Governance in Asymmetric Buyer-seller Relationships:

A Small Supplier’s Perspective

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ABSTRACT

We model the strategies adopted by Original Equipment Manufacturer (OEM) suppliers to protect specific investments in asymmetrical OEM-supplier relationships by value creation and reciprocal specificity. In general, weak OEM suppliers are more likely to make specific investments first in exchanging for association with OEMs. After making specific investments, OEM suppliers redeploy their resources and work closely with OEM buyers to maintain current and future transactions. Such bonding strategies result in mutual dependence between suppliers and OEMs. In-depth interviews with five executives have identified two types of bonding strategies as ex post safeguards by OEM suppliers in asymmetric buyer-seller relationships.

Keywords: Specific investments, dependence, ex post safeguards, asymmetric inter-organizational relationships

INTRODUCTION

In an original equipment manufacturer (OEM)-supplier relationship, an OEM supplier commonly makes investments in tools, equipment, operating procedures, and systems that are specialized to the requirements of a particular buyer (Bensaou and Anderson, 1999; Stump and Heide, 1996). Taiwanese OEM suppliers are small-medium firms with limited resources (capital, growth capacity). Most of their buyers (OEMs) are international brand name manufactures, such as Dell, HP or Nike. As an OEM supplier, it has to follow the OEM’s production specification and quality standards. Therefore, its manufacturing equipments need to be specially designed for particular uses and would be difficult to switch to alternative buyers. For example, the investment in tooling of Sony’s PS2 connectors would be of little use for manufacturing Microsoft’s X-Box.

When Taiwanese OEM suppliers make specific investments for their buyers, they are less likely to forward integration. For example, a small PC connector firm is hardly able to buy out Dell. On the other hand, PC industry is highly specialized in vertical supply chains, OEMs chose not to retain the manufacturing activities which are less related to their core competence. Vertical integration is not an alternative for both OEMs and suppliers even if transactions involve highly specific investments.
OEMs do cancel subsequent orders and do not guarantee continued orders. Many OEM suppliers still commit specific assets and did not receive any formal protections from their buyers. When asymmetrical power relationships exist, ex ante safeguards will not be used to reduce transaction cost of the weak party. Knowing that clients may have opportunistic behaviors, OEM suppliers in Taiwan still make specific investments for them without their commitments. How do these suppliers manage the asymmetrical relationships to avoid falling into the trap predicted by the transaction cost economics (TCE)? This study intends to shed some light on this issue.

This study takes the view of an OEM supplier, the weaker party in an OEM-supplier relationship, who makes specific investments as a requirement to entering relationships with OEMs. We argue that specific investments create inter-organizational dependence and we draw from a transaction value perspective to identify weak supplier’s strategy to such a condition. Bonding strategy can safeguard specific investments and protect suppliers from hold-up hazards. Thus, specific investments would no longer be a liability for the receiving party after bonding strategy is implemented.

The contribution of this study is linking TCE with a value perspective to explore the safeguard mechanism in asymmetrical relationships (Zajac and Olsen, 1993). Moreover, the ex post perspective (Hart, 1995) broaden the theoretical application in asymmetrical buyer-seller relationships (Subramani and Venkatraman, 2003). We also offer alternative solutions other than hierarchy for a weaker party who has to make specific investments in the outset. Specific investments are viewed by a weaker party not only as a signal of willingness to cooperate but also a strategic asset in exchange for future growth.

THEORETICAL BACKGROUND

Assets that are highly specific to a transaction bear a higher transaction cost. They are incurred in advance of exchanges and their value in alternative uses or by alternative users are greatly reduced (Williamson, 1983). It is similar to the notion of a sunk cost. Williamson (1985) identified several types of
specific investments, including both specialized physical and human capital, along with intangibles such as firm-specific knowledge or competence. The downside of specific investments in exchange relations under incomplete contracting is a hold-up hazard (Klein, 1996; Klein, Crawford, and Alchian, 1978; Wimmer & Garen, 1997). If circumstances change, then the party who does not make specific investments in a transaction may try to appropriate the rent. The party who make specific investments will suffer post-contractual losses and will be potentially dependent on non-opportunistic behavior by exchange partner (Heide and John, 1988). The suggestions by TCE to minimize a hold-up hazard are long-term contracts, mutual hostages, or vertical integration (Rindfleisch & Heide, 1997; Shelanski & Klein, 1995). Hence trading parties choose from a set of institutional alternatives ex ante to offer protections for specific investments at the lowest total costs.

The limitation of TCE solutions is that it is practically infeasible for a weaker party, such as OEM suppliers, to adopt. Compared with foreign buyers (i.e., OEMs), OEM suppliers are usually subject to resource constraints and are incapable of engaging in forward integration. Most of all, asymmetric dependence between OEMs and their suppliers do exist and, on many occasions, can be characterized as buyer dominance. The one with a stronger bargaining position will hardly adjust its behaviors to accommodate the demands of a weaker party. As a matter of fact, the dominant party tends to exercise its power and win accommodations from the weaker party (Dwyer and Walker, 1981; Yan and Gray, 1994). OEMs often push or force suppliers to make specific investments. On the other hand, they usually make no commitments to suppliers (such as Taiwanese suppliers), especially in the early transaction stages, when they are not confident in suppliers’ capability to fulfill their obligations.

We argue ex post safeguards are second best solutions in case the ex ante safeguards are not available in asymmetric relationships (Table 1). Small OEM suppliers are more likely to make specific investments first in exchange for orders and social connections. From transactional value point of view (Dyer, 1996; Dyer & Singh, 1998), specific investments signal trust and credible commitment and create an expectation
of future interaction (Axelrod 1984; Heide and Miner, 1992; Gulati, Khanna, and Nohria, 1994; Celly, Speckman, and Kumauff, 1999). The bonding strategies adopted by OEM suppliers transform the specific investment to strategic assets. The importance of the bonding strategy in balancing the asymmetric relationship is discussed next by examining five cases of Taiwanese OEM suppliers.

**TABLE 1**

Comparisons of Safeguards in Ex Ante Relationships

<table>
<thead>
<tr>
<th>Specific Investment</th>
<th>Symmetry</th>
<th>Asymmetry</th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>Hierarchy, Hybrid form</td>
<td></td>
</tr>
<tr>
<td>Low</td>
<td>Market</td>
<td>Market</td>
</tr>
</tbody>
</table>

**METHODOLOGY**

The selection of cases is guided by the goal of finding firms with specific investments and experiencing change of relationships with OEM buyers. We used multiple case studies to replicate the findings to provide greater confidence in the overall results (Yin, 1994). As expected, firms interviewed confirmed that specific investments are perceived as a necessity to help firms differentiate their services in an increasingly competitive outsourcing marketplace. Five Taiwanese OEM suppliers with different businesses were selected, including footwear, children’s furniture, animation films, notebook PCs, and computer power supplies. All five firms have made specific investments, either tangible or intangible assets, to solidify relations with OEMs. The types of specificity, single and multiple buyers and symmetrical power relationships were within the case selection scope, and hence statistical representation was not our concern (Eisenhardt, 1989; Yin, 1994). The background and characteristics of the five firms are shown in Table 2. The firms’ names were disguised to ensure confidentiality and were labeled in letters of the alphabet.
TABLE 2

Background of Companies Interviewed

<table>
<thead>
<tr>
<th>Company</th>
<th>HG*</th>
<th>KS*</th>
<th>LF*</th>
<th>MM*</th>
<th>WTS*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Products</td>
<td>Animation films and series</td>
<td>Power supplies for PCs/telecom products</td>
<td>Men’s footwear</td>
<td>Infant playing pans, car seats and strollers</td>
<td>Notebook computers</td>
</tr>
<tr>
<td>Major buyers</td>
<td>Warner Brothers</td>
<td>Dell</td>
<td>Hush Puppies</td>
<td>G*</td>
<td>A: an international brand</td>
</tr>
<tr>
<td></td>
<td>Walter Disney</td>
<td>IBM</td>
<td>Clarks</td>
<td></td>
<td>B: a local brand</td>
</tr>
<tr>
<td></td>
<td>Nickelodeon</td>
<td>HP</td>
<td></td>
<td></td>
<td>C: a channel brand</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Cisco</td>
<td></td>
<td></td>
<td>D: a distributor brand</td>
</tr>
<tr>
<td>Share of total sales (%)</td>
<td>25-30</td>
<td>30</td>
<td>60</td>
<td>99</td>
<td>60</td>
</tr>
<tr>
<td></td>
<td>25-30</td>
<td>20</td>
<td>40</td>
<td></td>
<td>15</td>
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<td></td>
<td>10</td>
<td></td>
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<td>10</td>
</tr>
<tr>
<td>Years of business relationship</td>
<td>20</td>
<td>8</td>
<td>20</td>
<td>20</td>
<td>7</td>
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<tr>
<td></td>
<td>10</td>
<td>6</td>
<td>5</td>
<td></td>
<td>3</td>
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<td>10</td>
<td>3</td>
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<td>3</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2</td>
<td></td>
<td></td>
<td>2</td>
</tr>
<tr>
<td>Type of specific investments</td>
<td>Animation production software</td>
<td>Safety spec, JIT warehouse</td>
<td>Tooling, dedicated design room</td>
<td>Tooling, MIS, personnel</td>
<td>Tooling, matching business model, BIOS</td>
</tr>
<tr>
<td>Position of informant</td>
<td>CEO</td>
<td>Marketing vice president</td>
<td>Consultant</td>
<td>President and CEO</td>
<td>CEO</td>
</tr>
<tr>
<td>Length of interview</td>
<td>3 hrs.</td>
<td>4 hrs.</td>
<td>3 hrs.</td>
<td>2 hrs.</td>
<td>2 hrs.</td>
</tr>
</tbody>
</table>

*Disguised

FINDINGS AND DISCUSSION

Specific investments are common features in international outsourcing. Williamson (1985) pointed out different types of specificity, and addressed the issue of non-redeployment. Firms in our cases both invest tangible and intangible assets. Tangible assets are those investments in tooling, dedicated equipment, specially designed clothes and Just in Time (JIT) warehouses. Intangible assets include those expatriate executive directors moving to Hollywood, employees training to become familiar with a special technology, applications of safety specifications for PC power supplies, time and effort spending to interact with customers, adaptations to specific business model, and coordinating production processes for OEM clients.
There were some standard format purchasing agreements, but no long-term contracts or formal safeguards designed for OEM suppliers’ specific investments. The vice president of KS reported that OEMs are reluctant to promise long-term relationships in advance if they are not confident with suppliers’ capability. OEMs require quality and prompt delivery and would not commit to long-term contracts unless they can be sure about the capability of suppliers. We found that *ex ante* safeguards suggested by the TCE exist only when both parties are in a comparable status. OEM suppliers usually do not have the same levels of capability or the market status as those of their clients. That is why smaller OEM suppliers cannot request *ex ante* safeguards. OEM suppliers invest before signing contracts not only because they want to win the trust of their buyers, but they also expect to receive some rewards compared with transacting with less known buyers. The rationales of suppliers for making specific investments were revealed in the cases.

First, competitors face an entry barrier if transactions involved specific investments and incumbents have already invested. Once an order is in process, assuming no quality problems, theses investments can protect the transactions from price competition. Without prior agreements from buyers, competitors generally will not invest beforehand to take away the business. The higher the value of specific investments (e.g., tooling of plastic parts for car seats), the less likely alternative suppliers would be available.

Second, OEM suppliers expect future profits and do not care if they lost in one transaction. That is, if an OEM supplier expects a large order from a major buyer, the threat of specificity may not be so serious. When the value of future transaction is high, a specific investment would be relative small. One executive reported that if it is a large buyer or a buyer with growth potential, he is more willing to commit first.

Third, OEM suppliers are smaller in size relative to their counterparts. They have no choices: they either accept these requests or loose these customers. The executives from the footwear manufacturer (LF) and children furniture firm (MM) pointed out that, if they did not follow their customers to relocate their production sites to mainland China and to serve these customers on an exclusive basis, they would not receive any orders from these customers. In order to become a core supplier for an OEM, Firm KS actively
invested in the Just in Time (JIT) business model for Dell nine years ago. Core suppliers have priorities to respond to the Requests for Proposals (RFPs) issued by buyers, which are valuable in the competitive PC industry.

Prior research has identified a variety of governance mechanisms that protect a firm making specific investments from opportunistic behaviors by its partners. Despite the insights provided by previous research, the solutions are incomplete or infeasible especially for smaller firms with less bargaining power, such as Taiwanese suppliers in an OEM-supplier relationship. We found that firms with weaker bargaining power adopted ex post safeguards if they were required to commit beforehand. When OEM suppliers view making specific investments as an opportunity to grow, they tend to invest continuously.

However, investing in specific assets without safeguards puts firms in a vulnerable situation; smaller firms should consider some forms of protections. We observed from the cases that two types of bonding strategies, value creation and reciprocal specificity, act as ex post safeguarding mechanisms. A theoretical model of ex post safeguards in asymmetrical OEM-supplier relationships was derived (Figure 1).

![FIGURE 1](Image)

**A theoretical model of ex post safeguards of specific investments**

**Value Creation**

We define value creation as the degree to which an OEM supplier adapt to the changing demands of
OEMs. Accommodating actions are a focused operationalization of the broader definition of value creation effort which one party makes in the context of an OEM-supplier relationship. A high level of accommodation reflects a good-faith adjustment and serves the changing need of a buying firm in a distinctive way (Dyer, 1996; Zajac and Olsen, 1993). All of our informants expressed their efforts to re-allocate resources to accommodate the changing needs of OEMs. For example, Firm HG gave up its own control of its staffs and let the OEM’s animation director change the overall procedure. In addition, Firm LF reserved exclusive rooms for different OEM designers to prevent the leakage of fashion ideas.

Prior research also indicates explicit signals by one firm conveying the likelihood of trustworthy behavior will trigger reciprocal commitments by the other firms, and therefore two parties are more likely to enter into a long-term relationship (Anderson and Weitz, 1992; Rokkan, Heide, and Wathne, 2003). We found that the OEM suppliers, after making a significant amount of specific investments, were able to work more closely with their OEM buyers. Taiwanese OEM suppliers even continued to dedicate more investments than expected, and they became more qualified suppliers.

Firm MM is an example of value creation for its OEM supplier. It actively involved in designing new models of strollers before the buyer initiated an order. Due to years of the efforts in research and development, the level of production capability was far beyond that of its OEM buyer and outperformed other competitors. With better knowledge of materials and production, it became the only qualified supplier years later. Now, the OEM hesitates to terminate the relationship.

Consistent with the transactional value perspective (Dyer, 1996; Zajac & Olsen, 1993), OEM suppliers’ efforts to facilitate transaction efficiency create a relational value for their OEM buyers. Since specific investments are valuable only in a particular dyad, a relationship-deepening action by two parties would maximize the overall value of transactions. For a period of time, the OEM buyer would then experience an added value, such as lower costs, better quality, or shorter time to market. Because OEM supplier’s accommodating actions provides significant value to the OEM, the perceived value of the OEM would
increase and then its payoff would change. We therefore propose the following: *Proposition 1. In an OEM-supplier relationship, if the supplier continues to create value for the OEM after making a specific investment, the OEM would also depend on the supplier. The supplier then can balance the asymmetrical relation to prevent a hold-up hazard.*

**Reciprocal Specificity**

We define reciprocal specificity as the degree of specificity of a buyer’s investments, usually occurred with a time lag, responding to a supplier’s specific investments with no safeguards. Reciprocal specificity, as oppose to a mutual hostage (Williamson, 1983), is an *ex post* safeguard due to one party gradually commits more resources to invite the other party to devote intangible assets. Heide and John (1988) indicated small firms could make offsetting investments as means of safeguarding specific assets. They invest more with an attempt to bond themselves more closely to another party. Such investments create exit barriers and result in a lower level of dependency by decreasing the replaceability of the small firms (Emerson, 1962; Heide and John, 1988).

If a supplier has frequent communications and personal contacts with a buyer, usage knowledge for both parties is created and friendships between the staffs of the two parties are cultivated. With frequent interaction, it is as if the buyer invests in usage knowledge which is only valuable with the specific supplier. They both are locked into a situation with reciprocal specificity. For example, the executive of Firm HG reported the experience of working with a leading animation studio. Animation itself is an art and is difficult to stipulate as standard operation processes. Films are characterized by highly personal style. For Firm HG, its drawing artists have a proprietary knowledge about each director’s preferences; on the other hand, the studio is also familiar with the technical levels of staffs in Firm HG. When Firm HG handed out the list of project team members, the studio immediately knew the film quality. This is a tacit knowledge for the buyer and also a specific knowledge which would be lost if the supplier is switched.
Technical inseparability would also create reciprocal specificity and a hostage effect for both parties (Chen & Hennart, 2004). The CEO of Firm WTS mentioned that BIOS software in notebook was jointly designed by the supplier and the OEM. They were systematically specific to each other. If the OEM terminated the transaction, not only the supplier would face the switching cost, the OEM itself would suffer even bigger losses than its partner. The executive of Firm KS, which manufactures power supplies for brand name PC companies, also pointed out that a safety specification was dedicated to one particular buyer. Although a safety specification belonged to the supplier, the buyer also had to adjust its system specification to comply with the safety requirement. Because of the technical inseparability, OEMs teach their suppliers related techniques and managerial skills in order to guarantee the final quality of their products. The higher the level of technical inseparability, the more likely reciprocal specificity would occur. We therefore propose the following: Proposition 2. In an OEM-supplier relationship, if the supplier can invite the OEM to make a reciprocal investment after its specific investment, the OEM would also depend on the supplier. The supplier then can balance the asymmetrical relation to prevent a hold-up hazard.

Our findings are consistent with the logic of transaction cost economics that farsighted parties would not invest specific assets without ex ante safeguards. We do not encourage suppliers making specific investments without reservation. For OEM suppliers, they could not ask for protections until they are in symmetrical relationship with OEMs. Therefore, we suggest weaker suppliers might actively make specific investments first as a ticket to win the placement of orders and opportunity of exploration. Then, ex post safeguards should be followed, either by creating value for the major OEM or invite OEMs to devote time and efforts of reciprocal investments. The bonding strategies increase the OEMs’ dependence on suppliers. The OEMs hesitate to act opportunistically.
REFERENCES


