

Business Suppliers' Value Creation Potential: A Conceptual Analysis

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Joint value creation through partnering and networking is currently a hot topic. This paper proposes that the dimensions of supplier's value creation taking place in a supplier-customer relationship can be classified through efficiency, effectiveness, and network functions. These functions are interrelated but conceptually separate. The value creation process can be described through a spectrum ranging from core value, through added-value, to future value. The value producing potential of a supplier can be assessed reasonably well only in the case of core value where there is sufficient benchmarking information in the form of existing alternative offerings and solutions. An apriori evaluation of the costs and benefits of added value, and especially future value projects is wrought with problems as the realisation of the value is dependent on the development of multiple partners, technologies, and industries. In these cases we suggest that a customer can use supplier's capability profile as an indicator of how well a particular supplier is suitable for specific value creation projects. A framework connecting specific capabilities to different types of value production is suggested.

INTRODUCTION

This paper focuses on the value that can be achieved through strategic supplier relationships. During the last decade traditional supplier-buyer relationships have changed dramatically. Business firms are increasingly concentrating on their core competencies and externalising such traditionally important activities as manufacturing, design, and logistics. This externalisation of value activities is dependent on creating strong supplier partnerships in those activities that have high strategic relevance for the customer firm. The externalisation process is well documented and has led to hierarchical structures consisting several tiers of suppliers forming complex supply-chain networks (Christopher 1998, Cooper et al., 1997, Ford et al., 1998, Möller and Halinen 1999, Sheth and Sharma 1997).

This process is driven by several factors. The global competition, enhanced by the removal of regulative barriers, forces firms to increase their operational efficiency. Customers are demanding shorter and more flexible delivery times at very competitive prices. The quality is taken for granted after a decade of total quality management. In response to these demands firms are creating streamlined supplier networks where each member specialises on the activities (components, parts, services) where it has a strong core competence. With the help of efficient logistics, enhanced by electronic corporate interfaces, this kind of concerted action leads to shorter lead times. Combined with a Total Quality Management approach,

covering the whole supplier system, these value creating networks can offer better products and services cost-efficiently and with shorter delivery terms.

In developing partnering supplier relationships both the buyer and the supplier often have to make substantial commitment of resources (Ford and McDowell 1999, Ritter 1999, Wilson and Jantría 1994). Due to the strategic nature of the key supplier relationships it is essential for the buyer to be able to evaluate the value creation potential of suppliers. This is a demanding task, however, as a particular supplier's value potential can be dependent on the network of other relationships this supplier and the customer has (Ford and McDowell 1999). Moreover, an important part of supplier's value is generally realised in the future, which makes its evaluation problematic. This paper examines the dimensions of value that a supplier can provide for a customer. We are especially interested in the evaluation of a supplier's value creation potential and try to provide a conceptual clarification of this topic. The paper is structured into the following themes: (1) discussing the types of value that can be achieved through or with a supplier, (2) identifying the factors enabling or impeding the value creation, (3) proposing a conceptual framework facilitating the evaluation of a supplier's value creation potential.

TYPES OF SUPPLIER VALUE

Issue of Value

The issue of supplier value can be seen as a "mirror problem" to that of analysing customer value that has attracted considerable interest. At operational level it is a question of estimating the revenue received from a customer and the cost of serving that customer (Shapiro et al. 1987, Storbacka 1997, Turnbull and Zolkiewski 1997). Beyond this simplistic view is a problem of defining value. Value and the perceived value have received considerable attention in such wide literatures as pricing, consumer behaviour, business marketing, and strategy; for good reviews see de Chernatony et al. (2000) and Wilson and Jantría (1994).

In business markets some researchers define value primarily in monetary terms (Anderson et al., 1993, Anderson and Narus 1999), whereas some use broader definitions that include non-monetary benefits and sacrifices, such as competitive gains, competencies, social relationships, knowledge, managerial time spend etc., (Biong et al., 1997, Flint et al., 1997, Ravald and Grönroos 1996, Wilson and Jantría 1994). In their recent review of value de Chernatony and his colleagues (2000) show that the prevalent view is to regard value as a perceived trade-off between the total benefits obtained and the total sacrifices incurred. The actual assessment of value is seen as a complex task due to the problems in identifying and measuring both the monetary and non-monetary benefits and sacrifices. Moreover, the perceived value and sacrifices are bound to vary between cultures, between customers, within customers, and during the supplier-customer relationship.

Relational Value: Dimensions and Realisation Levels

A supplier can provide value for its customers in several ways. This value is essentially created through the supplier-customer relationship. Functions of business relationships can be basically classified into direct and indirect functions (Anderson et al., 1994, Campbell and Cunningham 1983, Cunningham and Homse 1982, Ford et al., 1998, Gemünden et al., 1992, Walter and Ritter 2000). Direct functions describe the immediate cost and revenue effects of a supplier relationship for the customer. Indirect functions are more difficult to ascertain as their impact is realised through the linkages of the supplier-customer dyad to other actors.

Two recent contributions help us to understand the dimensions of value and value generation in a more refined fashion. Walter and his colleagues (Walter et al., 1999, Walter and Ritter 2000) have used the direct and indirect value function dichotomy for identifying the following value functions in a business relationship from a supplier's perspective:

Direct value functions

- Profit function - refers to the relative direct revenue from a customer.
- Volume function – refers to the volume of business generated by a customer.
- Safeguard function – refers to the possibility of ‘guarantee’ a level of business and revenues through contractual arrangements with specific customers.

In-direct value functions

- Innovation function – refers to the possibility of product and process innovation with a particular customer.
- Market function – refers to the possibility of accruing new customers/distributors through a reference impact of a particular customer.
- Scout function – refers to the market and other information that can be reached from the working environment through a particular customer.
- Access function – refers to gaining access to relevant other actors in the working environment through a particular customer.

These functions can be interrelated and they are dynamic, meaning that the functional profile of a supplier-customer relationship evolves through time. As can be noted the direct functions can be realised within a specific dyad whereas the in-direct functions rely on the effect of the dyad or a larger network environment. This dyad versus network aspect in the value creation has been examined by Ford and his colleagues (Ford et al., 1996, Ford and McDowell 1999). They propose that the influence of actions carried out in a relationship should be analysed through the following four levels.

First Level, direct effects in a relationship. These refer to such activities that can be realised without any – or only minor - adaptations in the exchanging actors. For example, a customer's decision to concentrate the procurement of certain components to a specific producer generally reduces the purchasing costs and may also involve the reduction of the need for incoming quality inspections. Also the producer may achieve cost reductions in terms of selling and negotiation costs and more predictable production runs. The key point is that “in the relationship” effects are relatively transparent and as such identifiable and often calculable in monetary terms. We call the value creation at Level 1 “transaction value” to refer to its character of direct benefits and costs.

Second Level, generative effects on a relationship. These represent the impact of such activities that presume adaptations by the actors. To continue the previous sole sourcing example actors may, after learning to know each other, to carry out relationships specific investments in order to utilise better their value creation potential. The supplier may suggest modifications into the components and the companies can establish joint logistic and electronic data interchange systems. This generative development, as Ford and McDowell (1999) point out, can be based on deliberate decisions and plans or be a result of a more organic and unconscious development. We call the value creation at Level 2 “generative value” to denote its basis in mutual learning and adaptation.

Third Level, effects on the relationship portfolio, refers to the impact of value activities on the portfolio of relationships of the supplier and/or customer. Just as in the case of Level 2 effects, the portfolio effects can be direct or in-direct, planned or unconscious. For example, by getting engaged in a major co-operative venture with a specific customer may block the access of this supplier to some other customers, but may also make more attractive through the reference effect to such new customers that are not competing with the co-operative partner. A pronounced commitment to one partner also signals potentially less commitment – an inevitable result in the world of scarce resources – to other customers/suppliers.

Fourth Level, effects on a network, refers to the influence of value activities on the wider network of the supplier/customer. An example provided by Ford and McDowell illustrates the point. If a buyer develops a new technology with a particular supplier (Level 2 activity) this may become a new industry standard and be adopted throughout the network providing positive revenues for the initiator. Similarly, a move to establish a strategic alliance typical in telecommunications and electronics industries by two major players may be emulated by other actors leading to a major restructuring of the industry as witnessed in the airline business.

When reflecting the above discussion from the perspective of assessing a supplier's value potential a number of key points can be derived. First, the value dimensions proposed by Gemünden, Walter and Ritter can also be applied to a supplier. To make them more operational in supplier evaluation we suggest that the targeted value functions should be defined in terms of the costs and benefits involved when possible. Second, the complexity of the impact of any major value development, as indicated by Ford and his colleagues, suggests that managers should define very carefully the type of value they want to produce from or with a specific supplier. Only direct efficiency type of gains can be evaluated at a relationship level (Level 1). All developmental activities targeting to more effective product or production solutions are bound to have network level effects (Levels 3 and 4) that influence their final profitability for the principal company. Finally, the complexity involved in assessing any major changes in supplier strategy is very high due to the number of contingencies and the relatively long time horizon influencing the realisation of the benefits and costs of the activity. From the point of managerial feasibility this means that one has to use approximation in the supplier evaluation.

Supplier Value Dimensions

We propose that the value that a supplier can provide for a business customer can be classified into efficiency and effectiveness dimensions (Pfeffer and Salancik 1978), and a network dimension, see Figure 1.

Effectiveness refers to an efficacious use of current resources; a gain in efficiency results in lower production or transaction costs. Better efficiency can be achieved by fine tuning the business processes of the supplier and customer and the exchange processes linking them. Efficiency is the major underlying factor of Walter and his colleagues direct value functions: Profit function, Volume function and Safeguard function (2000). A supplier that can offer a better price for a component operates more efficiently than its competitors, it may also have a better supplier portfolio itself. These conditions match also a supplier that can produce a large volume with a competitive price. On the other hand, a supplier that is able to meet volume fluctuations must have clients also in other sectors in order to achieve this kind of flexibility (Safeguarding function).

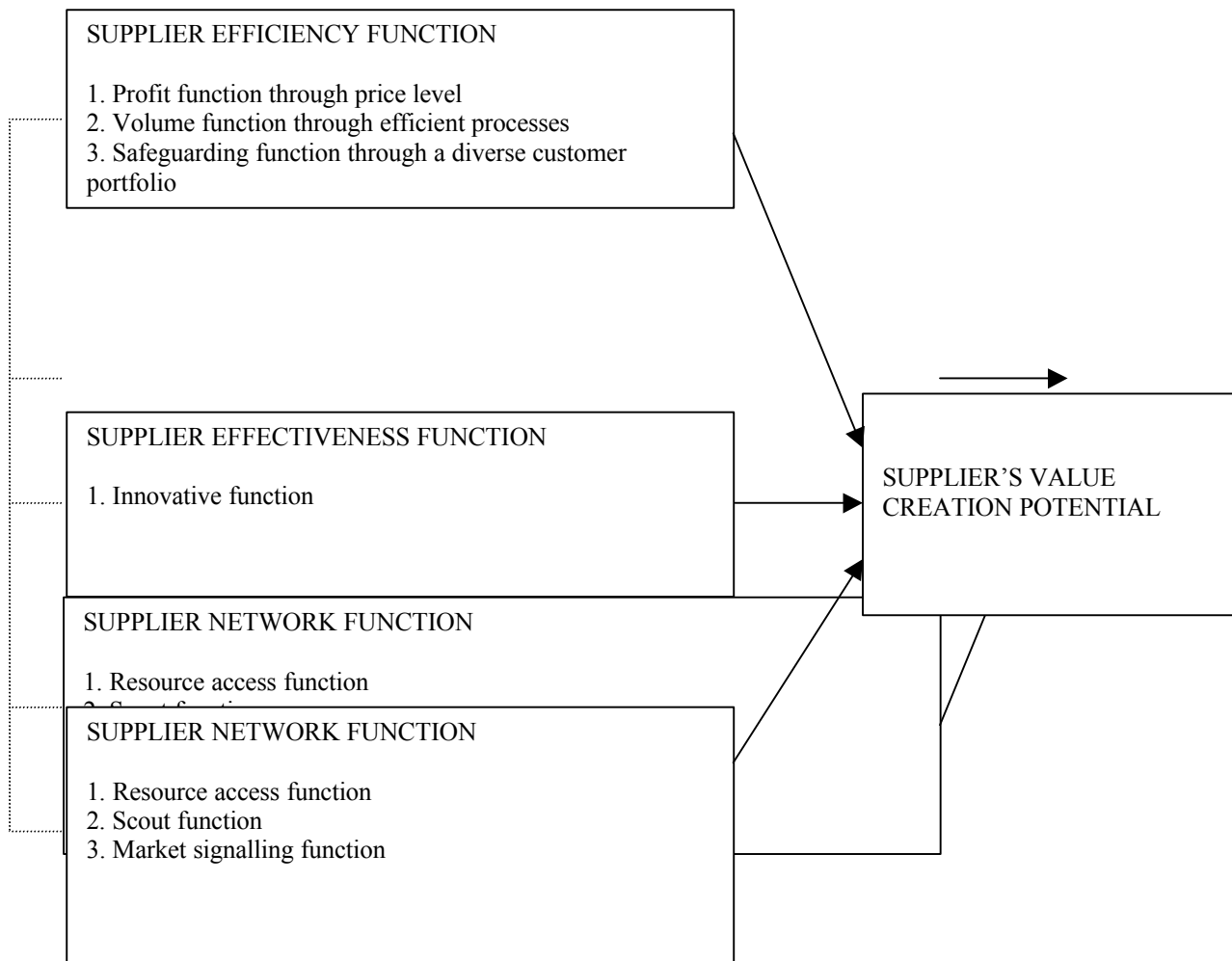


Figure 1. Dimensions of Supplier's Value Creation Potential

Efficiency refers to an actor's capability to perform an activity better, faster, and/or cheaper, without any actor adaptations. By adjusting their operations (Level 2) to achieve a better match between their processes the actors can often gain considerable efficiency gains as proved by numerous Just-in-Time production and logistic supplier nets.

Effectiveness refers to an actor's capability to invent and produce solutions that provide more value to markets (customers) than the existing offers. This creation of new resources is increasingly taking place through co-production between firms and research institutions (Teece et al., 1997). Through the Innovation function a specific supplier or supplier-customer team can produce new product and process solutions that if very successful may form new industry standards like the Wireless Application Protocol in mobile telecommunications. Also more incremental gains in effectiveness are very important in the current global competition. If a supplier cannot keep up with the pace of developing next

generation solutions within a technology – like PC processors, Internet interface software – its major customers will lose their competitiveness at least momentarily.

A single supplier can produce new effective solutions, although this is becoming rare due to the difficulties and costs involved in mastering the multiple technologies generally involved. Commonly the development of products and processes takes place through joint action between the supplier and customer in multifunctional teams. The implementation requires mutual adaptations (Level 2) that can have effects on the current supplier/customer portfolio (Level 3), and even the larger network (Level 4).

We adopt the term Supplier Network Function to cover the rest of the indirect value functions proposed by Walter et al., see Figure 1. Resource access function describes the network connections of a specific supplier, like its linkages to next level suppliers, research and government agencies, other customers, etc. These linkages can provide the customer access to actors that possess relevant resources for enhancing the customer's business processes. These can range from potential R & D partners, channel actors, actors having a gate-keeping position for specific markets, etc. A supplier's network provides also an indicator of its own general development potential.

Scout function refers to the market and other information that can be reached from the working environment through a particular supplier. In abstract sense this dimension could be collapsed with the resource access discussed above as information falls under the more abstract category of resource. This comment is also valid for the market signalling function. When a supplier is highly esteemed a relationship with it may have a positive reference or signalling effect that realises through the wider network actors.

In our discussion we have treated the three basic supplier value functions independently. In reality they are generally highly intertwined as indicated by the left-hand hairline in Figure 1. For instance, in order to achieve a good Safeguarding capability (a supplier can accept flexible and changing demand from the customer) the supplier must have access to customers from other fields (requiring a Networking capability). The Network access and scout functions also support a supplier's capability to develop innovative solutions (Innovative function).

As can be noted the potential value of a supplier is highly related to its various capabilities. This notion forms the backbone of our discussion of the evaluation of supplier's value potential.

EVALUATION OF SUPPLIER'S VALUE CREATION POTENTIAL

Following the previous discussion we propose that a supplier's value creation potential can in theory be evaluated by identifying the level of various functional values and the costs of achieving them. This is basically the same definition as regarding perceived value as the difference between total benefits received and the total sacrifice incurred. The issue is how to do it?

About Production Costs, Transaction Costs and Supplier Risk

Jarillo (1988) has suggested that any major supplier-customer decisions can be treated as a make-or-buy dilemma. It is the question of evaluating the production costs and transaction costs involved in using an outside supplier versus the internal costs of the potential customer.

Although this simplifies the situation considerably, as we are only too well aware of after the discussion in the previous section, it forms a solid starting point.

If TC_b represents the total cost of internal production (or any development project) by the buyer then the externalising becomes interesting if:

$$TC_b > TC_s + TRC;$$

where TC_s are the internal total costs of the potential supplier and TRC are the transaction costs. It can be assumed that a company specialising in the components or services can be a more efficient producer than a potential buyer who is focusing on other intermediate or end products. This makes transaction costs more interesting and even more so if we assume further that the current production costs are reasonably transparent.

The transaction costs can be divided into two components, operational transaction costs (TRC_o) and strategic transaction costs (TRC_s). The former are constituted of the costs of all the activities that are necessary (1) for establishing the supplier-buyer relationship (like information collection about the supplier candidate, contract negotiations and contract, establishing delivery procedures, etc.), and (2) for running the relationships (logistics, quality inspections, etc.). Although these may be difficult to evaluate we can assume that a reasonable approximation of both of these costs can be made.

The strategic transaction costs involve two major elements, (1) the risk that the supplier will lose its competitiveness as a producer of the specific product in question, and (2) the risk that the supplier will behave opportunistically if we become dependent on it. The functional risk is enhanced if the technological development is highly turbulent (increasing the probability of supplier's R&D insufficiency), and if there are no alternative suppliers (potential others are engaged with our competitors) and if the component is important for our business (this provides an approximation of the financial stake in question). How then to evaluate the value potential of the supplier and the strategic risks involved in a strategic relationship?

Understanding Supplier Value Creation – A Value Spectrum

We suggest that it is useful to describe value production through a continuum expressing simultaneously the level of complexity involved and the time horizon of value realisation; cf., Figure 2. Our relational value spectrum is based, besides the discussed work of Ford and his colleagues, on the emerging notions about the relative interactional intensity of business relationships, see Araujo et al., (1999), Day (2000), Möller and Halinen (2000), and Wilson (1995).

At the left end of the spectrum value production does not need any major adaptations by the actors nor creation of new resources. Production of this kind of value – labelled here as “core value” - aims at maximum efficiency in terms of the current resources and process technology. Because of this established nature of value production we can assume the focal products and services offered by a particular supplier have reasonably closed substitutes offered by competing suppliers, that is, there is at least some kind of market for the core value production.

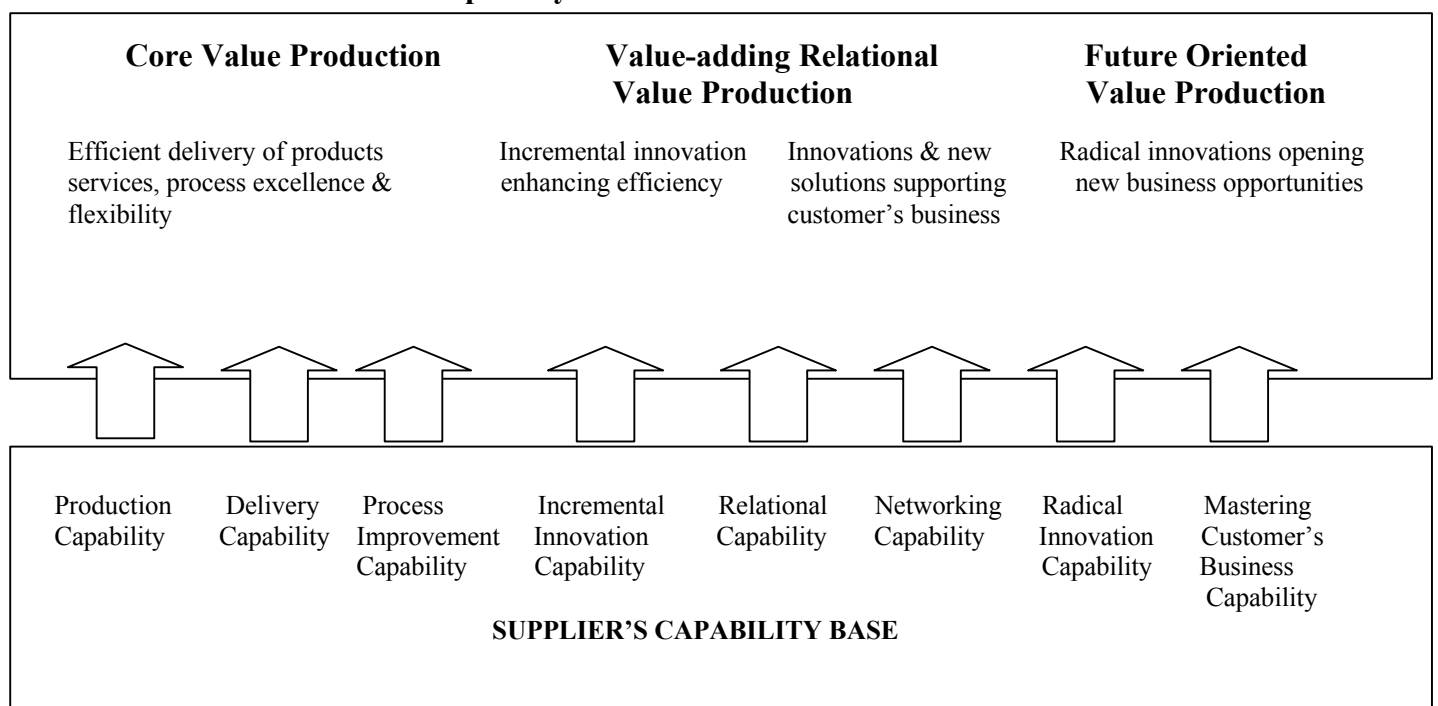
The far right side of the spectrum deals with such radical innovations the value of which depends on many networked actors and realises in the future. The value of this kind of solutions is impossible to evaluate with any accuracy in advance as it depends on the evolution of the field or several fields and the society. Any major radical innovation like combustion engine, transistor, microprocessor, and Internet validates this notion. The high risk associated with the future value production is partly compensated by the potentially huge revenues to be accrued. Because of this challenge any proxies that enable the managers make better “guestimates” of future value production projects are invaluable.

To summarise, only the production of core value can be sufficiently estimated in terms of costs and benefits. The more we move from the left to right the more problematic the evaluation of suppliers’ value production potential becomes. It is conditioned by such factors as the radicalness of the targeted or potential innovations, whether the innovation fits the existing systems or needs auxiliary system innovations, whether the innovation can be mastered and distributed by a few actors or does it require wider networks, and how trusting relationships the key actors have.

Evaluation of Supplier’s Value Creation Potential – a Capability-Based Approach

In our concluding discussion we focus on the possibilities to evaluate the added-value and future value creation potential of a supplier-customer relationship. As it has proved very difficult to assess the potential value of any such innovations whose success is conditioned by multiple factors that change their character in time we suggest that the best feasible alternative is to examine the supplier’s existing capabilities. These capabilities, as recognised in the resource-based theory of the firm (Day 1994, Penrose 1959, Prahalad and Hamel 1990, Wernerfelt 1984), form the platform on which all the current and future value activities of a firm must rely. Figure 3 suggests how capabilities are linked to the relational value-production.

**Figure 3
Capability Base and Value Production**



The capabilities needed in value production are presented in an approximate order of ascending complexity. With this we do not mean that capabilities in the left-hand end of the spectrum are less important. On the contrary, being able to produce core value is generally a necessary condition for achieving incremental innovations and these form the platform for more radical innovations. In the same vein, being able to manage one business relationship well is a necessary learning step towards a capability of working in a net of complex relationships. Another point is that although the capabilities are presented in a row generally a set of them is required to produce any type of value. Broadly speaking more capabilities are needed the more ambitious and innovative value production is in question. A small supplier may, for example, make a major technological innovation but is able to generate only an application fitting to the process of its core client. A supplier with a more broad knowledge of different types of processes could come up with more applications matching the requirements of different technologies. Similarly a supplier may have a highly competitive production capability but lacks the relational capability needed in building the systems of serving many customers in a flexible manner.

Our value production framework and discussion emphasises the role of the supplier. Obviously the production of value in a relationship is dependent on the capabilities and orientation of both of the parties. Only a few comments can be made about this much studied topic in this connection; for a more general discussion on the dynamics of buyer-seller relationships see Halinen (1997), Håkansson and Snehota 1995, Morgan and Hunt 1994, Möller and Wilson (1995). It has been shown that managerial orientation is a decisive factor in developing the supplier-customer relationship from a basically transactional production of core value towards the higher value levels demanding a relational and at the far right a partnering orientation to value co-production, Brennan and Turnbull (1999). The more complex and novel technologies in question the more a partnering orientation and matching of working cultures are needed for producing future value.

The actors must also have complementary technological capabilities. If their capability profiles are too similar they possess more limited opportunities for new knowledge creation than if their profiles are more specialised. On the other hand, the actors must have a sufficient “common ground” or joint knowledge that enhances the mutual learning processes. Companies with widely different technologies and business systems have great difficulties in trying to co-produce value.

We have discussed about the capabilities required in producing value in fairly general terms. In order to be managerially useful the proposed capability approach needs operationalisation. That is, clear indicators for each supplier capability that is seen essential in producing the targeted value should be derived. These indicators are often contextual, that is, they are dependent on the types of industry and technology in question. Although the work of Day (1994, 1999, 2000) has shown that even general level capability indicators are useful in directing our attention to less recognised skills in value production. Managers, however, would benefit on having more concrete indicators the identification of which should be done by persons having experience in the field. To give the reader an idea of potential indicators a few examples is given in Table 1; see also Day 2000.

Table 1
Indicators of Supplier's Value Production Capabilities

Capability Type	Example Indicators
Production Capability	Documented process records (capacity, speed, flex, quality) Production facilities – technical specifications, certifications Qualifications of work force; history of labour relations
Delivery Capability	Documented process records (accurate deliveries and documentation in terms schedules, volumes, and quality) Flexibility in emergence cases
Process Improvement Capacity	Record of stepwise improvements in production and delivery capability Record of continuous cost reductions in core processes
Incremental Innovation Capability	Record of product improvements (better functionality, lower costs, or both) Record of production process and delivery process innovations (functionality and costs influence of these innovations)
Relational Capability	Working key-account management Qualified technological support personnel Committed personnel with team working skills Ability to view things from customer perspective Organisation wide relational orientation Sharing of proprietary information Makes propositions enhancing customer's business processes Information systems integration
Networking Capability	Organisation wide network player orientation – key personnel shares and supports the achievement of joint goals Can mobilise and maintain multilevel and multifunctional contacts between several actors Working communications system supporting the maintenance of network relationships
Radical Innovation Capability	Record of R&D achievements (patents, other IPRs, major product or process innovations) Number of technologies mastered, number of familiar application fields Qualifications and track record of key scientific/technical personnel Relations to core research institutions and other relevant actors (organisations, expert individuals)
Capability for Mastering Customer's Business	Track record of understanding the business logic of the customer (production process, logistic process, customer types and their needs, competitive situation) Track record of proposing major suggestions leading to business improvements or new business concepts Capability to offer "externalisation" of some key business processes or complete business (e.g., manufacturing, design, distribution, etc.)

Indicators measuring the process and innovative capabilities of a supplier can be used to evaluate the value-added potential and the future value production potential, as well as the functional risk incorporated in these kind of major R&D projects. Relational capability indicators and networking capability indicators provide proxies for estimating the potential of opportunistic behaviour of the supplier. These are fairly general notions obviously. More research is needed to establish a validated set of capability indicators.

SUMMARY

The core of this paper can be expressed through the following notions and propositions. We suggested that the dimensions of supplier's value creation taking place in a supplier-customer relationship could be classified through efficiency, effectiveness, and network functions. These functions are interrelated but conceptually separate. We proposed further that value creation can be described through a spectrum ranging from core value, through added-value, to future value. The value producing potential of a supplier can be assessed reasonably well only in the case of core value where there is sufficient benchmarking information in the form of existing alternative offerings and solutions.

An a priori evaluation of the costs and benefits of added value, and especially future value projects is wrought with problems as the realisation of the value is dependent on the development of multiple partners, technologies, and industries. In these cases we suggest that a customer can use supplier's capability profile as an indicator of how well a particular supplier is suitable for specific value creation projects. A simple framework connecting specific capabilities to different types of value production was suggested. Hopefully it proves useful for identifying good partners for value creation.

Joint value creation through partnering and networking is currently a hot topic. More empirical research should be targeted at understanding the process of relational value creation. An important sub-theme is the development of decision-making tools for managing this complex activity. We hope that this paper enhances such efforts.

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