focal relationship, then the manufacturer can be said to have a high level of dependence on that supplier. By the same token, if a large portion of a supplier's output is consumed by a single manufacturer, if the supplier has few or no other alternative consumers, or if it made irreversible investments in the given relationship, it is highly dependent on the manufacturer.

Our analyses show that the key to successful management of dependence lies in realizing that in any business partnership, dependence may independently vary along two different dimensions. One dimension, called dependence asymmetry, reflects how much more (or less) one company is dependent on its business partner than vice versa. If one company is relatively more dependent on its partner, then the difference in the dependencies on each other reflects the degree of power or influence that the less dependent (and hence more powerful) partner potentially has over the more dependent company. By the same token, if a business is less dependent on its partner than vice versa, then the degree of difference in dependence shows that company's influence edge over its partner. However, this dimension, while valuable in understanding potential influence positions in the exchange, gives only a part of the picture.

The second important dimension is that of joint dependence, which reflects the extent to which two companies mutually depend on one another. Put simply, one company may be twice as dependent on its exchange counterpart as vice versa. That difference reflects the level of dependence asymmetry. That asymmetry, however, can exist at different levels of joint dependence: low -- where the two companies are only barely dependent on each other -- and high, where both companies are highly mutually dependent. Our research shows that it is joint dependence that fosters a more cohesive exchange in the relationship by business partners. Specifically, buyer-supplier relationships that feature higher levels of joint dependence trigger a higher degree of involvement by both companies and are characterized by higher quality information flows between business partners. On average, the buyer-supplier relationships in our study that had greater joint dependence showed significantly greater joint involvement in business activities as well as more detail, accuracy, and timeliness of information exchange between business partners. As a result, relationships characterized by higher joint dependence become superior in value creation and generate a large pool of value available for both businesses in the relationship, subsequently boosting a company's performance.

Now, what happens when it comes to claiming this value? This is certainly where dependence asymmetry comes into play: If one company has an edge there by having its partners more dependent on it, then it is in a better position to claim a greater piece of the pie. But beware! Claiming value by squeezing a business partner, even if beneficial in the short run, does not go unnoticed in terms of the well-being of the relationship. It triggers negative affect, withdrawal and avoidance by a business partner, thereby hurting the relationship and its overall value creation. Thus, a company may end up grabbing a bigger share of a rapidly shrinking pie: Our

results show that, on average, those manufacturers who had greater power in a relationship had poorer performance. Our fieldwork seems to support this finding, as one of the managers we interviewed commented, “The thinking used to be here that we'd like to see a supplier totally dependent on us and then we'd have the thumb over them. Now we recognize that neither extreme is good.” Another manager echoed this idea: “I have found that bullying the supplier does not pay in the long run.” Our study thus provides a tool to enable managers to think systematically about dependence in interorganizational relationships. In particular, we show that there are benefits to mutual dependence and that striving to maximize power in a buyer-supplier relationship can have a negative impact on a company's performance.

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