THE INTERNAL COMPETITOR: BUYER MOTIVES AND EXTERNAL SUPPLIER MARKETING STRATEGIES

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Abstract

Purpose of the paper and literature addressed:
The purpose of this paper is to identify buyer motives for supporting internal competitors and to suggest relevant marketing strategy elements for external suppliers confronting these internal competitors.

Research method:
With basis in a literature review we identify different buyer motives for choosing to combine external suppliers with internal production, i.e., an internal competitor. For each buyer motive, possible marketing strategies are identified and briefly discussed.

Research findings:
The paper describes different buyer motives for choosing dual sourcing by combining internal production and external suppliers. Central buyer motives are (1) to avoid idle production capacity, (2) to avoid quality debasement and cheating, (3) to avoid unreliable suppliers and hold-up problems, (4) to avoid inefficient problem solving, and (5) to access technologies and capabilities. These different buyer motives found in the literature indicate that the external suppliers do not face a homogeneous set of buyer motives when their customers produce the same components internally. Though, it may be difficult for the external suppliers to immediately identify relevant buyer motives, the existence of different buyer motives suggests that these buyers should be targeted with different marketing strategies. For each buyer motive, possible marketing strategies are suggested and briefly discussed. Thus, for each buyer motive it is briefly discussed (1) how the external supplier may try to replace the internal competitor, (2) how the external supplier may try to operate in parallel with the internal competitor, and (3) when the external supplier should refuse to deliver to the customer with internal production of the same components.

Main contribution:
The paper brings into focus the situation and buyer motives that external suppliers face when they confront an internal competitor. Furthermore, for each buyer motive a number of possible marketing strategies are identified.

Keywords: internal competitor, buyer behavior, business-to-business, marketing strategies.

INTRODUCTION

In some industries more than half of all companies simultaneously source the same component from both external and internal suppliers (Harrigan, 1985; Heriot & Kulkarni, 2001). Thus, external suppliers often confront an internal competitor. This phenomenon is not confined to private companies, and hence suppliers to public sector organizations also often face internal competition (Warner & Hefetz, 2008, Miranda & Lerner, 1995). Research has revolved around explanations for why firms simultaneously make and buy the same component. Consequently the perspective of the external supplier is missing in the marketing literature. A few researchers focus on the internal competitor in situations where a potential buyer considers outsourcing (Haas & Wotruba, 1976, Maltz & Sautter, 1995), but they assume that the buyer has to choose between either an external or an internal supplier. There may be at least three reasons why few researchers have been interested in analyzing the situation where a buyer uses both an internal and external supplier from the viewpoint of the external supplier.

First, the assumption may be that the internal suppliers have no idiosyncratic effect on buyer behavior, and hence the external supplier can apply the usual marketing strategies. However, several researchers point to differences between internal and external suppliers (Williamson, 1991a, 1991b). For example, the internal competitor has inside access to data and buying centre-members. The internal competitor may even be a member of the buying centre and the supplier selection team (Maltz & Sautter, 1995; Huber, 1993). Furthermore, network researchers point to the connections between business relationships (e.g. Bradach & Eccles, 1989, Havila, Johanson, & Thilenius, 2004) and economists emphasize that complementarities between internal and external suppliers explain how much a firm buys and how much it makes (Puranam et al., 2009). Finally, Parmigiani (2007) finds that the combination of external and internal suppliers is not a midpoint on a continuum, but a distinctly different choice. This suggests that internal and external suppliers are different, and that there are connections or complementarities between these two kinds of suppliers.

Second, a situation with an internal competitor may be regarded as a transitory state. If the external supplier cannot reverse the process of insourcing, this does not call for particular attention – except for the loss of a customer. The same applies to a transitory state of outsourcing where internal production is replaced by external suppliers. However, empirical studies indicate that the simultaneous making and buying of the same good is indeed a stationary phenomenon (e.g. Parmigiani, 2007).

Third, there are few papers on the combination of internal and external suppliers. In Heide's (2003) paper on plural governance in industrial purchasing, he notes that there are unanswered questions pertaining to firms' motivations for using internal and external suppliers as well as the mutual influence of the different supplier relationships. Accordingly, it is complicated to formulate useful marketing strategies for suppliers facing buyers with an internal production unit. However, recent works by e.g. Parmigiani (2007) and Puranam et al. (2009) have identified diverse explanations why buyers often choose to produce some of their requirements internally, and this literature may serve as a starting point for identifying buyer motives for supporting an internal competitor. The identified buyer motives may then be used for discussing marketing strategy elements relevant for suppliers facing such buyers.

In this paper we argue that buyers who also produce internally are different from other buyers. Therefore suppliers have to distinguish between buyers with and buyers without internal production and adapt their marketing strategies to these different buyers. First the paper shortly reviews the literature on why firms both make and buy. Based on this review the paper

identifies different buyer motives for choosing to combine internal production with external suppliers. Included are a few illustrative examples of firms simultaneously sourcing the same components or services from both external and internal production units. Then for each buyer motive a number of possible marketing strategies are identified and briefly discussed. Finally, the paper offers research and managerial implications.

WHY DO SUPPLIERS FACE INTERNAL COMPETITORS?

Several questions arise for the external supplier that faces a buyer that both makes and buys. For example:

1) Why does a buyer simultaneously make and buy the same component or service?
2) What initiates a change from make or buy to a situation where the firm both makes and buys?
3) How does the internal competitor affect the relationship with the external supplier?
4) What marketing strategies are useful for suppliers confronting an internal competitor?

A change in marketing mix does not itself explain why a buyer at a certain point in time chooses to simultaneously make and buy the same component or service. The marketing mix neither explains why an external supplier faces an internal competitor nor how an internal competitor affects the relationship between the external supplier and the buyer. Other types of explanations are needed. For example, a buyer could experience decreasing demand. The lower demand results in free company specific resources which have the highest value when used for internalizing part of the production of components sourced from external suppliers. Outsourcing a part of the production of a component also results in buyers that simultaneously buy and make. A firm's decision to start sourcing from external suppliers is an opportunity for external suppliers to get a foot in the door and to increase sales. The reason for such a shift in sourcing mode could be a change in the marketing mix of a potential supplier, but this does not explain why a buyer maintains internal production.

A review of the literature on why firms both make and buy results in a number of different explanations (see Table 1). There are basically three different marketing responses when buyers also produce internally. First, the external supplier may build strong economic arguments for the buyer to abandon the internal production unit. When a buyer both makes and buys, the buyer has to invest in an internal organization and at the same time gather information from and establish contractual relationships with external suppliers (Costantino & Pellegrino, 2009, Freytag & Mikkelsen, 2007, Williamson, 1985, p. 60). Moreover, the internal production unit may also have weaker capabilities and higher production costs than the external suppliers. Second, the supplier may accept the internal production unit and choose a more transactional approach to the buyer. Short-term optimization, an arms-length approach and short-term marketing mix adaptations may be attractive to producers of standard components on a large scale. A buyer may need to solve non-decomposable problems, or he may have a policy of reducing dependence of external suppliers. Both scenarios explain why the internal production unit is maintained despite the higher costs of internal production. When a buyer's internal production unit is maintained merely because it represents sunk costs, the internal production unit is probably replaced by external suppliers at some point in time. In this situation the external supplier may, in the short-run, accept the internal production unit, adopt a long-term perspective, and use the relationship with the buyer to be positioned as the future sole supplier. Finally, suppliers may refuse to deliver to these buyers.

Table 1: Buyer motives and marketing strategies					
Buyer motives for internal and external suppliers	**To avoid idle production capacity**	**To avoid quality debasements and cheating**	**To avoid unreliable suppliers and hold-up**	**To avoid inefficient problem solving**	**To access technologies and capabilities**
Possible motive in the presence of	Fluctuations/ changes in demand	Measurement difficulties Asymmetric information	Dependence, transaction specific assets	Non-decomposable problems	Multiple or changing technologies
Central theoretical approaches	Neoclassical economics Production planning	Agency theory	Resource dependence theory TCE	Knowledge-based theory	Resource-based theory
Primary assumptions	Rationality in production	Opportunism Bounded rationality	Opportunism Bounded rationality	Bounded rationality Opportunism	Bounded rationality
Central goal for the buyer	Minimize production costs	Minimize agency costs	Survival Minimize transaction cost	Create valuable new knowledge for problem solving	Capability renewal. Diversification
Buyer advantages from internal production	Exploits internal production facilities and idle resources	Access to information and improved benchmarks	Reduce dependence and provide a termination safeguard	Efficient problem solving	Hedge against/toward technological changes
Marketing strategies:					
To eliminate the internal competitor	Offer to acquire production facilities and deliver at lower costs (at least until the internal competitor is eliminated)	Offer more open exchange of information for benchmarking. Develop trust-based relationship Offer guarantees	Offer alternative safeguards. Willingness to make adaptations. Develop trust-based relationship Offer privileged access to knowledge	Offer open exchange of information and exchange of key employees, develop trust-based relationship Offer joint problem solving arrangements	Offer access to a broader portfolio of technologies including the technologies of the internal competitor
To operate parallel with internal competitor	Offer short delivery time and flexible production of the uncertain part of demand	Benchmark against internal competitor and offer guarantees	Benchmark against internal competitor	Benchmark against competitor and offer joint problem solving arrangements	Offer access to components based on alternative technologies
Refuse to deliver	When economies of scales are not met or the price of flexibility is too high	When buyer's benchmarking and "full" information removes all profit	When dependence and the risk of a hold-up becomes too high	When improvements in components remove profit	When technology is transferred/given away to a potential competitor

Buyers which permanently maintain an internal production unit do not develop a high dependence on external suppliers and they are not likely to be involved in building strong relationships with external suppliers. Furthermore, the buyer may end up as a competitor which makes it more attractive to focus on other types of buyers.

Buyer motive: to avoid idle production capacity

Buyers may use independent units for the irregular part of their demand and internal units for the stable part of their demand. Hence, the buyer can exploit economies of scale and scope by producing internally and avoid idle capacity when demand is fluctuating (Adelman,1949, Carlton, 1979, Harrigan, 1983). For example, the company L.C. Møller outsourced welding to one sub-supplier in peak seasons (Johansen & Riis,1995). Another related explanation for why buyers both make and buy could be that a decrease in demand frees a buyer's production capabilities and creates idle employees accordingly. Then, instead of laying off employees, the buyer internalizes part of the production of components supplied by external suppliers. Sunk investments and gradual reduction of upstream operations combined with expanding operations in a downstream segment where a buyer has its strongest productive capabilities may also change the relative use of external suppliers and internal production (Jacobides & Hitt, 2005). Under such conditions, the external supplier may be able to gradually increase its share of the business as the buyer's internal production facilities become outdated and too costly to maintain.

If the strategy for the external supplier is to operate in parallel with the internal competitor, the supplier needs a flexible sourcing strategy to absorb these changes in demand. In order to satisfy the fluctuating demand for a buyer, the external supplier can choose to (1) maintain excess production capacity, (2) improve forecasts of changes in demand, (3) hold significant storages of components and/or (4) gather demand from several buyers. Moreover, to operate in parallel with the internal competitor, the external supplier needs to benchmark cost and quality against the cost and quality of the internal competitor.

On the other hand, the supplier may seek to eliminate the internal competitor. Establishing a deep understanding of the internal competitor's production costs and comparing these costs with the costs of buying from the external supplier is a fundamental starting point for planning strategic moves towards the buyer (Haas & Wotruba, 1976). If supplies can be made with consistently better quality/price ratios in a sufficient amount of time, the external supplier may surpass the internal competitor. Another strategy is to acquire the buyer's production facilities. Acquisition of a buyer's production facilities is a value creating strategy if the external supplier is able to exploit economies of scale and scope in production better than the internal supplier.

Finally, the external supplier may be forced to refuse delivery if the demand is too low for reasonable economies of scale or if the cost of flexibility in production and delivery is too high.

Buyer motive: to avoid quality debasements and cheating

A combination of internal and external suppliers provides access to more information and makes it possible to use information from one relationship to evaluate and control other relationships (Bradach & Eccles 1989; Heide 2003). Thus, Walker and Weber (1984) argue that buyers with experience in producing a component are better informed and thus better able to avoid opportunistic suppliers. Also, Heide (2003) argues that internal production provides the buyer with information the buyer can use, first of all, when choosing between potential suppliers and

designing a contract, and second, when it is difficult to observe and measure all aspects of the quality of output.

The fundamental problem is lack of trust or sufficient contractual instruments. Hence, if the strategy for the external supplier is to surpass the internal competitor, the supplier needs to develop an alternative to the control mechanism offered by the internal competitor. By behaving non-opportunistically and by creating social bonds with the buyer, it may be possible for the external supplier to build trust (Gulati 1995). The consequence of increased trust between the parties of a relationship is an increase in each party's confidence in the partner's performance (Chiles & McMackin, 1996). Hence, over time open exchange of information and trust potentially obviates the need for internal production. Moreover, often it is not obvious how to evaluate external suppliers, and therefore the external supplier should try to manipulate which part of the marketing mix is viewed as important by the buyer. As with the motive to avoid idle production capacity, we expect that a consistent delivery of higher quality components at lower costs than the components produced internally will eliminate the internal production unit and make the external supplier the sole supplier in the long run.

If the strategy for the external supplier is to operate in parallel with the internal competitor, a transactional marketing approach is effective as long as the external supplier is able to supply at lower cost and higher quality than the internal supplier.

Finally, when a buyer's benchmarking and "full" information remove all profit, the external suppliers should consider breaking off the relationship with the buyer.

Buyer motive: to avoid unreliable suppliers and hold-up problems

A buyer can establish an internal production unit in order to avoid becoming too dependent on the external production unit (Harrigan, 1984, Kulkarni & Jenamani, 2008, Porter, 1980). The buyer may face external supplier capacity, bottlenecks and other delivery problems, or fears that the external supplier will deliberately hold-up the buyer (Pfeffer & Salancik, 1978, Williamson, 1991a). In this respect, the combination of make and buy provides the buyer with more alternatives and thus with a termination safeguard (Dutta *et al*., 1995). Similarly the buyer also reduces dependency on the internal production unit; for example when the buyer faces strong unions (Parmigiani, 2007) or other powerful internal stakeholders (e.g. Coff, 1999).

There are several examples of firms that source partly from an internal supplier in order to reduce dependence on an external supplier. Andersen and Kumar (2006, p. 532) describe how Novo Nordisk needed to ensure that delivery would continue even if their supplier of needles, Nissho, went bankrupt, and therefore maintained internal production of needles. According to Caniëls and Roeleveld (2009) the Dutch firm NSR did not fully outsource their heavy maintenance because it would make them too dependent on external manufacturers for spare parts provision. Another firm combining internal and external suppliers is IKEA. After some suppliers broke their contracts with IKEA, an internal production unit, Swedwood, was created with the purpose of ensuring IKEA continuous supply of furniture (e.g. http://www.swedwood.com/99/our-history/).

If the external supplier wants to eliminate the internal competitor, the supplier can offer alternative types of safeguards and guarantees to reduce and remove the need for internal production as a dependence reducing device. Possible safeguards include for example long-term contracts, (Williamson, 1985), balanced investments (Vazquez *et al*., 2007), and norms of relational exchange (Brown *et al*., 2000). The creation of shared norms between the parties can reduce the feeling of dependence and vulnerability (Heide & John, 1992). Less vulnerability and dependency towards the external supplier will decrease the buyer's incentives to produce

internally as well. Furthermore if the supplier successfully develops trust between the parties, the risk of opportunism is attenuated (Chiles & McMackin, 1996). This implies a reduction of the buyer's fear of being opportunistically exploited and hence his need for internal production as a supplement to the external supplies. Another strategy to reduce the need for an internal competitor is to make specific investments in the particular relationship to create mutual dependencies between the buyer and the supplier. For instance, the supplier may invest in a logistical system that specifically fits the buyer, or add product details to the production line that only fits the buyer. The downside of this strategy is that it exactly creates a potential hold up from the buyer toward the external supplier.

It may be necessary to accept to operate in parallel with an internal competitor. In this case the external supplier's approach should be to optimize the efficiency in the production and be able to deliver at low cost and flexible terms. However, a position as sole supplier is more attractive because it increases volume, enables exploitation of economies of scale in production, and eliminates costs to the buyer due to the management of more than one supply relationship (e.g. Costantino & Pellegrino, 2009).

Finally, the buyer may seek to develop a position where the external buyer is unilaterally dependent on the buyer. With such a position the buyer can appropriate all value created in the relationship. In this case the external supplier should consider exiting the relationship.

Buyer motive: to avoid inefficient problem solving

In order to efficiently solve non-decomposable problems, buyers may need internal production (Nickerson and Zenger, 2004). If a buyer produces complex products where different technologies are integrated into the same product and the different components are not modularized, the buyer most likely faces non-decomposable problems related to product innovations. For example, Ahmadjian and Lincoln (2001) describe why Toyota chose to internalize part of their requirements for electronic components. Toyota realized that it needed knowledge about electronic components in order to be able to solve its non-decomposable problems involving these electronic components. The knowledge was not transferred from its supplier Denso, so Toyota needed the learning-by-doing experience from producing these electronic components. However Toyota did not have to produce all its requirements internally in order to accumulate sufficient learning-by-doing experience. Therefore, the other part of the requirements was supplied by Denso. In this case Denso faced an internal competitor, because Toyota needed the internal production unit in order to solve non-decomposable problems related to improvements of engines. This is in line with Parmigiani and Mitchell (2009, p. 1065) who suggest that "firms often need to make in order to know, but can partially outsource if they possess sufficient expertise".

If the external supplier seeks to eliminate the internal competitor, it needs to overcome the problem of decomposability. The fundamental problem is that of obtaining and transferring fine-grained information which is problematic in an arm's-length relationship (Uzzi 1997). Hence, the external supplier needs a relationship based on trust that facilitates joint problem solving arrangements and open exchange of information. Moreover, the supplier can allow employees from the buying firm into the firm to learn the technologies used by the supplier. Alternately, the supplier may offer to lend out employees to the buyer. There are, however, pitfalls related to this strategy. The knowledge of the external supplier may be transferred to the buyer, and the buyer-seller relationship may afterwards change into a transaction-based relationship, or worse, the buyer may end up as a major competitor (e.g. Cassiman & Veugelers, 2002, Hamel, Doz & Prahalad, 1989).

An alternative strategy is to accept the internal competitor and benchmark against the costs and quality of the buying firm. An exit strategy becomes relevant when the suggested solutions to the non-decomposable problems are highly unfavorable to the external supplier. This includes changes in demand which transform the relationship with the buyer into an arms-length relationship and remove the profit for the external supplier.

Buyer motive: to access technologies

Both making and buying may strengthen external as well as internal capabilities, i.e., knowledge complementarities (Puranam et al., 2009). First, strong internal capabilities may be used for strengthening external suppliers' capabilities through supplier development programs (e.g. Sánchez-Rodriguez *et al*., 2005, Giannakis, 2008). Second, the buyer may also learn from its external suppliers. Thus, the use of both internal and external suppliers makes it possible for the firms to learn from each other (Cassiman & Veugelers 2006; Parmigiani 2007, Veugelers & Cassiman 1999). Buyers especially benefit from both buying and making when technological uncertainty is high (Parmigiani, 2007, Rothaermel *et al*., 2006). Buyers with this motive seek access to external capabilities and technologies to reduce technological uncertainty. Therefore the present capabilities of the external supplier relative to the internal supplier are important.

If the external supplier seeks to eliminate the internal competitor, the supplier should focus on identifying, developing, and offering the capabilities wanted by the buyer. This may include identifying the present capabilities of the buyer and the capabilities needed in the future in order to predict how to contribute with complementary resources. However, if the buyer has established an internal competitor to improve the capabilities of the external supplier, the supplier should demonstrate sufficient absorptive capacity and improve capabilities as wanted by the buyer. This is important even if the external supplier seeks to work in parallel with the internal competitor. To eliminate the internal competitor, the need for the buyer to help develop and maintain supplier capabilities should be rendered superfluous. This frees buyer resources and ties the buyer closer to the supplier.

A buyer with internal production is also potentially dangerous, because such a buyer is also a competitor. As noted by Cassiman & Veugelers (2002) commercially sensitive information often involuntarily leaks to competitors through common customers, and such outgoing spillovers are risky and firms should therefore actively manage their information flows. Ideally, the external suppliers should try to benefit from the incoming spillovers while trying to avoid transferring important capabilities to the buyer (Hamel, Doz & Prahalad, 1989). If this is impossible, the external supplier should either insist on an arms-length relationship or consider terminating the relationship with this type of buyer.

Other buyer motives

In our literature study several other than the above analyzed motives for buyers to combine internal and external suppliers were identified. Not mentioned in Table 1 are the less prominent motives in the literature like (1) access to market prices for use as internal transfer prices (Eccles & White, 1988), (2) a response to conflicting institutional pressure (Hansen et al., 2009), (3) options-based explanations (Alvarez & Stenbacka, 2007), (4) mixed public-private delivery because of internal opposition, internal obstacles, and lack of private suppliers (Warner & Hefetz 2008; Hefetz & Warner 2007, 2004), and (5) transitory phenomena such as when buyers enter upstream activities to exploit core competences (Prahalad & Hamel, 1990). Companies like the toy producer LEGO has temporarily sourced its bricks from Flextronics while maintaining internal

production, and the producer of wind turbines Vestas has, after a merger with NEG Micon, temporarily sourced wind turbine blades from both internal and external suppliers (http://www.investindk.com/visNyhed.asp?artikelID=16193). This suggests that though a situation with an internal competitor may last several years, it may be inherently instable and consequently lead to elimination of either the internal competitor or termination of the relationship with the external suppliers.

DISCUSSION AND CONCLUSION

External suppliers do not face a homogeneous set of buyer motives when their customers produce the same components internally. This suggests that these customers should be targeted with different marketing strategies. Furthermore, buyer motives may change, and thus the appropriate marketing strategies may also change. However, it is difficult for suppliers to immediately identify relevant buyer motives. This leads to problems especially when knowledge is transferred to the buyer and the buyer is pursuing a growth strategy and expands in the vertical segment where the external supplier is present.

Buyers which maintain internal production units in addition to external suppliers seem to be regarded as an anomaly in the make-or-buy literature. This literature has mainly focused on static efficiency explanations for the internal competitor, and therefore buyer motives derived from this literature may not be sufficient for explaining and understanding this phenomenon. Likewise, the literature on business-to-business relationships has emphasized the advantages of relying on one or a few external suppliers in order to develop close cooperative relationships and to keep costs low. Therefore a point of departure in this literature may not either lead to a comprehensive explanation for the relatively wide use of an internal competitor. Instead there seems to be a need for new case studies focusing on the situation when buyers employ external as well as internal suppliers and hence confront the external production units with an internal competitor. Longitudinal case studies able to describe the dynamics and the decisions leading firms to use both internal and external suppliers may be particularly suitable for studying this phenomenon.

The empirical base on which this paper builds is very limited. Therefore we may be providing possible prescriptive marketing strategies prematurely. However, the different strategies are merely an attempt to suggest elements which can be used for future empirical studies. Bringing into focus an under-researched phenomenon like the internal competitor primarily generates new research problems and new research questions. Questions regarding buyer motives like “why do buyers choose to combine internal and external suppliers?”, “what are the antecedents of this buyer behavior?", and “how does this buyer behavior affect the performance of buyers?” remain to be answered. These questions deserve immediate research attention. Likewise, supplier behavior and supplier strategies deserve attention from researchers. However, the relationship between the external supplier and the buyer is not only affected by the buyer’s internal production unit. A large number of relationship variables and contextual and situational factors also affect the buyer-seller relationship (e.g. Ford, 2002). The complexity of the phenomenon again points to case studies as a possible research method for future research.

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