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Navigating alliances with bigger partners

By ***René Bakker***

Start-ups face many life-and-death choices as they grow. One of the most crucial is how to work with larger partners. On the one hand, the surest way for a start-up to get the resources it needs is to form an alliance with a much bigger and more established company. On the other, interacting with that larger company can be dangerous.

As an example of that possible danger, how do you stop a company 20 times your size from paying too little for your idea – or even stealing it outright? My colleague, Joris Knoben, Professor of Business Economics at Radboud University, and I have given a lot of thought to what we call this "guppy versus whale" problem. We never found the data to study the question empirically, however, until I stumbled onto something I thought might work. While I was doing research at the Australian Centre for Entrepreneurship Research in Brisbane, I happened to run across a book called *The Register of Australian Mining*.

"The meek shall inherit the earth, but not its mineral rights." ***J. Paul Getty***

It's about 3,000 pages long and five centimetres thick, and amounts to a telephone book of all the mining businesses in Australia, including their boards of directors. To me as a Dutchman, it looked very exotic – we don't have many diamond and silver mines in the Dutch outback – but more importantly, I could see right off that Joris and I could use this information to answer our guppies-versus-whales question.

As I did more research on the register, I found that it had been published for 31 years. Eventually, I flew out to Perth and persuaded the people who compiled this data to share 10 years of electronic files with us; files we could use to see whether there were organisational reasons that some mining industry "guppies" survived in a sea of mining sharks and whales while most disappeared.

Guppies and whales

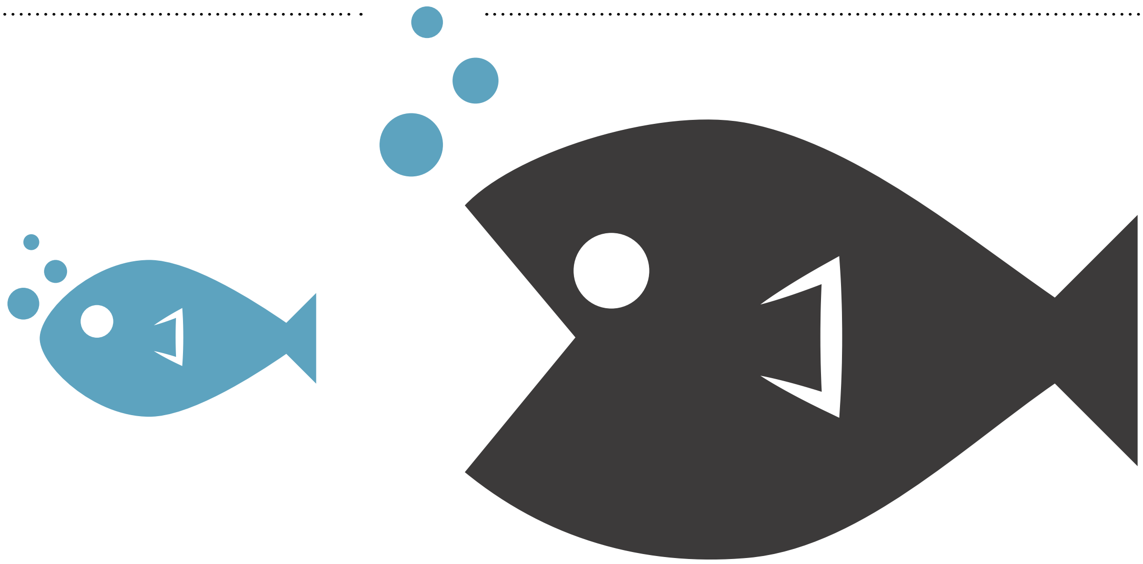
The Australian mining ecosystem has two important parts: the major mining companies and what they call junior miners. The junior miners are generally start-ups organised around a few key individuals who go out and prospect to find a promising resource.

The major miners, on the other hand, are typically large companies that operate portfolios of extraction projects. The risks of failure are so high that most of the majors no longer look for new mineral deposits themselves – that front-end work is mainly done by the junior miners.

The relationship between the majors and the juniors is highly symbiotic. The days of walking around in the Australian outback and finding a gold nugget at the side of the road or in a riverbed are long gone. To mine minerals now requires considerable capital, technological know-how, and considerable knowledge of how to manage the "green and red tape" of environmental and governmental regulation. Just as the majors look to the juniors to handle the time-consuming and risky work finding deposits, the juniors rely on majors to support the costly and time-consuming process of turning hunches into reality.

Finding the right partner is difficult for both parties. The major miner must choose winners out of a field in which 90 per cent of projects fail. The junior miners need to find partners who will treat them fairly.

Of course, the risks are highest for junior miners. These start-ups may be "muscled out" of a promising asset by a larger company through intimidation, hostile takeovers, or the threat of expensive litigation. Disputes are generally settled in court, where the major miner's large legal team tends to overwhelm the junior miner's attorneys. One junior miner executive told us:



That is the hardest part, going through the court process and the money involved in that when you find something valuable. What happened to us is, we were discussing a farm-out with [redacted to preserve anonymity] and we hadn't reached any agreement but we had some discussions and then when everyone had realised how valuable this was [..] they took us to court and in the end we had to settle. It cost us 400,000 dollars. [..] We had worked with them and talked with them, [yet] [..] they almost took us out. [..] You've got to fight for everything you've got.

This tends to happen fairly frequently in the mining industry, at least in Australia. One junior miner executive told us: 'I can give you countless situations where people who had good deposits were given two to five million dollars and then told to piss off and the other people were able to turn that into billions of dollars.'

As oil tycoon J. Paul Getty once quipped: 'The meek shall inherit the earth, but not its mineral rights.'

Who you know

When we traced the relationships of 915 junior miners and 331 major miners in our 10 years of data, we found that junior miners that were doing well in their partnerships with major miners tended to structure their alliances in a quite typical way: they made sure that their strategic alliances (joint projects) were accompanied by a board interlock – that is, that both the junior miner and the major miner appointed the same individual to both of their boards. We call such partnerships *pluralistic ties*.

When we interviewed mining executives about this phenomenon, we found that three factors explain this behaviour. First, having a member on both boards is likely to facilitate communication and help build trust between the junior miner and the major. Second, alliance partners often have a hard time assessing and monitoring each other's incentives, capabilities and effort, and a board member with a seat at both tables is better positioned to assess what's actually going on.

Finally, a pluralistic tie may act as a safeguard against the major miner taking advantage of the junior, because the interlocked board member is generally a more senior person in the industry. We believe having a powerful partner on the board is a strong signal of the start-up's legitimacy and an important defensive mechanism, as the member is in a position to tell others in the industry about any bad behaviour that goes on.

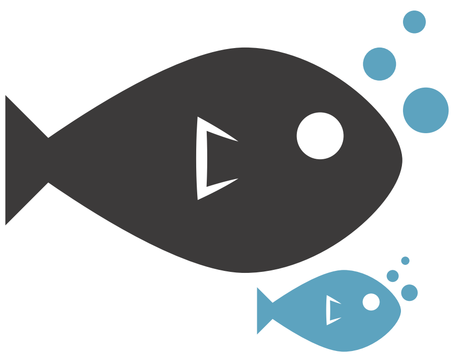
We had suspected that all this would be the case, but another pattern surprised us: such tie formation is relatively rare. Overall, only 10.1 per cent of juniors formed the kind of pluralistic ties (consisting of a board interlock *and* an alliance) that we found to be particularly beneficial.

What's also salient about our findings is the strength of the effects we find. Although our empirical models indicate that the formation of stand-alone alliances and the formation of pluralistic ties each has a positive, statistically significant effect on start-up performance, the latter's effect size is roughly three times larger. The magnitude of the effect is such that one standard deviation increase in asset growth (our measure of start-up performance) requires a start-up to form 3.4 stand-alone alliances, but only 1.2 pluralistic ties. Importantly, the difference between pluralistic tie formation and stand-alone alliances is not simply due to the formation of board interlocks per se.

We controlled for the number of board interlocks and found it had no statistically significant effect on performance. That is, the effect of four pluralistic ties (four pairs of alliances and board interlocks) is stronger than that of the formation of four stand-alone strategic alliances and four stand-alone board interlocks. In line with our theory, this implies that the pluralistic overlap of a board interlock and an alliance *with the same partner* drives the effect.

We found a second pattern that was even more salient: it turned out that the sequence of tie formation was very important. When the partnership commenced with a board interlock, and the partners only then later formed a strategic alliance, this had the largest positive effect.

"...our research suggests it pays to look for strong relationships in the form of pluralistic ties."



Friends first, cash later

For entrepreneurs, this result suggests an important lesson: it's not only who you know what matters, *but when you get to know them*. Whether you are looking for gold in the Australian outback or in Silicon Valley, our research suggests it pays to look for strong relationships in the form of pluralistic ties. Really getting to know your partners prior to forming a strategic alliance has many benefits. Venture capitalists too may want to bear this in mind. ■

This article draws its inspiration from the paper *The guppy and the whale: Relational pluralism and start-ups' expropriation dilemma in partnership formation*, written by Joris Knoben and René Bakker, and forthcoming in the January 2019 issue of the *Journal of Business Venturing* (Volume 34, Issue 1, Pages 103-121). DOI: https://doi.org/10.1016/j.jbusvent.2018.05.008

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