Strategic Alliance and Firm Growth

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Abstract

According to Penrose's (1959) internal growth theory, the possession of abundant resources has impacts on a firm's expansion. Researchers also notice that lack of managerial resources will limit the rate of growth of the firm. Prior research have demonstrated that contractual organizational forms that allow firms to gain access to resources beyond the boundary of the firm will help them to overcome internal managerial limitations to the firm growth. Strategic alliance, as one of the most popular contractual organizational forms in recent years, allows firms to obtain complementary resources from their partners as well as to find new opportunities in the network relationships. We argue that strategic alliances can overcome the limitations of firm growth by bringing new resources and opportunities for firms. Thus, we hypothesize that firms that have allied with other firms may overcome the limitations of firm growth and grow faster. Using a sample of 178 manufacturers in Taiwan, this study examines the effects of strategic alliance on the growth of a firm.

Keywords: Strategic alliance, firm growth

Introduction

For decades, firm growth has been a core issue in the field of strategic management because the rate of growth has become a widely adopted performance indicator in current practice. Some research has used a set of independent variables to predict differences in growth rates across firms. And some research has examined the effects of growth on the different ages and different sizes of firms. However, most prior research has emphasized growth rates (i.e., *how much* a firm grows). There are few studies examining *how* a firm grows (Mckelvie & Wiklund, 2010). In particular, the effects of organization forms on firm growth have been under-explored. MacKelvie and Wiklund (2010) argued that we must grasp the "how" aspects of firm growth before turning our attention to the "how much" aspects. In other words, different firms may have different growth processes, and the boundary choices of resource allocation vary substantially. There are multiple actions and organization forms that may promote growth.

In order to understand how a firm grows, we have examined contractual organizational relationships and their implications for firm growth. In particular, we test whether contractual organization forms may overcome the managerial limitations to firm growth. Penrose (1959) argued that a firm's growth is limited by the finite capacities and capabilities of a firm's internally experienced managers. The impact of managerial limitations on a firm's growth is called the Penrose effect (i.e., Gander, 1991; Shane, 1996; Thompson, 1994; Tan & Mahoney, 2005; Tan & Mahoney, 2007). The Penrose effect happens when a firm's internal managerial resources are

not sufficient to handle more complicated organizational tasks associated with rapid expansions. Firms have many ways to overcome managerial limitations on accelerating a growth rate or on maintaining a high one. In recent years, research has demonstrated that the hybrid organizational form is a possible strategy by which firms can overcome limitations and grow faster (Shane, 1996). However, while emphasizing the effects that a few types of contractual forms have on the rate of firm growth (Lu & Beamish, 2006; Shane, 1996; Zahra, Ireland, & Hitt, 2000), current research has paid little attention to whether the mechanism of overcoming managerial limitation found in one type of contractual organizational forms, for example franchising, is also applicable to other types of contractual organizational forms, like licensing and strategic alliance (Shane, 1996).

In general, there are two common contractual organizational forms: franchising and alliances. Franchising is an organizational form based on a legal contract between franchisors and franchisees to sell a service or product using the franchisors' brand name (Child, 1987; Miller & Grossman, 1990). This kind of organizational form provides firms with external resources and a managerial capacity geared toward growth (Combs & Ketchen, 2003). Because the ownership and operations of a franchisee's outlet is independent of franchiser's control, the contributions of each franchisee to a particular outlet are easily identifiable. However, there are some cases in which firms need indivisible activities such as the sharing of complementary resources and knowledge. When firms base their growth on these activities, where the boundaries of ownership of resources are unclear and performance outcomes of shared resources cannot be cleanly divided, they must manage these activities by means of another contractual organizational form (e.g., a strategic alliance). Although strategic alliance is an important topic in strategic-management research, the field has yet to discuss the relationship between alliances and firm growth. In this study, we explore the mechanism underlying the effects that alliances can have on firm growth. In particular, we examine whether firms can accelerate their growth through the use of contractual organizational forms of alliance.

An alliance is a form of business association in which two or more firms join together in order to acquire complementary resources and capabilities (Das & Teng, 2000). According to Penrose (1959: 43), there are two factors that drive firms to grow. One is the presence of unused productive services within the firm; the other is the growth opportunities outside the firm. Alliances help firms locate complementary resources that the firms can use in order to realize the value of their own unused productive services. When entering alliances with these aims, firms need neither invest in additional managerial resources nor devote time and other resources to the training of existing mangers. In short, firms can acquire complementary resources through alliances while avoiding adjustment costs associated with an expansion of managerial capacities (Slater, 1980). In addition, managers seeking to maximize the profits of an alliance should be able to recognize pursuable opportunities when they arise. Alliances also help firms recognize extra-firm opportunities (i.e., opportunities outside a firm). Accordingly, we argue that firms can maintain their growth rate or grow even faster through the arrangement of alliances.

The current paper complements the extant research by focusing on the process of firm growth. Specifically, we examine the effects of contractual organization forms on firm growth. We assert that the use of contractual organizational forms is diverse across firms and that managerial limitations imposed on growth are thus heterogeneous. Firms are less likely to undergo the Penrose effect and are more likely

to grow rapidly when they can rely on organizational forms' choice and governance than when they cannot

The paper is organized as follows. The next section summarizes the literature on firm growth and develops several hypotheses concerning (1) the conditions under which firms are more likely to overcome limitations on growth and (2) how firms can grow faster. Then, we describe the data and measures that we used to test our theory, and we report the empirical results. The final section discusses the results and presents our concluding remarks.

Theory and hypotheses

Firm growth

For the past several decades, firm growth has been one of the most widely discussed issues in the strategic-management literature. Indeed, there are so many studies related to firm growth that McKelvie and Wiklund (2010) divided the literatures into three basic areas of interest. The first is growth as an outcome. The studies herein treat growth as a dependent variable and use a set of independent variables to explain the variance of growth outcomes such as growth rates and increments of growth (Phelps, Adams, & Bessant, 2007). However, researchers working in this area of interest have been unable to isolate variables whose effects on growth across studies are consistent. The researchers have found that this limitation occurs because the status and the intentions of a firm may change over time. The choices that firms make are not stable either. Moreover, few firms can engage in consistent, linear growth over time. Studies may ignore the ups and downs that occur within a given timeframe. Most important of all, the willingness to grow varies across firms (Mckelvie & Wiklund, 2010).

The second area (growth outcomes) and the third area (growth as a process) are no less important than the first. The studies on growth outcomes treat growth as an independent variable and use stages-of-development models or life-cycle models to examine the changes that result within organizations as a consequence of growth. However, research in this area of interest has revealed a limitation insofar as all these models assume that organizations experience growth when they make specific organizational arrangements. The third area—growth as a process—pivots on the issue of *how* firms grow instead of *how much* firms grow (Mckelvie & Wiklund, 2010).

Little research has dealt with this issue of growth processes. According to McKelvie and Wiklund (2010), the extant empirical studies and theoretical development on firm growth have been notably slow to advance because few studies have addressed the question of how to achieve adequate firm growth. Researchers have used a number of potential dependent variables to measure growth and have tended to identify particular variables that promote growth. Researchers have argued that they should explain *how* firms grow before explaining *how much* a firm grows.

According to Penrose (1959: 24), firms are not only administrative units but also organizations that integrate resources. Firms that inherit resources internally and acquire resources externally need to arrange them rationally and use them effectively. Penrose (1959: 26) argued that the optimum plan for expansion is to use resources in ways that maximize advantage. Managerial services play an important role in resource allocation. In addition to routine work, managerial services are responsible for planning growth. Managerial resources must have firm-specific knowledge and

experience to handle daily official business, and also must be able to choose, distribute, and integrate resources. Only when managerial resources have a surplus can firms plan for the next period's growth. However, firms often cannot get satisfaction from hiring the services of extra-firm managerial resources (Penrose, 1959: 46-47) because externally recruited new managerial resources often have no firm-specific knowledge and experience. It takes time for such resources to accumulate experience and to grow familiar with a given firm's operations. The costs that firms incur when coordinating extra-firm resources with intra-firm objectives are known as adjustment costs (Slater, 1980), which are prohibitive for many firms seeking to absorb new recruitments in a timely fashion. Also, many new managerial recruits cannot meet their firms' growth plan by the identified deadlines. In the literature, the Penrose effect (Penrose, 1959: 48-49) occurs when a high-growth firm cannot maintain its high rates of growth in successive time periods and, in subsequent time periods, experiences slowed growth due to the managerial limitations. Thus, we propose the following:

Contractual organizational forms

According to Penrose (1959), firms face internal limitations to growth. However, recent research has examined hybrid organizational forms and suggested that firms may use the hybrid organizational forms to overcome managerial limitations to firm growth (Norton, 1988a; Norton, 1988b; Shane, 1996; Teece, 1986). Hybrid organizational forms are also known as contractual organizational forms. These forms lie somewhere in between markets using price system and firms base on authority or combines elements of each (Williamson, 1991). We suggest that contractual organizational forms can greatly clarify the process of firm growth. Hybrid modes consist of contractual relationships that bind external actors to firms at the same time as the firms maintain a certain amount of ownership and control over how many assets are used (McKelvie & Wiklund, 2010).

In general, there are two common contractual organizational forms: the franchise and the alliance. In a franchise, the franchiser retains a degree of ownership and authority (Castrogiovanni & Justis, 2002) over the trade name, the operating procedures, the outlet locations, and contracts with franchisees (i.e., independent entrepreneurs) whose job is to operate the outlets (Child, 1987). The practice of franchising involves a franchisee who enters a contractual relationship with a franchiser in exchange for the right to use the franchiser's intellectual property. The franchiser receives compensation for using this asset; generally a lump-sum payment and a royalty fee based on an agreed-upon set of conditions (Miller & Grossman, 1990). This organizational arrangement provides some benefits for growth. For example, (1) franchisers do not need to invest further managerial resources into new outlets because franchisee must hire and train new employee to undertake activities in their outlets and (2) franchisers save time by avoiding the efforts to monitoring additional employee. Through the use of franchising-based growth, franchisers may also reduce agency problems resulting from moral hazard and goal inconsistency, and may decrease monitoring costs (Shane, 1996; Combs & Ketchen, 2003).

However, there are some drawbacks to franchising. Franchising requires that the franchiser surrender a degree of control over the firm (McKelvie & Wiklund, 2010) and that the franchiser bear higher transfer costs if assets and knowledge of franchisers are firm-specific (Darr, Argote, & Epple, 1995). In particular, franchising does not work when the growth of firm is based on indivisible activities such as finding complementary resources and joint R&D. Firms requires a more cooperative

organizational form to deal with these activities so that firms may leverage contractual relationships to grow faster.

Alliances are another common hybrid organizational form. It provides more joint actions and more collaborative decision-making than franchising. This organizational form combines two or more firms that either pursue a set of agreed-upon goals or leverage each other's resources while remaining independent organizations. The main purpose of alliances is to acquire resources and capabilities that the firms otherwise would need to develop on their own (Das & Teng, 2000). Alliances provide firms and their partner firms an opportunity to share with each other not only resources but risk, as well. Therefore, alliances are a less risky and less costly (Pearce & Hatfield, 2002) method for achieving firm growth than internal investment. However, the two main themes addressed in the extant literature on alliances concern the gains that firms derive from alliances and the reasons underlying the success of alliances (Gulati, 1998). There is little literature exploring the causal relationship between strategic use of alliances and its impact on firm growth.

Alliances as a mechanism of firm growth

Penrose (1959) proposes that within a firm, entrepreneurship and unused productive resources are key drivers to a firm's growth. On the other hand, Penrose (1959: 43) specifies three factors that might impede a firm's growth: managerial capacity, product or factor market, and uncertainty and risk.

The first driver of firm growth is the level of unused productive resources within firms. Firms face internal obstacles in the form of inefficiently distributed resources. According to Penrose (1959: 65), every firm has its own internal resources but cannot always fully exploit them because these resources are firm-specific and are less valuable if sold to other firms. Some firms pursue growth as a way to strengthen the degree to which they efficiently exploit these unused resources. As they grow, firms need more resources, especially complementary resources, to support the growth. As a result, firms seek and use various methods to achieve this end. In other words, growth is a cyclical process wherein firms try to find complementary external resources and try to balance them with internal resources.

Some firms acquire complementary resources through vertical integration. However, the process of vertical integration incurs costs. It requires additional investments of such capital as equipment and land. Also, vertical integration typically requires additional investments of human capital: in particular, new managers. Firms that fail to hire new managers have to spend time and money on familiarizing existing mangers with a new business technique or a new capital acquisition. These additional costs result from the process of internalizing external complementary resources and from training new managers to be effectively used by the firm (Slater, 1980)

In this paper, we suggest that alliances can give firms access to complementary resources without forcing the firms to incur significant adjustment costs. That is, firms can avoid investing in capital outlays by acquiring complementary resources from alliance-based partners. Because allied firms by acquiring complementary resources through alliances can avoid the costs associated with investments in additional managerial resources, the firms can devote any excess managerial capacity they might have to the next period's planned growth.

The second driver of firm growth is productive opportunity outside firms. According to Penrose (1959: 31), growth is limited by a firm's productive opportunity. The success with which a firm finds opportunities for growth depends mainly on the firm's entrepreneurial capabilities. Penrose identified several

entrepreneurial services: entrepreneurial versatility, fund-raising ingenuity, entrepreneurial ambition, and entrepreneurial judgment (Penrose, 1959: 35-41). In the process of growing, firms must be able not only to raise funds, but more important to identify and perceive opportunities for growth. Social network theory (Granovetter, 1973) posits that firms can use networking to acquire opportunity-recognition skills. Granovetter (1973) first introduced the concept of tie strength, and suggested that strong ties and weak ties differ from each other regarding their function in the transmission of information. Strong ties involve larger time commitments than weak ties. If strongly tied to each other, two individuals can trust each other and engage in significant reciprocity regarding the transmission of information and other resources. By contrast, a relationship whose members are weakly tied to each other would tend to engage less in mutually beneficial exchanges than would members of "tight" relationships. However, because members of weak-tie relationships are more heterogeneous than members of strong-tie relationships (Burt, 1992), weak-tie relationships are more effective than strong-tie relationships at providing their respective members with large stores of novel information and of information-collection strategies. As a result, firms are inclined to use weak ties for the diffusion of novel information (Nelson, 1989). Novel information in turn enables firms to identify more opportunities for expansion (Singh et al., 1999). Therefore, weak ties seem to facilitate firms' opportunity recognition by providing them with novel information (Singh et al., 1999; Elfring & Hulsink, 2003).

Through alliances, firms can acquire resources without incurring any significant managerial expenses.) The allied firm could leverage partner's complementary resources without using their own managerial resources, which could help the allied firms plan a future growth project. Also, alliances, by giving firms access to novel information, help them strengthen their opportunity-recognition skills. Thus, we propose the following:

Hypothesis: Through alliances, firms can both overcome managerial limitations and maintain or improve on growth rates.

Methodology

We drew this study's data from the Taiwan Economic Journal (TEJ) Database, a widely used data source for listed firms in Taiwan. Our focus is on Taiwanese firms in the information-technology industry because it is both highly aligned and highly developed in the island-economy. Our sample consists of 178 Taiwanese firms: 83 firms that had formed strategic alliances in 2004 and 95 firms that do not form any strategic alliance.

We tested the hypotheses by using regression models. To examine our hypotheses, which predict the effects of alliances and alliance capabilities on firm growth, we entered the independent variables one by one in the regression model. The definitions of the variables are as follows:

Definitions of variables

Dependent variable

To examine the limitations to firm growth, we adopted Tan and Mahoney's (2005, 2007) approaches. For each firm, we analyze its growth (referred to herein as GROWTH) from the 2001-2004 period and from the 2005-2007 period. Our study uses the employee growth rate of the 2005-2007 period as the dependent variable.

There are several approaches to calculating a firm's growth, such as the revenue-based, the employee-based, and the asset-based approaches (Tan & Mahoney, 2005; Helfat, Finkelstein, Mitchell, Peteraf, Singh, Teece, & Winter, 2007). Employee growth can bring with it complex management problems and generate the Penrose effect. Thus, the employee-based approach is more in line with this study's context and underlying questions, and we chose the approach to measure firm growth.

Independent variables

This paper tests how contractual organizational forms may, because of firm forming strategic alliance, influence the occurrence of the Penrose effect. We use the interaction terms concerning the relationship between the growth rate of the preceding period and the following variables in the regression to exam whether contractual organizational forms can help firm overcome the Penrose effect.

To test our hypothesis, we used the total number of strategic alliances (i.e., NUMALLY) as the measurement. The alliance information was coded from news releases of the firms in TEJ database. Then, we accumulated the total number of firms that had formed strategic alliances in 2004.

Control variables

We included in this study several control variables that may have influenced the growth of a firm: (1) AGE, which we defined as the number of years between a firm's start up and the year 2004; (2) SCALE, which we defined as the natural logarithm of total assets; (3) SLACK, which we defined as firms' retained earnings; and (4) BONUS, which we defined as the percentage of the firm's total net profit that would constitute employee bonuses.

Results

Concerning descriptive statistics, Table 1 presents the correlation coefficient matrix sampling information such as the average value of individual variables and standard deviation. Because the correlation coefficient matrix indicates that correlations between some variables are greater than .50, suggesting a correlation that is higher than usual, we used VIF to test multicollinearity in the analysis process. Although a number of variables are correlated with other variables at the 0.05 level, the largest variance inflation factor (VIF) in the model (1.935) is far below 10, and the mean VIF value (1.411) is close to 1, suggesting that multicollinearity does not threaten the validity of our coefficient estimate.

Table 1. Correlations, Means, and Standard Deviations

Variable	Mean	SD	1	2	3	4	5	6
AGE	17.528	8.456	1					
SCALE	6.70	0.617	0.201**	1				
SLACK	2613905.247	8751162.826	0.058	0.561**	1			
BONUS	13.266	14.817	-0.123	0.298**	0.261**	1		
NUMALLY	0.910	2.332	0.075	0.416**	0.431**	0.127	1	
PREGROW	0.584	0.983	-0.246**	0.148*	0.105	0.175*	0.082	1

p<0.05; ** p<0.01 (2-tailed)

Table 2 presents the empirical results. The dependent variable is the growth rate of employees in the second time period (2005-2007). The key explanatory variable (PREGROW) is the growth rate of the employee in the preceding time period (2001-2004). Our hypothesis 1 predicts that the Penrose effect would present itself. As shown in Model 2, the coefficient of PREGROW is negative and statistically significant. This finding provides empirical support for hypothesis 1 that a fast growing firm might not maintain its high rate of growth and might experience a deceleration of growth in the subsequent time period.

Table 2. Regression Results

Item/ Model	Model 1		Model 2		Model 3		Model 4	
AGE	-0.146	(-1.890)	-0.196*	(-2.469)	-0.162*	(-2.067)	-0.164*	(-2.060)
SCALE	-0.013	(-0.141)	0.019	(0.200)	-0.074	(-0.766)	-0.067	(-0.672)
SLACK	0.035	(0.387)	0.034	(0.384)	-0.115	(-1.167)	-0.120	(-1.195)
BONUS	0.139	(1.742)	0.155	(1.957)	0.162*	(2.096)	0.158*	(2.020)
PREGROW			-0.179*	(-2.299)	-0.177*	(-2.325)	-0.178*	(-2.254)
NUMALLY					0.116	(1.406)	0.116	(1.388)
PREGROW* NUMALLY							0.011	(0.148)
N	178		178		178		178	
F	2.185		2.849		3.697		2.857	
R-squared	0.048		0.077		0.133		0.133	
Adj R-squared	0.026		0.050		0.097		0.087	

* p<0.05; ** p<0.01 (2-tailed)

As for our study's findings on the allied firm's ability to overcome the Penrose effect, we did not find any empirical evidence supporting the assertion that firm can overcome the Penrose effect through alliances. The coefficient of NUMALLY in Model 3 is positive but not statistically significant, suggesting that the number of alliance formed by firms cannot predict the growth rate of the allied firms in the subsequent periods. The estimates of Model 4 show that the interactive term PREGROW*NUMALLY is positive (.011; p=.883) but also not statistically significant, suggesting that we are not able to empirically support the argument that the more alliances formed by firms, the more likely that the allied firms may overcome the managerial limitations to firm growth. Therefore, hypothesis is not supported. We speculate that the benefits of having more alliance partners cannot offset the costs associated with alliance management.

Disscussion

Alliances are a popular contractual organizational form. Alliances provide firms a way to find resources and to recognize opportunities. Through alliances, firms may gain complementary resources without incurring costs related to further managerial investment. Alliances also help firms recognize opportunities through interflows of novel information. This form of assistance saves managers both time

and energy searching for and identifying complementary resources. Thus, the allied firms can leverage their existing managers' capacity to plan a subsequent growth program. Also, by giving firms access to novel information, alliances strengthen firms' opportunity-recognition abilities.

We suggest that there may be some limitations to this study. First, its sample size may have distorted the statistical results. If we amplify our sample size, the effects that the number of alliances can have on firm growth may be more significant. Second, since alliances are difficult to manage, the more alliances a firm concludes, the more costs and complex problems the firm may face. Therefore, we speculate that there may be an optimal scale of alliances and that the relationship between the number of alliances and firm growth may form a curve. Although our empirical results indicate that firms' possession of alliance capabilities may help the firms improve their growth rate in the next time period, the results do not constitute statistically compelling evidence that using alliances and possessing alliance capabilities can reduce the Penrose effect. We suggest that future research examine, on the basis of this empirical study, whether or not an optimal scale and a curve relationship exist . Also, because (1) this study may have other limitations such as routine inconsistency and resource heterogeneity, (2) the Penrose effect is complicated, and (3) the mechanism for lessening the Penrose effect varies across firms and industries, we suggest that future research might broaden the governance and capability-based view by considering multiple forms of contractual organization that concern the relationships between markets and hierarchies.

Conclusion

The main purpose of this study has been to examine whether the choice of organizational forms may help firms overcome limitations to growth and experience greater growth in the next time period. Our empirical results suggest firms pursuing long-term growth should be prepared to undertake problem-solving actions in response to a decline in growth. We have also found that firms' possession of alliance capabilities indeed help accelerate firm growth, suggesting that researchers in strategic management should incorporate the level of firms' governance capabilities into the research of firm growth.

In summary, the current study contributes to the extant literature in the field of strategic management and entrepreneurship by addressing the question of how a firm grows and implications of contractual organizational forms for managerial resource allocation. Importantly, this line of research is likely to be generative of further empirical exams. Finally, this study offers a mechanism by which to explore evolving organizational forms and their effects on firm growth.

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