Successful Alliance Establishment and Evolution in a Volatile Business Environment: the Case of "Cellars of Canterbury"

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Introduction

The reason some alliances can withstand unforeseen environmental shifts and evolve while others fail is an intriguing issue. Many have identified critical properties of alliances that have been able to make such transitions. However, little attention has been given to the process of development that leads to these flexible alliance relationships. We believe that the problem stems from the contractual rigidity imposed by partners in the initial stages to the formation of an alliance. This paper analyzes a process to create self-enforcing agreements that lead to a flexible alliance architecture capable of reconfiguration to meet the demands of environmental change. Using an empirical case study of "Cellars of Canterbury" a New Zealand wine producing and marketing joint venture, we suggest that immediate value creation establishes private enforcement capital in a relationship which allows for critical relation-specific investment to take place without the need for written contractual safeguards. We also emphasize the advantage of external contract enforcement mechanisms and third party verification in reinforcing these relationships. We then argue that it is this lack of contractual rigidity that allows an alliance agreement to be reconfigured when environmental circumstances change.

Research Trends

Existing strategic alliance research is endowed with numerous studies that investigate the factors critical to successful formation, or alternatively, those that lead to alliance dysfunction (Yan, 1998). However, little attention has been given to the area of alliance evolution (Inkpen, 2001). In other words, the questions of "how" as opposed to those of "what".

Recent and notable contributions to the subject of alliance evolution include that of Ring and Van de Ven (1994) who developed a process framework of the developmental processes in alliances that cannot be fully specified or controlled by the parties ex-ante execution. Following on from this, Doz (1996) explored the evolution of cooperation, suggesting that alliance evolution occurs through a process of learning, reevaluation, and readjustment cycles and focused on the conditions fostering or blocking inter-partner learning in alliances. Gulati (1998) approached evolution from a social networks perspective and examined the influence of structural and social embeddedness on alliance longevity. Child and Faulkner (1998) considered the evolution of trust based relationships and suggested that trust develops gradually overtime as partners encounter particular stages in the alliance. Arino and de la Torre (1998) examined the evolutionary interaction between two partners in a failed alliance. However, as yet there has not been an investigation of how to establish an alliance that can successfully evolve overtime in accordance with shifts in the external environment (Gulati, 1998). This paper focuses on expanding both our conceptual and empirical understanding of how alliances evolve over time.

Governance of Alliances

Within its definition, the term strategic alliance can take on a broad range of inter-organizational forms. However, it is generally understood that the purpose of a strategic alliance is the pooling of resources in a synergistic manner to enable value creation that would not be achievable by acting alone (Mjoen and Tallman, 1997; Madhok and Tallman, 1998; Inkpen, 2001). As such the alliance relationship is not just a mechanism of governance but a productive resource for value creation (Madhok and Tallman, 1998). An effective alliance relationship also provides its partners with a degree of strategic flexibility suitable for operating under uncertain environmental conditions (Mjoen and Tallman, 1997). However, to realize the potential synergistic combinations of resources and appropriate the expected knowledge or economic outcomes from these relationships often requires significant relationship or transaction specific investment (Gulati and Singh, 1998; Madhok and Tallman, 1998). The failure of partners to recognize the extent of this investment is a common reason for alliance failure (Madhok and Tallman, 1998). Kumar and Nti (1998) theorize that such under-investment in relationship or transaction specific investment at establishment causes negative outcome discrepancies and it is the firms' reactions to such discrepancies that decide the longevity of the alliance.

It is clear that investment in relationship specific assets, often 'soft' relational assets (Kumar and Nti, 1998), must be made by the partnering firms if the alliance is to be successful. However, as numerous authors recognize, investment in relationship specific assets early in an alliance's lifecycle exposes the firms involved to the threat of opportunistic behavior from each other (Alchian and Demsetz, 1972; Williamson, 1975, 1985; Reich and Mankin, 1986; Kogut, 1988, 1989; Doz *et al.*, 1989; Barney and Hansen,

1994; Gulati, 1995). This vulnerability to opportunistic behavior often leads partners to create safeguards between one another (Williamson, 1985). Since, as Williamson (1985) purports, when the appropriate safeguards are in place, partners become more willing to make the necessary relation-specific investments[1], which will generally lead to the generation of greater relational rents[2].

It seems that the most appropriate solution to these concerns of opportunistic behavior is to construct stringent contractual agreements between alliance partners that address the matters. However, although these contractual mechanisms may be viable in very stable business environments, they are often found to be inappropriate solutions in volatile, uncertain environments prone to unforeseen shifts and changes (Klein, 1996; Gow *et al.*, 2000). Problems arise, as it is costly, if not impossible, to stipulate pre-specified contractual terms to cover all possible future states of nature, hence, formal contract mechanisms are inherently incomplete (Klein, 1996). Thus, recognizing that contracts are naturally incomplete, if market conditions change substantially from those initially envisioned, the creation of a legally binding agreement, enforceable by either party, may in fact support further opportunistic behavior to occur rather than removing it, one party may be able to enforce the rigid literal terms of the contract to adversely affect other parties, even when these terms are contrary to the initial implicit intent of the contracting parties (Klein, 1996, Gow *et al.*, 2000). This is generally referred to as a hold-up problem.

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[1] We define relationship-specific investments to include time, effort, knowledge as well as the physical assets directly relating to the relationship.

[2] Relational rent, as defined by Dyer and Singh (1998) is a supernormal profit jointly generated in an exchange relationship that cannot be generated by either firm in isolation and can only be created through the joint idiosyncratic contributions of the specific alliance partners.

Trust and Private Enforcement

The widely reported solution to this dilemma is to base these types of inter-organizational relationships on trust (Ring and Van de Ven, 1992; Mohr and Spekman, 1994; Gulati, 1995; Doz, 1996; Gulati and Singh, 1998; Carney, 1998; Dyer and Singh, 1998). However, trust has wide and varying connotations (Gulati, 1995) and there is not a unifying definition (Inkpen and Currall, 1997). Some distinguish between knowledge based trust - that developed through ongoing interaction and built around the norms of equity; and deterrence based trust - the threat that untrustworthy behavior will result in costly sanctions that exceed any potential benefits of opportunism (Gulati, 1995). Bradach and Eccles (1989) define trust as the expectation that alleviates the fear that a partner to exchange will act opportunistically. Chiles and McMackin (1996) suggest that the social norms of reciprocity, obligation, cooperation, and fairness generate trust. Barney and Hansen (1994) on the other hand give a three-fold definition of the level of trust that will be exhibited between business partners based on the circumstances of the relationship. Further, mechanisms reported as having the ability to create trust include repeated transactions (Ring and Van de Ven, 1992; Gulati, 1995; Gulati and Gargiulo, 1999), making equity investments to signal ones intention to their partner (Gulati, Khanna, Nohria, 1994), or alternatively, making requisite equity investments to create a mutual hostage between partners (Williamson, 1975, 1983; Gulati, 1995).

We believe that a more comprehensive and workable definition of trust can be found in what Klein (1996) terms, private enforcement capital (PEC). PEC consists of a combination of privately enforceable sanctions that influence the partners to a transaction to abide by the agreement they have made (Klein, 1996). These sanctions have two parts,

one being the loss of the discounted present value of all future relational rents accruing to non-salvageable relationship-specific investments (Klein, 1996). The other is the loss of the transactor's reputation in the market place (Klein, 1996). This includes the potential exclusion from further transactions with the current party to contract, plus, either exclusion from, or increased costs of doing business with other transactors in the market place (Klein, 1996, Gow *et al.*, 2000). This increased cost is the result of future transacting parties imposing more explicit and/or unfavorable terms of contract on the opportunistically behaving party (Klein, 1996, Gow *et al.*, 2000). At any point in time, partners to a transaction balance the costs of behaving opportunistically against the benefits to be gained from opportunism (Klein, 1996, Gow *et al.*, 2000). If the gains from opportunism are greater than the PEC that exists between the partners then a breach of the agreement will occur (Klein, 1996, Gow *et al.*, 2000). In one way or another, this framework effectively encompasses all of the definitions of trust previously provided. Trust therefore is a function of relational rents and reputation and can be considered synonymous with private enforcement capital**.**

The magnitude of PEC between partners to an alliance defines the range over which an agreement will be self-enforcing. If circumstances in the external environment change sufficiently to cause the cost/benefit ratio of a breach in the agreement to shift outside this range then a breach will occur (Gow *et al.*, 2000). Outside of this range contacts must be enforced via external mechanisms. The solution that Klein (1996) advocates is that in any agreement that carries a risk of significant loss should either partner engage in opportunism, transactors should use written contractual terms to bring the agreement close to the desired performance level and then rely on PEC to force performance the

remainder of the way. The existence of PEC between partners, and therefore a self-enforcing range, means that actors will perform in a manner consistent with the mutually understood implicit contractual intent even when not all elements of the contractual understanding are pre-specified in the written contract (Klein, 1996). The fact that more explicit contractual terms create greater rigidity (Klein, 1996) also means that the presence of PEC allows for a greater degree of flexibility within a relationship without the fear of opportunistic behavior. Such flexibility enhances the ability of transactors to adjust and renegotiate their agreement to meet changes and shifts in the underlying external environment.

Alternative External Enforcement

During the establishment of an alliance in a highly volatile environment, or an environment where legal enforcement is weak or absent, it is difficult for parties to use strict written contractual terms to bring and hold themselves together. Under such circumstances Gow and Swinnen (2001) advocate the use of alternative external enforcement mechanisms and institutional structures. Third parties can be used in such a way to provide verification of performance or to adjudicate in matters of arbitration. In reference to strategic alliances, these third parties can form what Dyer *et al.* (2001) term, the "strategic alliance function". The role of an alliance function is to improve knowledge management, increase external visibility, provide internal coordination, and eliminate accountability and intervention problems (Dyer *et al.*, 2001).

Thus, the key to establishing a successful alliance relationship with the durability to subsist in a volatile market environment is to establish the agreement such that a

sufficiently large self-enforcing range exists, or can be developed, that encourages the optimal level of investment to take place without constructing written contractual terms that may create the potential for opportunistic behavior and impose undue rigidity on the relationship. As has been illustrated, to form a self-enforcing agreement a degree of PEC must exist between partners. In an initial alliance between unknown partners, there is little or no PEC present. At establishment little multilateral reputation exists between alliance partners. They have their reputation in the market place to protect, however, this assumes an element of market transparency and if absent or constrained in some way, then reputation alone will not create a sufficient level of PEC. Therefore, rents must be generated by the alliance to create PEC. Given the difficulty of attracting investment from the partners in the absence of PEC, this must be done without requiring a large expense by the alliance partners.

Generating Private Enforcement Capital

Prahalad's (1993) theory of value creation provides an insight as to how this is possible. According to Prahalad (1993) value creating activity can be viewed as having two aspects: the performance gap - optimizing performance through operating efficiencies - and the opportunity gap - exploiting opportunities for new product, market, or business development (Prahalad, 1993). Thus, a concentration on managing the performance gap does not require large investments of capital but if done well can return immediate profits (Prahalad, 1993) and consequently, create private enforcement capital between the alliance partners. Overtime and as [perhaps successive] performance gap issues are worked through, the foreseeable scope and opportunities for the alliance become clearer and as such multilateral reputation among its partners becomes important. Such

reputation adds additional PEC to the relationship until the accumulation is such that it extends the self enforcing range of the alliance to where the partners feel comfortable pursuing opportunity gap activities, that is, investing in relation-specific assets, engaging in business activities with more uncertain returns, and generally accepting a greater risk of opportunism. It is these initial incremental transactions that Doz (1996, 77) refers to as the "early 'small' events in an alliance [that] have a disproportionate importance in establishing a self-reinforcing cycle of heightened efficiency expectations, greater institutional and personal trust and commitment, joint sense-making and learning, and greater flexibility and adaptability".

Case Study: Cellars of Canterbury

'Cellars of Canterbury' is a wine producing and marketing joint venture between five independent New Zealand (NZ) wineries. The alliance was initially established in 1996 as a mechanism to save promotional costs. In the six years ensuing its establishment the alliance has underwent several structural changes in response to changes in its operating environment and now controls the complete production and supply of its own label of wine into the two largest export markets for wine in the world, the United Kingdom (UK) and United States of America (US). Data for the case study was collected in December 2000 through a series of semi-structured interviews with the 'Cellars of Canterbury' owners, staff, and business partners.

In 1996, the NZ trade development board put a program in place designed to encourage the formation of business networks between individual enterprises. The rationale for this was that if businesses were prepared to cooperate they could compete more successfully

in the international market place. The government funded scheme offered to provide the services of a business consultant and significantly subsidize the establishment costs of these hard business networks (HBN), as they were termed.

A member of what is now the 'Cellars of Canterbury' joint venture was made aware of this scheme and immediately saw the opportunity to implement an initiative he had been contemplating for sometime. His vision, was to form an alliance between a group of wineries from the same geographical region and share the expenses of entering the NZ wine trade fairs, the most widely recognized promotional event for NZ wineries. He and the newly appointed business consultant approached what they felt were the four most attractive potential business partners with this concept. They were all virtual strangers but some of the more high profile and innovative vintners in the Canterbury[3] region. All could see that there were significant benefits to be realized if they were prepared to cooperate and accepted the invitation to join the alliance.

They registered the name "Cellars of Canterbury" as a limited liability company. The initial strategic intent of the alliance was to collectively raise the profile of Canterbury as a wine producing region and save costs in the process. The strategy they followed was to enter the regional NZ wine fairs under a collective "Cellars of Canterbury" banner. They would place one entry but put their whole range of wines on the stand and share the attendance duties among the partners, thereby spreading the fixed costs of entry, time, and travel. This was a performance gap they were exploiting and by entering the alliance, the partners were presented with an immediate value gain. These relational

[3] Canterbury is a province of the South Island of New Zealand.

rents were generated with very low investment and therefore created immediate private enforcement capital between the partners.

Concurrently, external enforcement mechanisms were developed. The business consultant formalized the agreement by writing a constitution for the newly formed company which specified guidelines for business conduct and protocols. Most importantly, this included provisions for exit and entry of partners from the alliance. The consultant also acted as a means of third party verification of performance levels and compliance to the agreement. He facilitated information flow between the partners acting as a mediator in discussions and an arbitrator in disputes. This information flow and personal interaction was based around regular bi-monthly directors meeting which only the directors could attend, they each held equivocal voting rights so the power of decision making and control was effectively positioned to allow maximum responsiveness. This was also important since it meant that the same individuals were interacting at the interface of the alliance which aided to develop and reinforce the importance of multilateral reputation. In effect the consultant represented the "alliance function". All of these factors provided further enforcement to help solidify the relationship and guide it through the initial uneasy stages of establishment until sufficient internal enforcement existed. The significance of the government assistance cannot be understated since this made putting these provisions in place costless and therefore did not deduct from the present value of the relational rents earned.

'Cellars' hired the services of a reputable wine-maker as a wine consultant to accompany them on monthly tours of each others vineyard and winery to assess and advise on grape quality and viticultural procedure. This helped to ensure a high quality product, provided

transparency, gave the partners a degree of process control over the product, and represented another form of third party verification, thus, preventing free-riding. These regular engagements stimulated social interaction between the alliance partners which developed further multilateral reputation between them all and led to increased vision of the potential scope for the alliance. During these semi-formal proceedings many side transactions took place, partners arranged to share facilities, trade produce, and share the expense of capital equipment purchases which all acted to further strengthen the relationship by increasing PEC.

These early incremental transactions were the "small events" that Doz (1996) refers to, and all contributed to creating PEC among the alliance partners. The initial performance gap, cost saving strategy, produced immediate value and as such created PEC, the continual personal interaction and increasing vision of the alliance's potential developed multilateral reputation between the business partners, thus creating additional PEC, and the external enforcement mechanisms that were put in place acted to further extend the self-enforcing range of the agreement. All of this took place before any significant capital investments and therefore contractual safeguards were required and thus, the alliance relationship was established with minimal contractual rigidity.

The first opportunity they saw to advance the alliance was to use it to increase their presence in the local Christchurch[4] City market. 'Cellars of Canterbury' employed a salesperson whose role was to place the member's wines onto the wine-lists of as many licensed restaurants in Christchurch City as possible. This spelt the first significant relation-specific financial investment for the alliance. They were now financing the sale

[4] Christchurch is the largest city of the Canterbury province, third largest in NZ.

of product on behalf of each other, as opposed to only promoting it, as they had done in the past. The fact that they felt comfortable investing this additional capital and resources and modifying the initial agreement is evidence of the level of PEC that had accumulated in the relationship and its flexible nature. At the same time their business consultant had developed some small export trade relationships in the pacific islands. These were not ideal markets and were not the primary focus of the 'Cellars' partners themselves but served as a means to fill the export trade requirement of the government assistance they received and also provided valuable export trading experience for those partners that had not done so previously. The small distributors they dealt with found 'Cellars' an attractive prospect since by dealing with one supplier they were presented with a multitude of wines. 'Cellars' charged a sales commission on top of the wineries' retail prices so in effect it was more expensive than dealing with the wineries directly.

The local market strategy was a success but there was an ever increasing demand for Marlborough[5] Sauvignon Blanc which by then had gained profound recognition both domestically and internationally[6]. In order to maintain there current market position the wineries would have to make Marlborough Sauvignon Blanc a part of their offering. Contracting for grapes or buying from the spot market was not a satisfactory option from a long-term perspective. The importance of grape quality for the purpose of wine-making cannot be overstated. To assure quality at an affordable price they required vineyard ownership. When it appeared that this was the direction the joint venture was headed,

[5] Marlborough is a province in the Northern part of the South Island of NZ. It is the largest grape growing region in NZ, most recognized for its Sauvignon Blanc.

[6] NZ has won the Silverado trophy for the best Sauvignon Blanc at one of the worlds most prominent wine contests – The International Wine and Spirit competition – 9 times since it was first established 11 years ago.

one of the partners became uncomfortable. The winery he represented did not have the desire nor the financial standing to push the alliance to this next level.

Some of the wineries already had small holdings in Marlborough Sauvignon Blanc vineyards but could not afford to extend themselves further privately. ‘Cellars’ provided another avenue toward vineyard ownership, but it would require a change of personnel. This did not pose a problem since they had a formula for exit in place and were not bound by any other contractual rigidity. There were many interested parties waiting to join the alliance given the opportunity, this was a clear indication of the industry reputation that had accumulated to the ‘Cellars’ entity. They evaluated the strengths and weaknesses of the alliance as it stood, the markets they were operating in, the intended strategic direction they had for the company, and chose a new partner with the complimentary core competencies they required. The owner/director of this new partner winery was also managing director of a large Australian commodity trading company and possessed a wealth of experience in international business and export trading.

Late in 1998, almost immediately after restructuring the alliance they purchased a large vineyard holding in the Marlborough region. Operating through the joint venture allowed for this purchase to made using 100 percent debt financing. The land purchase signified a large relation-specific asset investment and spelt a major structural and operating change for ‘Cellars of Canterbury’. However, a large stock of PEC had amassed in the alliance to nullify any threat of opportunism. ‘Cellars of Canterbury’ was providing significant returns to the partners and opportunities not available to their individual enterprises. They had become well known in the domestic marketplace, hence market reputation was also providing significant PEC. In addition, external enforcement mechanisms in the

form of an exit strategy, the legal rights to land ownership, and the fact that they held equal authority and control in the company provided powerful incentives. Internal enforcement capital had reached a level where the company felt they could manage without the third party enforcement provided by the business consultant. At this point in time they took over the administrative duties of the company and established their own private office. They kept this independent of any of the five wineries' private offices and employed an independent office clerk, this way the authority and control in the company remained balanced.

Domestic competition had heightened in NZ, the number of suppliers was increasing rapidly (the number of wineries increased 173% between 1990 and 2000), wine consumption had stabilized, and it appeared that the situation would only worsen owing to the fact that a large acreage of vineyard planting and development had taken place throughout NZ that was yet to come on stream. The largest outlets for NZ wine were very cost/price oriented and large volumes were required to compete in this market arena. These were the principle forces that convinced 'Cellars of Canterbury' to refocus its direction and embark on a strategy of International promotion. Initially they implemented the same strategy as they had in the domestic NZ market, they entered the high profile European wine trade shows as 'Cellars of Canterbury' but touted the wines of each of its members on the stand. From here they aligned themselves with distribution agents predominantly in the UK which amounted to varying levels of success among the partners.

The problem was they were not exploiting the comparative advantage that 'Cellars' endowed them. The decision was made to advance the 'Cellars of Canterbury' concept a

step further and produce a "Cellars of Canterbury" labeled range of wines. Among other advantages this provided a means of raising capital for debt repayment without requiring a direct input from the partners. Another benefit was the opportunity to add value to surplus fruit from the individuals' wineries by selling this directly to 'Cellars' rather than a third party. It also allowed them to replace their domestic salesperson with a specialist International marketing agent, whose task was to seek markets and distribution channels in the UK and US specifically for the generic label. Beside the obvious PEC contained in the relationship that such a development depicts, of most interest is how the flexible links between the components in their supply chain architecture allowed 'Cellars' to reconfigure there domestic supply chain to create an international supply chain to meet the unique market opportunities that confronted them. The marketing agent aligned them with one of the largest wine importers into the UK and an extensive distribution channel in the US. Owing to a number of factors, the position 'Cellars' has taken in these two markets would not have been possible individually. Acting through the joint venture reduced the individual capital requirement, spread the risk bearing, and provided them the volume of product required to fulfill a significant export market.

Conclusion

We believe a lot can be learned from this case about the process to establishing alliances that can successfully evolve in volatile business environments. By implementing a strategy aimed at a performance gap issue 'Cellars of Canterbury' was able to create immediate value in the relationship with little expense. This led to private enforcement capital amassing in the relationship which negated the need for written contractual safeguards when relation-specific asset investment took place. As the potential scope for

the alliance became visible multilateral reputation became important and thus increased the private enforcement capital between the partners further. In this sense a type of self-reinforcing cycle developed, where generation of rents created private enforcement capital which increased the importance of reputation, adding additional private enforcement capital. The strengthened relationship allowed for entry into further market opportunities creating greater rents and so the cycle repeats.

The fact that the alliance was based upon self-enforcing agreements meant that the company was not bound by stringent contractual rigidities and could make necessary changes to the structure and operation of the joint venture when environmental forces commanded. In addition, having a consultant guide the establishment of the alliance provided an important external enforcement mechanism that acted to reinforce the alliance agreement until sufficient internal enforcement capital existed.

Discussion

The research reported here draws on a single case, thus, as always, one must treat the findings and propositions drawn with a degree of caution. However, we believe that this case provides some interesting insights into the process of developing successful flexible alliance relationships. A question that immediately comes to mind is would these findings hold in a corporate setting where there is perhaps a much less personal interface in alliance relationships.

A policy issue arising from this study is that of the role of central government in funding the establishment of such Hard Business Networks. As was noted in the case, government funding made the initial facilitation and external enforcement of the alliance

relationship costless, therefore, it did not detract from the initial relational rents generated and thus allowed for a higher level of private enforcement capital to amass from these rents.

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