Factors Affecting the Termination Propensity of Inter-Firm Relationships

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ABSTRACT

The decline of inter-firm relationships remains an important, although little studied, topic within the channel management literature. With special emphasis on those channels spanning international borders, this paper outlines a mediational model of termination propensity which exploits the tension between the costs of switching and the opportunity costs of maintaining the status quo. Two original contributions are made. First, it is proposed the switching motivators identified in the literature are mediated through manufacturer-clients’ satisfaction with their intermediary’s current and anticipated performance. Significantly, it is shown that changes in the market, organisational and relational contexts can alter client’s perceptions independently of any changes in actual intermediary performance. Second, and in contrast with the direct links espoused in previous studies, switching costs are predicted to moderate the link between client satisfaction and termination propensity.

KEYWORDS

inter-firm relations, termination propensity, distribution channels

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INTRODUCTION

The removal of intermediaries from distribution channel describes a situation of relationship termination. Although much is known about how inter-firm relationships are formed and maintained (Holmlund and Törnroos 1997; Morgan and Hunt 1994), the dissolution of such relationships remains relatively un-studied (Alajoutsijärvi, Möller and Tähtinen 2000; Harrison 2004; Ping 1999). Issues pertaining to the decline of inter-firm relationships have been examined in the context of channel management generally (e.g., Hibbard, Kumar and Stern 2001; Weiss and Kurland, 1997) and export channels particularly (Anderson and Coughlan, 1987; Balabanis 1998; Benito et al. 2005; Ellis 2005; Peng 1998; Petersen et al. 2000), with the conceptual foundation for much of this work has been provided by transaction costs analysis (e.g., Heide and John, 1988; Klein, Frazier and Roth, 1990), agency theory (e.g., Lassar and Kerr, 1996; Nicholas 1983) and recent insights from the work on relationship marketing (e.g., Harrison 2004; Izguierdo and Cillán 2003). Much of the literature on channel management is concerned with the potential for conflict and cooperation in dyadic settings characterized by parties with asymmetric power pursuing non-aligned goals (Hibbard et al. 2001). Even when goal differences are not an issue, coordination efforts are affected by external factors such as environmental uncertainty, the balance of power within the channel and the ease with which partners can be replaced (Heide and John, 1988). These within-channel tensions ultimately affect the duration, and hence the termination prospects, of inter-firm relationships (Hibbard et al. 2001; Weiss and Kurland 1997).

While the study of export channels may rightly be considered a subsidiary of the broader channel management literature, research in this area is worthy of special mention for the particular attention it has given to the related issues of channel integration (e.g., Anderson and Coughlan 1987; Aulakh and Kotabe 1997; Nicholas 1983) and intermediary replacement (e.g., Benito et al. 2005; Ellis 2005; Petersen et al. 2000). Much of this work is built around the idea that a proper matching of exchange characteristics with alternative exchange modes (hierarchical or market-based) will lead to more efficient outcomes (Anderson and Coughlan, 1987; Heide and John, 1988). From this starting point it is easy to see that any changes in the underlying exchange conditions may alter the cost-benefit ratio of past decisions triggering a reorganization of a firm’s channel strategy and creating possible termination consequences for intermediaries. These consequences have been explored more fully in studies examining agent opportunism and the replacement of trade intermediaries (e.g., Balabanis 1998; Nicholas 1983; Petersen et al. 2000). Indeed, international trade intermediaries, or ITIs, may be profoundly affected by termination issues given the nature of their cross-border match-making function. By providing clients with information and assistance in setting up a new market or source of supply, ITIs can foster the very conditions that lead to their eventual replacement by clients in those markets (Ellis 2005).

THE INEVITABILITY OF TERMINATION

ITIs reduce the costs associated with searching for foreign exchange partners, negotiating agreements, monitoring and enforcing contracts (Peng 1998). Those costs will be highest when the information gaps separating potentially-transacting parties are widest. As markets mature and competition intensifies, information and resources will begin to flow more freely between producers and consumers undermining the asymmetries that give intermediaries their “edge” in the market (Ellis 2003). The result will be a shortening of channels (Sharma and Dominguez, 1992), and the termination of some mediated exchanges. Fortunately new
opportunities to broker exchanges are constantly emerging ensuring the survival of the intermediary. But, unless deliberate steps are taken to ensure otherwise, intermediary relationships inevitably decay over time (Ellis 2003).

While the “built-in mortality” of ITI-client relationships is recognized in the literature (Ellis 2003; Peng 1998), no comprehensive explanation of the process of decline has yet been developed. Instead, the emphasis has generally been on the identification of those organizational, relational and external variables thought to forestall or hasten the inevitable (see Table). These variables have been categorized as either motivators or deterrents in the sense that they either impel or impede the replacement of intermediaries by channel members (Petersen, et al., 2000).

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Studies which examine lists of relationship–enhancing or –depreciating variables contribute significantly to our understanding of the broader factors affecting the termination propensity of inter-firm relationships. But such lists do little to explain how termination decisions come to be made, or even predict the circumstances under which actual termination takes place. Some scholars have speculated that some antecedents are more important than others with the implication that careful attention to these variables can provide intermediaries with an early warning of impending termination. Morgan and Hunt (1994, p.23) argue that commitment, a construct which is “central to relationship marketing”, is a “key mediating variable” separating numerous antecedents from the propensity to leave or terminate a relationship. However, an issue of discriminant validity arises given that others find commitment to be essentially inseparable from termination propensity, defining it as an “expectation of continuity” (Kumar, Scheer and Steenkamp 1995). Intuitively, the notion that termination somehow hinges on any particular variable and is unaffected by the operation of other, perhaps countervailing, factors, is unappealing. In practice, termination decisions are contextually-embedded, reflecting numerous concerns at the level of the organization, the inter-firm relationship and the environment. One-factor explanations pursue parsimony at the cost of utility.

Others have embraced the complexity of the termination decision by examining in some depth the ambiguous effects of variables such as ITI performance (Ellis 2005) and relationship age (Petersen et al. 2000). For example, Petersen et al. (2000) make a cogent argument that relationship age is both positively and negatively related to termination. Over time the information asymmetries separating buyers from sellers (or hiding opportunistic agents from their principals) erode raising the likelihood of termination. But at the same time long-lasting relationships may enjoy higher levels of trust leading to a lock-in effect and a lower risk of termination.

These conflicting claims suggest that mediational relationships are at work through which antecedent variables such as relationship age, or ITI performance, exert indirect effects on termination propensity. For example, if the duration of a client-ITI partnership is correlated with the accumulation of experiential knowledge (enabling clients to make better-informed assessments of intermediary behaviour), then relationship age will indirectly contribute towards an incentive to terminate. If however, relationship age is correlated trust-building investments made by the ITI, then the effect is reversed.

These examples suggest that the termination choices faced by managers are made at the intersection of at least two pairs of variables. In the following section, propositions linking termination propensity with combinations of variables are identified.
TERMINATION PROPOSITIONS

**Termination Triggers**

Despite the long lists promulgated in the literature, fundamentally the incentive to terminate ITIs is filtered through the manufacturer-client’s satisfaction with, or expectations of, current and anticipated intermediary performance. Other switching motivators identified (e.g., the client’s accumulation of market knowledge or the growth rate of the market) can be expressed in terms of this mediating variable. For example, having acquired first-hand knowledge of a growing market, a manufacturer may conclude that their intermediary is not making a promotional effort commensurate with the market potential. The manufacturer’s dissatisfaction may trigger a search for alternative distribution strategies and the non-renewal of the existing intermediary agreement. But client dissatisfaction is only one of two termination triggers. The opposite scenario – high satisfaction – is equally potent from a termination point of view. If the intermediary’s efforts to develop a new market far exceed expectations, as evidenced by a significant rise in sales, this may send a signal to the manufacturer indicating that the market is worthy of closer inspection. The manufacturer may then decide that the high market growth rate warrants their first-hand involvement and so internalize functions previously outsourced to the intermediary. In this case the intermediary’s above-average levels of performance have effectively raised the client’s opportunity cost of relying on indirect exchange modes. In short, there is a non-linear relationship between the client’s satisfaction with intermediary performance and termination propensity; an incentive to eliminate the intermediary will arise whenever the ITI’s performance falls far below or far exceeds client expectations (Ellis 2005). This can be expressed in proposition form, as follows:

P1: Termination propensity is positively related to extreme levels of client satisfaction with ITI performance.

The unknown variable in this equation is the baseline of client-expectations against which intermediary performance is assessed. This baseline is not fixed but changes over time as the client becomes better acquainted with the demands and opportunities of selling abroad. The central premise of this paper is that many of the switching motivators identified in the literature affect termination propensity by altering the expectations manufacturer-clients have of their ITIs. In short, client satisfaction with current and anticipated ITI performance – which is the final arbiter of termination propensity – is influenced by market, organizational, product and relational factors. The significant and worrying implication for ITIs is that changes in client satisfaction can occur independently of changes in actual ITI performance.

**Market factors:** Changes in the economic, political and cultural environments have a fundamental impact on the competitiveness of alternative channel designs. These changes may be signaled to the manufacturer-client by fluctuations in sales to the foreign market (via the ITI or other channels), unsolicited approaches from potential customers, or through a formal or informal study of the market in question. Of primary interest in this termination context, is how external market changes alter the opportunity costs associated with relying on an ITI. There is evidence in the literature to show that increases in market demand raise the likelihood of switching to direct modes of exporting or pursuing foreign direct investment (Klein et al. 1990; Nicholas 1983). Large markets enable manufacturers to achieve economies of scale in marketing reducing the cost advantages of external intermediaries. At the same time, increased competition in the market raises manufacturers’ needs to exercise control over the entire marketing mix to ensure consistent implementation of their marketing policies (Sharma and Dominguez 1992). In short, as foreign markets expand and become more
attractive, manufacturers’ expectations are raised, possibly to the point where existing ITI arrangements are considered to be sub-optimal. To the extent to which ITIs are unable to meet these rising expectations, an incentive to terminate is created.

P2: Client satisfaction with ITI performance will be negatively related to market demand.

Organizational factors: Internal organizational changes may also alter the balance between opportunity and switching costs. In the literature, export channel integration has been linked with company growth (Benito et al. 2005), the accumulation of market experience (Nicholas 1983), and the pursuit of corporate objectives geared towards establishing a global market position (Aulakh and Kotabe 1997). The implication is that as ITI-clients grow, become more internationally experienced, or implement global marketing strategies, their desire to maintain indirect channels will decline. Yet, the potency of these change-inducing factors will be constrained by managerial capabilities. A rapidly growing company that finds itself stretched serving existing markets may be content to continue outsourcing distribution to ITIs in other markets. While increases in company size and foreign experience may raise the expectations of what can be achieved in foreign markets, there will be no real pressure to integrate until the management of the company is in a position to take-over the distribution functions of the ITI.

P3: Client satisfaction with ITI performance will be negatively related to increases in managerial resources.

Product factors: Increasing product specialization will lead to growing dissatisfaction with the intermediary option for two reasons. First, in competitive markets where products are readily substitutable, the incentive for ITIs to behave opportunistically is tempered by their replaceability (Klein et al. 1990). But greater product complexity may increase the manufacturer’s dependence on the ITI raising the potential for opportunistic behaviour. Thus, an incentive to terminate arises when the additional monitoring costs required to meet this growing threat exceed the benefits of selling direct to the market. Second, for products involving a high or increasing service component, manufacturers may have expectations of quality control that cannot be met or easily verified when outsourced to external intermediaries, providing them with yet another reason to integrate (Anderson and Coughlan 1987).

P4: Client satisfaction with ITI performance will be negatively related to increases in product complexity.

Relationship factors: Finally, several relationship-level factors have been linked with an incentive to terminate trade intermediaries. These include; channel conflict (Balabanis 1998), opportunistic behaviour (Nicholas 1983), and client perceptions of ITI performance (Ellis 2005). As judged by the manufacturer-client, the health of any ITI-relationship can perhaps be expressed in terms of intermediary performance. Conflict has been defined as behaviour by one channel member which prevents or impedes another channel member from achieving their goals (Stern and El-Ansary 1988). In other words, conflict arises when manufacturers’ perceive their ITIs to be performing in a manner inconsistent with their expectations. Goal incongruency can also lead to the temptation for channel members to transact dishonestly or opportunistically. Opportunistic behaviour can take on both active and passive forms. For example, a distributor can actively breach a contract by selling into unauthorized territory or passively fail to honour an agreement by withholding effort (Wathne and Heide 2000). In either case, to attenuate the
risk of opportunism, manufacturers must invest in monitoring and control mechanisms using 
resources that could have been better deployed elsewhere. These costs drag down the 
performance of the ITI relative to other modes of governance (Nicholas 1983).

Irrespective of the source of their dissatisfaction (e.g., conflict or opportunistic 
behaviour), ITI performance which falls below manufacturers’ expectations leads to client 
dissatisfaction and an incentive to terminate. Conversely, ITI performance which exceeds 
manufacturers’ expectations may alert manufacturers to the benefits of integrating channels 
(Ellis 2005).

P5: Client satisfaction with ITI performance will be positively related to ITI performance.

**Moderators of Termination Propensity**

Changes in market, organizational, product and relationship factors, mediated by client 
satisfaction with ITI performance, can create an incentive to terminate proportional to the 
opportunity costs of not changing. But actual termination will not take place unless these 
costs exceed the costs of switching to other exchange modes. Switching costs thus moderate 
the link between client satisfaction and termination propensity; the greater these costs, the 
weaker the link.

In the channel literature two classes of switching cost or deterrent have been identified; 
(i) market-specific deterrents and (ii) relationship-specific deterrents. Market-specific 
deterrents are essentially the costs of learning about, and setting up in, foreign markets 
(Benito et al. 2005). These costs will be greater for markets perceived to be culturally 
unfamiliar (Anderson and Coughlan 1987), risky (Aulakh and Kotabe 1997) and otherwise 
unpredictable. Relationship-specific deterrents include explicit contractual restrictions 
limiting the exit choices of either party (Petersen et al. 2000), as well as manufacturer- or 
customer-specific investments made by the ITI as insurance against termination (Heide and 
John 1988; Weiss and Kurland 1997). These investments can take the form of special efforts 
made by the ITI to understand the manufacturer’s idiosyncrasies and product line or to foster 
close relationships with the manufacturer’s customers (Weiss and Kurland 1997). The first 
type of investment adds value to the ITI’s position in the channel (how hard would it be to 
replace this ITI with another willing to exhibit a similar level of effort?), while the second 
type of investment raises the costs of termination (might customers that have bonded with the 
ITI be lost?).

The dampening effect of market- and relationship-specific factors are stated in 
proposition form, as follows:

P6: The link between client satisfaction and termination propensity will be moderated 
by:

(a) market-specific factors such as cultural distance to market and government 
restrictions limiting the integration options of foreign firms

(b) relationship-specific factors such as contractual restrictions and 
manufacturer- and customer-specific investments made by the ITI

**CONCLUSION**

Factors affecting the termination propensity of inter-firm relationships are undeniably of 
great interest to channel intermediaries facing the threat of elimination. Yet past approaches 
examining a single cause of decline, are demonstrably inadequate to the task of explaining 
the complexities underlying the termination process. Conversely, studies which advance ever-
longer lists of switching motivators and deterrents often fail to consider the interdependencies
between these factors. The unasked question is how these variables interact to tip the balance towards, or away from, the inclination to terminate. Further work on this important, yet relatively unstudied, topic would benefit from a shift towards mediational explanations such as the one outlined here.

REFERENCES


TABLE: Factors affecting the termination propensity of intermediary agreements

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