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Governance Value Analysis: A Framework for Structuring Optimal Relationships

Firms operating in Asia widely accept the fact that external relationships with other companies are essential to viable success. Whether it be a firm's relationship with downstream channel partners, internal constituents, or buyers, complex cooperative partnerships in Asia act as the bloodline to the heart of a firm's success. But how does a firm integrate strategy within the broad notion of relationship management? Governance Value Analysis (GVA) is a model that seeks to address marketing strategy decisions, particularly those concerning cooperative relationships. Resources, positioning, governance structure, and attributes of exchange, all affect the success of a firm's strategic decisions. In this vein, GVA addresses how different firms react differently in similar circumstances.

With so many factors to consider, GVA can greatly improve managerial decisions by taking into consideration how a firm's specific set of resources and positioning within the market affect the design of the supply chain. An optimal governance structure should create generated joint value while succeeding in protecting a firm's specific resources. Should a relationship with another firm be based on arms-length exchanges or a cooperative partnership with information sharing? When should a firm choose to vertically integrate instead of opening up to the market? GVA assists firms with this choice by structuring optimal relationships while lowering marginal costs, securing investments, and reducing uncertainty.

GVA was first introduced in 1999 by Mrinal Ghosh, the W. "H" & Callie Clark Associate Professor Marketing at the University of Arizona's Eller College of Management, and

> How does a firm integrate strategy within the broad notion of relationship management?

George John, the General Mills-Gerot Chair in Marketing at the University of Minnesota's Carlson School of Management. Woodward Partners recently sat down with Dr. Ghosh to discuss how GVA provides a framework for aligning a firm's channel relationship structures with its strategy and resources, thus enabling the firm to understand and structure optimal partnerships with other firms.

Featuring

Professor Mrinal Ghosh is a faculty member of Marketing at the Eller College of Management, University of Arizona. He is an expert on designing and managing distribution channels, structuring contracts and alliances in industrial, business-to-business, and high technology marketing, and designing sales force compensation. Prior to joining the University of Arizona, Professor Ghosh worked as an Assistant Professor of Marketing at the University of Michigan, Ross School of Business. He obtained his doctoral degree in Marketing and Management from the University of Minnesota. He also holds a Bachelor of Engineering from the University of Bombay.

Limitations of Resource-Based View and Transaction Cost Economics Models

GVA integrates Resource-Based View (RBV) and Transaction Cost Economics (TCE) to create an overall firm strategy.

RBV maintains that the basis for a competitive advantage of a firm lies primarily in the application of valuable resources at the firm's disposal. According to RBV, transforming a temporary competitive advantage into a sustained competitive advantage requires that these resources are heterogeneous in nature and not perfectly mobile. TCE, which claims that the costs and difficulties associated with market transactions favor vertical integration and not the open market, attempts to explain why firms exist by seriously examining the internal structure of organizations. More specifically, it attempts to explain the particular structure of a firm and the extent to which the firm will integrate vertically.

While TCE considers the internal structures of firms, it also assumes that all firms will seek to optimize their relationships in certain ways given certain circumstances. Ghosh and John, however, observed that there is wide variation in how firms responded to similar circumstances. More specifically, they found that not all firms respond in the same way because of firm-specific differences and other

factors that affect decision making (e.g. positioning, trust, conflict of interest, etc.). "[TCE] doesn't take into account firm specific resources," said Ghosh. "Once we add firm specific motivation, we start seeing the differences. Different firms, depending upon what endowments they have, are going to react differently."

By providing a framework for understanding and structuring optimal partnerships, GVA significantly influences firm strategy in business partnerships. The key, according to Ghosh, is the model's ability to pinpoint what factors influence the types of structure that a company gives to relationships with downstream channel partners, distributors, retailers, etc. Each firm has a distinctly different set of firm specific resources that are different than their competitors and directly affect how relationships are structured. Gosh explains, "Firms have brand resources, technology resources, managerial resources, and so forth. How do they use those resources? How do they start incorporating strategic parts in this choice of how to manage relationships?" To illustrate this point, Ghosh uses vertical integration as an example of these strategic factors. For instance, vertical or forward integration in distribution is not feasible for every company. "They have to determine what sets of feasible options they have and then tailor the broad principle to that particular situation," he said. The beneficial control firms can have when they vertically integrate must be balanced with the capital intensive costs that arise. Toyota's manufacturing, for instance, is highly vertically integrated due to the company's positioning on reliability. To support their brand positioning, Toyota can justify the high costs of vertical integration for the ability to ensure reliability through high control and protection of their assembly line innovation and technology. GVA shows that the more specific the investment such as knowledge intensive operations with specific technology, the more likely it is that a company would benefit from internalizing an operation that brings superior value to the company. Smaller firms cannot vertically integrate as easily since the upfront costs often outweigh the benefits. GVA assists in identifying these options and the corresponding governance structure that best supports the firm's resources.

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Improving Performance in Asia Using the GVA Model

GVA is particularly valuable for firms operating in Asia because it helps account for the complex, and necessary, partnerships in the region. To realize success, firms first need to identify their resources that they possess such as positioning within the market, brand identity, and resources such as technological capabilities. Next, they need to identify the activities that will support and protect their specific assets as identified above. As the value of the brand is communicated through certain activities, what steps does the firm need to take in order to protect this positioning? Strategic decisions might involve where not to sell the product, the level of product expertise needed from distributors, and other specific requirements for those who would be selling the product or services. "There has to be a cut off line, or minimum requirements of who would be selling or installing the product," said Ghosh. "You need to have minimum level of activities to support the brand."

Use of GVA can greatly enhance the managerial decision process by providing a framework for creating optimal relationship structures that are essential to a firm's success.

Once firms have identified activities that are needed to support the brand, they must determine the governance form. In other words, they must determine the arrangements and relationship structures that are most appropriate to implement the strategic decisions to support the firm's resources and positioning. Firms may determine, for instance, that a national distributor, series of distributorships, or even establishing their own distribution shop is best to suit their needs. This choice depends on the amount of control needed by the firm, the conditions within the market, and the brand identity as specified above. Once the appropriate structure is decided upon, they need to determine the incentive for a structured design form that would enable these activities to be accomplished successfully. "It is easy to say, 'I want this to be done,' but who is going to do it? This is the part where you have to identify the incentives to do it," said Ghosh. Once firms determine the governance form, they must examine the margins (i.e. who gets what) and constraints. If the constraints are binding, the particular choice of governance will likely need to be modified to a structure that takes those constraints into account.

Applying GVA Model: Thailand Case Study

Applying GVA to a Western firm's recent expansion in Thailand clearly shows GVA to be an extremely valuable tool when assessing the best governance structure to support the brand position of the firm. A Western firm with a strong brand name expanding into Thailand chooses to distribute its products in the country through a national distributor that has a reputable national brand name but not a global one. At first glance it would seem that the Western firm would have a superior position in which to forge a relationship with a distributor eager to work with a strong brand name product that would be easier to sell. One would think that the Western firm with the strong brand equity would be in a position of power to negotiate a contract with a distributor for a low operating margin.

However, while the brand of the national distributor gives the Western firm credibility and a powerful distribution channel in Thailand, it creates a scenario in which the Western firm relies upon the distributor and reduces its own bargaining power. Through this cooperative relationship with the Thai distributor, the firm has placed itself in a vulnerable position. In this arrangement, the Western firm faces the risk of entering into a dependent relationship with the distributor who now has high leverage and great bargaining power with the firm. Ghosh explains that the Western firm needs to question what the national distributor in Thailand is capable of, "Take for example they have to train their sales people to go into the middle of nowhere trying to sell the product. Are they really good? What are they saying about the brand?" The risks of the governance structure such as the cooperative relationship chosen by the Western firm are often quantitative and very difficult to measure. According to Ghosh, these are non-observable, non-measurable efforts that need to be considered when choosing the governance structure. To account for these risks, the GVA model calls for a firm to impose certain restrictions on the distributor. GVA calls for a contractual safeguarding against these kinds of performance ambiguities. For example, the firm can choose a governance structure and demand the creation of certain kinds of training, marketing, and logistic procedures by its chosen distributor.

Despite having powerful brand equity, the Western firm should have first identified its market position and valued resources and then decide upon the governance structure that would best protect itself from the supplier becoming opportunistic. While taking into consideration a firm's specific set of resources, positioning, and context, GVA shows that firms with strong brand equity should avoid relational governance structures such as cooperative partnerships. Rather, firms with strong brand equity should use market governance (arms length relationships) that allow for greater safeguarding. As brand equity increases certain bargaining power is reduced. Use of GVA can greatly enhance the managerial decision process by providing a framework for creating optimal relationship structures that are essential to a firm's success.

Summary

GVA applies to both large and small firms either operating in, or considering entry into, Asian markets. Working through distributors in foreign markets entails many risks, and key factors need to be taken into account when selecting the right partners to structure relationships. Many Western companies come to Asia with advanced technology and other assets, such as brand names, but the distribution partners here also hold assets. Structuring the relationship so that both partners are aligned strategically and remain so over time requires careful thought – GVA can help firms align these relationships effectively.

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