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The importance of client heterogeneity in predicting make-or-buy decisions

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ABSTRACT

Scholars have begun to merge the transaction cost economics and capabilities perspectives to examine outsourcing decisions. Further integrating these perspectives with intermediation theory, we assert that a firm's decision to use an intermediary when entering a foreign market is largely a function of the intermediary's relative capabilities and relative transaction costs (i.e., relative advantage). We hypothesize that the intermediary's relative advantage is influenced by three significantly intertwined exchange conditions: client heterogeneity, intermediary risk, and firm learning. Using a sample of 929 new foreign market initiatives by a global consulting firm, our results support our theory.

1. Introduction

The question of whether a firm should undertake a particular function in-house, or outsource it to a third-party, is of fundamental importance to the field of operations management (Holcomb and Hitt, 2007; McIvor, 2009). This decision of whether to 'make-or-buy' frequently confronts a range of managers tasked with coordinating global distribution services (Handley and Benton, 2013), customer care and marketing services (Balakrishnan et al., 2008), and information systems (Palvia et al., 2010), among other operational needs.

Transactions cost economics and capabilities perspectives have served as perhaps the two primary lenses for understanding when a firm will be more likely to internalize a particular function versus transact using the market. From a transaction cost perspective, the most salient concern of managers is thought to be opportunism. As a result, the focus is on how the particular *characteristics of the transaction* (asset specificity, frequency, and uncertainty) predict when greater use of internal hierarchical controls are required (Williamson, 1975). From a capabilities perspective, a manager's most salient concern is thought to be production efficiency. Here, the focus is on how the particular *characteristics of the resource* required to undertake the particular function (tacitness, fungibility, and path dependency) predict when a resource can be quickly and effectively developed internally (Dierickx and Cool, 1989; Kogut and Zander, 1996).

Drawing upon intermediation theory as a relatively new lens (Spulber, 1996), we propose that prior to transaction and resource considerations, managers evaluate the *characteristics of the market* when undertaking make-or-buy decisions. More specifically, managers decide "what do we want to do" in regards to a market opportunity before determining "how do we want to do it." Thus, of primary concern to managers is the nature of the challenges within the market they intend to serve—specifically the degree of client heterogeneity. Client heterogeneity refers to the number of different types of clients that the firm seeks to serve with a new market initiative. In terms of new market initiatives, of particular interest to us are the operational activities associated with facilitating new client relationships and the customization and delivery of new products in foreign market entries. In such new market initiatives, client heterogeneity represents a salient consideration

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for managers, manifesting due to variance in size (from small entrepreneurial firms to large multinational corporations), sector (from financial institutions to socially-driven non-governmental organizations), and ownership structure (from private firms to government agencies) of potential clients. This heterogeneity that can exist in a business-to-business context presents myriad challenges, such as the need to manage clients' different goal orientations, decision-making processes, product customization demands, and delivery schedules, that can influence whether a firm seeks to undertake operational activities related to the new market initiative internally or via an intermediary.

To empirically test our assertions, we collected data on the decisions undertaken by managers of a professional services-oriented firm, Globalconsult (a pseudonym), between 1995 and 2008 with respect to whether or not to distribute their products and services directly to international clients or outsource to a third-party intermediary. The clients for any particular market initiative ranged from highly homogeneous to highly heterogeneous in nature, thus representing varying degrees of potential operational challenges. Highly homogenous client sets consisted primarily of only a single type of client being targeted (i.e. governments) while highly heterogeneous client sets consisted of a more complex set of different types of clients (i.e. governments, nonprofit organizations, small and medium sized enterprises, and financial institutions). Furthermore, we collected data on the level of corruption within a particular country environment in order to contrast the influence of transaction characteristics with market characteristics, as well as data on whether it was a wholly new market initiative or a replication of a previous initiative in order to contrast the influence of resource characteristics. A "new market initiative" is defined as the introduction of a completely new product or service to a new market environment, while a 'replication' is the introduction of an existing product or service to a new market. In total, our sample included 929 market initiatives undertaken during that period involving 115 emerging markets (e.g., Russia, Uruguay, South Africa, etc.).

We seek to contribute to theory in a number of ways. Complementing the conventional wisdom espoused in transaction cost and capabilities perspectives, we show that client heterogeneity is a primary exchange condition that influences the firm's intermediation decision, consistent with the logic of intermediation theory. Focusing on client heterogeneity contributes to theory in two key ways. Client heterogeneity should highlight the importance for scholars to shift away from comparative analyses based strictly on dyadic relationships to consider a broader market microstructure (i.e., a firm, a potential intermediary, and a client set) (Spulber, 2009). Our research also suggests that defining with whom a firm will transact influences how a firm will then govern the operational activities to transact with these clients. In fact, we show that the primary exchange condition of client heterogeneity dominates the influence on the firm's intermediation decision at very low and high levels of client heterogeneity. However, the moderating effects of other secondary conditions premised in transaction cost (i.e., intermediary opportunism potentially enabled by a corrupt institutional environment) and capability logics (i.e., learning supported by subsequent similar market initiatives) become strongly intertwined at moderately low and moderately high levels of client heterogeneity. Our research has implications for operations managers by informing the complex, dynamic, multi-faceted decisions that they make when a firm undertakes foreign market entry.

2. Intermediation: Phenomenon and theory

For firms selling products in new foreign markets, they are often faced with the make-or-buy dilemma of selling directly to the clients or going through an intermediary. Intermediaries can be viewed as transaction specialists (Holcomb and Hitt, 2007). Embedded in local markets, intermediaries possess specialized knowledge regarding local markets' cultural and institutional differences and can draw upon local network ties to facilitate a firm's transactional and operational needs (Elango et al., 2013; Klein et al., 2011). The firm may choose to go through an intermediary as opposed to direct exchange to not only create new relationships but also to customize and deliver products and services (Balabanis, 2001; Howells, 2006). Intermediaries' specialized knowledge can facilitate firms' efforts to understand local market needs, such as compliance with institutional requirements and nuances in how clients use certain types of products, thereby facilitating customization of products. Similarly, intermediaries' local presence can facilitate firms' efforts to deliver their products in markets where the firms themselves lack a physical presence. Not surprisingly then, intermediaries represent a particularly prominent structural arrangement in knowledge-intensive industries such as investment banking, real estate, and consulting services (Allen and Santomero, 1998), and is often the dominant choice by firms in the facilitation of cross-border expansion efforts (Peng and Wang, 2002).

As an example, in 1992 Deloitte Consulting LLP was in the final planning stages for its expansion into Bulgaria. Deloitte was particularly interested in Bulgaria because of its market potential for the company's newly developed cyber security training services. However, the targeted clients of large multinational corporations, small and medium-sized enterprises, and nongovernmental organizations in Bulgaria were considered extremely fragmented and diverse. Thus, Deloitte was faced with the choice of either attempting to internalize the activities supporting transactions with potential clients or rely upon an intermediary to do so. Turning to an intermediary could provide potential significant benefits in terms of the intermediary's specialized knowledge and local networks, but it also meant potential risks of the intermediary misrepresenting its capabilities, developing specific knowledge of the product, holding up Delotitte's efforts, shirking its responsibilities, or otherwise behaving in opportunistic ways. Deloitte ultimately decided that the heterogeneity of the client set along with its lack of experience with the product it was selling and the uncertainty of the environment made using a third-party intermediary specialist (i.e., an indirect transactional arrangement) a more efficient choice rather than attempting to seek out these myriad clients directly.

2.1. Transaction cost and capabilities perspectives

Transaction cost and capabilities perspectives have provided perhaps the two most predominantly drawn upon lenses for understanding decisions related to firm scope, such as whether a firm should transact directly with clients or outsource the relevant operational activities to an intermediary. Transaction cost logic focuses on the discrete institutional alternatives of hierarchies and markets (David and Han, 2004), to where firms choose to either 'make' internally the functions needed to transact or 'buy' such assets on the market. Internalizing a transaction is generally viewed as enabling a firm to better control the risks of opportunism as the firm has the fiat, or decision authority, to impose certain expectations and to better monitor and control behaviors (Williamson, 1985). However, the market may provide a more efficient alternative if the risk of opportunism is low. Transaction cost logic is premised on the assumptions of bounded rationality and opportunism (Grover and Malhotra, 2003). That is, firms cannot predict or foresee ex ante all contingencies related to a particular transaction, and exchange partners can act in ways that may be considered self-interested with guile. Firms then incur transaction costs related to negotiating, safeguarding, monitoring, and enforcing agreements to reduce the potential for opportunism (Williamson, 1985). Key to this framework is the notion that exchange conditions influence the risks