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**ALLIANCE FORMATION IN THE AGRIFOOD SECTOR:
THE CASE OF CELLARS OF CANTERBURY***

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This paper draws extensively from an extended working paper "Successful Alliance Formation and Evolution in a Volatile Business Environment: The Case of Cellars of Canterbury" by L.D Oliver and H.R Gow

Introduction

This paper focuses on expanding our understanding of how alliance formation and evolution occurs over time. Grounded in an empirical case study of "Cellars of Canterbury", a New Zealand wine production and marketing joint venture between five Canterbury wineries, we analyze how alliance partners can create flexible alliance architectures capable of being successfully reconfigured to meet changing environmental and market conditions through the use of self-enforcing agreements. Our conceptual model identifies the necessary conditions to ensure that sufficient private enforcement capital is available to support the alliance, thereby allowing relationship-specific investments¹⁶ to be made and providing sufficient flexibility to ensure the alliance can withstand any unexpected shocks without being forced into premature failure¹⁷.

The remainder of the paper will proceed as follows. In the next section, we define strategic alliances and outline the importance of trust and private enforcement capital in supporting alliance formation and governance. We then develop a contractual enforcement model to explain the relationship between the amount of private enforcement capital held between alliance partners and the capacity of an alliance to successfully adapt to changing environmental and market

¹⁶ We define relation-specific investments to include time, effort, knowledge as well as the physical assets directly relating to the relationship.

¹⁷ Failure in this context may mean that the alliance is disbanded, a partner breaches an alliance responsibility requiring external litigation or mediation, or the proposed alliance never occurs.

conditions. Finally we use the case of Cellars of Canterbury to support this theoretical framework and draw a number of implications and conclusions.

Governance of Alliances

The term strategic alliance can be used to define 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). In addition, an effective alliance relationship can also provide its partners with a degree of strategic flexibility suitable for operating under uncertain environmental conditions that may not be available otherwise (Mjoen and Tallman, 1997).

To realize the synergistic combinations of resources and appropriate the expected economic and knowledge rents that are potentially available from these relationships, often requires significant relationship or transaction specific investment (Gulati and Singh, 1998; Madhok and Tallman, 1998). However, the failure of partners to recognize the extent of the relationship-specific investments necessary to support an alliance is often cited as a common reason for alliance failure (Madhok and Tallman, 1998). Kumar and Nti (1998) suggest that such under-investment in relationship or transaction specific assets at establishment causes negative outcome discrepancies and it is the firms' reactions to such discrepancies that decide the longevity of the alliance.

A number of authors have referred to the need for partnering firms to invest in relationship specific assets¹⁸ if the alliance is to be successful, however, they are often reluctant to make these relationship-specific investments early in an alliance's lifecycle as it exposes them to the threat of opportunistic behavior from their partners (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).

Williamson (1985) asserts that if the partners put in place the appropriate safeguards then they will become more willing to make the necessary relationship-specific investments, generally leading to the generation of greater relational rents¹⁹.

¹⁸These relationship-specific assets may often be 'soft' assets (Kumar and Nti, 1998).

¹⁹ 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.

From a contractual perspective the most appropriate solution to opportunism is the construction of stringent contractual agreements between alliance partners that address these matters. However, although these contractual mechanisms may be viable in very stable business environments, problems arise in uncertain business environments; as it is costly, if not impossible, to ex-ante stipulate sufficient pre-specified contractual terms to cover all possible future states of nature. Consequently, the rigidity and inherently incompleteness of formal alliance contracts may in fact increase the alliances susceptibility to opportunistic behavior occurring, rather than removing it. If unforeseen shifts in market conditions occur that are substantially different from those initially envisioned when the legally binding agreement, enforceable by either party, was agreed upon, then one of the parties to the alliance may be able to enforce the rigid literal terms of the alliance to adversely affect other parties, even when these terms are contrary to the initial intent of the alliance parties (Hart, 1995; Klein, 1996; Gow *et al.*, 2000). This is generally referred to as a hold-up problem (Klein *et al.*, 1978).

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 lacks a unifying definition (Inkpen and Currall, 1997). Some distinguish between knowledge based trust, developed through ongoing interaction and equity, and deterrence based trust, developed through the threat of costly sanctions imposed for untrustworthy behavior (Gulati, 1995). Barney and Hansen (1994) further argue that the level of trust that exists between business partners is 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 the other party (Gulati, Khanna, Nohria, 1994), or alternatively, reciprocating 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 take two forms; one is 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 transactors 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).

Combined, these sanctions represent the magnitude of the private enforcement capital available within the alliance and define what Klein (1996) refers to as the “self-enforcing range”. This measures the extent to which market conditions can change without precipitating a hold-up by either party. Thus at any point in time, both partners to a transaction are balancing the costs of behaving opportunistically and breaching the relationship against the benefits to be gained from remaining in the relationship (Klein, 1996; Gow *et al.*, 2000). Hold ups only occur when a sufficiently large unanticipated event shifts the underlying market conditions outside of the self-enforcing range and consequently breach becomes economically optimal. Once outside of the self-enforcing range, contracts can only 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 means that actors will perform in a manner consistent with the mutually understood implicit contractual intent, as long as market conditions remain within the self-enforcing range, even when all elements of the contractual understanding are not pre-specified in the written contract (Klein, 1996).

As can be seen, the rigidity that contractual terms provide may be desirable in stable environments; however they can prove detrimental in uncertain business environments as partners may be able to opportunistically take advantage of these rigidities. Thus, the more uncertain the environment within which an alliance operates the greater should be the level of flexibility that any alliance partner will require, since this will provide them the ability to adjust to any unforeseen shifts in market conditions. Hence, the greater the uncertainty, the less willing alliance partners will be to impose stringent contractual terms, as this will reduce their susceptibility to rigidity induced hold ups. However, this necessitates that the alliance partners possess sufficient PEC to compensate for the lost contractual certainty and provide the flexibility for freely adjusting and renegotiating their agreement within the self-enforcing range to meet changes in the underlying external environment. Without sufficient PEC such negotiations would be uneconomic as breach would be the optimal and efficient outcome. Hence it is only in the presence of sufficient PEC that a strategic alliance can be successfully established.

Creation of Private Enforcement Capital

The problem however is the immediate creation of relational rents in the initial absence of PEC, as these rents must be achieved without any PEC support and hence without requiring any major investments or outlays by the alliance partners.

Prahalad’s (1993) theory of value creation provides an insight as to how it is possible to generate relational rents, thus PEC, without the need for large levels of investment. 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 PEC between the alliance partners. Overtime, and as [perhaps successive] performance gaps are worked through, relational rents and bilateral reputation develop, thereby increasing the levels of PEC among partners.

Once PEC accumulates to a sufficient extent that the self-enforcing range of the alliance extends beyond the point where the probability of breach becomes insignificant, partners will then feel comfortable pursuing opportunity gaps, that is, investing more heavily in relationship-specific assets and engaging in business activities with more uncertain returns that would have previously required accepting a greater risk of opportunism. It is these initial incremental transactions that Doz (1996, 77) refers to in his framework of cooperation 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”.

The key to establishing a successful alliance relationship with the flexibility to subsist in a volatile business environment is to establish the agreement, such that a sufficiently large self-enforcing range exists 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.

Case Study: Cellars of Canterbury

In the following section we evaluate the establishment and evolution of Cellars of Canterbury - an organization that has survived significant environmental change and uncertainty - against this theoretical framework. Cellars of Canterbury is a wine production 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 ensuing six years the alliance has undergone several substantial strategic and structural changes in response to unexpected endogenous and exogenous shocks. The alliance now controls the complete grape production and supply base for its own wine label marketed into the two largest global wine importing markets; the United Kingdom (UK) and United States of America (US).

In 1996, the NZ trade development board (TradeNZ) put a program in place to encourage the formation of business networks between individual enterprises. A member of what is now the “Cellars of Canterbury” joint venture became aware of this scheme and immediately saw an opportunity to develop such a network. He and the business consultant appointed by TradeNZ approached four potential business partners in the Canterbury region. All could see that there

were significant and immediate 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. Their initial strategy 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 evenly between the five wineries. This was a performance gap initiative they were exploiting: by entering the alliance, in terms of cost savings the partners were able to capture immediate value through reducing their marketing cost by 80 percent. These relational rents were generated with minimal investment, however they created immediate private enforcement capital between the partners.

The first opportunity they saw to advance the alliance was to use it to increase their presence in the local Christchurch²⁰ City market. Cellars of Canterbury employed a salesperson to penetrate the restaurant market with the wines of its individual members. This spelt the first significant relationship-specific financial investment for the alliance. With the hiring of a salesperson they were now financing the sale 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.

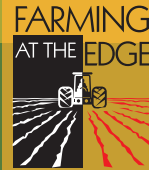
The local market strategy was a success but there was an ever-increasing demand for Marlborough²¹ Sauvignon Blanc, which had become highly recognized both domestically and internationally²². In order to maintain their current market positions, the wineries would have to ensure that Marlborough Sauvignon Blanc remained a part of their offering. Traditionally they had purchased all of their requirements from Giesens, the largest of the five partners, however Giesens were now becoming constrained attempting to meet their own increasing demand. To assure quality at an affordable price they realised that vineyard ownership was a necessary requirement. When it appeared that this was the direction the joint venture was headed, one of the partners became uncomfortable. The winery he represented did not have the desire or the financial standing to push the alliance to this next level.

²⁰ Christchurch is the largest city of the Canterbury province and the third largest in NZ.

²¹ 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.

²² NZ has won the Silverado trophy for the best Sauvignon Blanc at one of the world’s most prominent wine contests – The International Wine and Spirit competition – 9 times since it was first established 11 years ago.

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Some of the wineries already had smallholdings in Marlborough Sauvignon Blanc vineyards but privately could not afford to extend themselves any further financially. '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 valuation formula in place for exit and entry and alliance partners were not bound by any other contractual rigidity as long as the directors at the biweekly directors meetings agreed. So the alliance was quickly valued, the exiting partner bought out and the search began for a replacement. 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.

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 be made using 100 percent debt financing. The land purchase signified a large relationship-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, which effectively nullified any threat of opportunism. Cellars of Canterbury was providing significant returns to the partners and business 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 ability to separate the land into five separately titled parcels, 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 employed an office clerk, took over the administrative duties of the company, and established a private office independent of the individuals' wineries.

Domestic competition had heightened in NZ, the number of suppliers was increasing rapidly (the number of wineries increased 173 percent between 1990 and 2000), wine consumption had stabilised, 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 into production. 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 they had used 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 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. 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.

Conclusion

We believe a lot can be learnt 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 investment in relationship-specific assets took place. As the potential scope for the alliance became visible, both bilateral and multilateral reputations of the alliance and the partners became important, thus increasing 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.

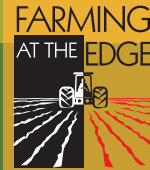
The fact that the alliance was based upon self-enforcing agreements meant that the company was not bound by stringent contractual rigidities and could make necessary changes to the structure and operation of the joint venture when environmental forces commanded. In addition, having a consultant guide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

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