Slacking off

How financial slack can boost alliance formations

Strategic alliances are becoming increasingly common, in part because of how important they can be for organizations to remain competitive. The central reason for forming alliances is to acquire resources that facilitate a stronger competitive position. Yet, a defining factor governing the formation of alliances is the stock of resources an organization has. There is some belief that a lack of resources can be an instigator for the forming of alliances, and that an excess of resources can reduce motivation to seek out alliances. Contradicting this is the belief that an abundance of resources can act as an attraction for those organizations that lack resources themselves, boosting the chances of an alliance.

Another element of an organization's resource is the ability for them to provide security to embark upon an alliance. An abundance of resources can mitigate the risks of a failed alliance, meaning they can act as an encouragement to pursue potentially risky, but ultimately rewarding, alliances. Between 30-70 per cent of alliances are reported to fail, typically resulting with shareholder value destruction. What therefore becomes useful in mitigating the risks of alliance building is the abundance and use of slack resources. Slack resources are those that are in abundance within an organization and used to mitigate the risks of strategic decisions. While ideally, slack is not needed within an organization as efficiency in managerial decisions should negate their need, in practice a buffer is integral to an organizations robustness. Slack resources are either low discretion slack resources (LDSR) or high discretion slack resources (HDSR). LDSR do not offer managers many options, typically being made up of the inventory, skilled labor, and equipment. HDSR provide managers with more options, typically coming in the form of financial slack.

The role of financial slack resources

Financial slack resources can be seen as ideal to protect an organization against the risks of alliance forming. While there are many types of slack resource, financial slack resources are ideal in this regard because of their versatility and being highly discretionary. Large financial slack creates a buffer against which managers can pursue risky decisions without compromising organizational functioning. There are two types of financial slack identified by Bizzi (2017):

1. internal funding of cash holdings, representing internally generated funds, maintained liquid, and unabsorbed; and
2. and external funding of financial leverage, meaning the proportion of debt over equity (with low financial leverage acting as slack, as it provides potential access to external funds through debt financing).

Financial slack offers protection against higher than expected costs from an alliance or lower than expected revenues. In either circumstance, the lower profitability can have significant financial effects which financial slack can alleviate in the short-term. It also

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allows for alliances to be considered reversible. Costs are incurred when embarking upon an alliance. But the presence of financial slack means that if the alliance is deemed unsuitable or too risky in reality, it can be used to offset any losses incurred by backing out of the alliance early. Financial slack also aids the winning of internal political arguments due to its flexibility. Top managers are able to use financial slack to combat internal resistance by using it to appease the demands of disparate groups within an organization. Financial slack also offsets the risks perceived by managers of opportunistic value misappropriation on the part of the alliance partner. An organization with financial slack is able to leave and alliance or subsume any unexpected losses without issue, meaning they are less subject to the will of the alliance partner, encouraging collaboration. Concerns about the use of financial slack state that such resources produce no value for an organization, and can encourage complaisance on the part of management who do not feel the need for efficiency or risk in the pursuit of profitability.

Financial slack hypotheses

Internal funding financial slack relates to the stock of cash holdings. Cash is seen as a valuable asset for organizations to use as a buffer against the failure of their initiatives, encouraging risky projects. It can be argued that the capital market could remove the need for organizations to hold internal funding, yet capital markets are unreliable compared to internal funds. Problematically, cash as financial slack costs an organization, as this funding could either be used to increase revenue or to pay back shareholders. Large cash reserves can also result in managers failing to use funds efficiently. Despite these issues, Bizzi (2017) identifies the following hypothesis:

H1. Cash holdings are positively associated with alliance formation.

External funding financial slack relates to financial leverage, which is understood as the ratio of debt financing over equity financing. Financial leverage, as with cash reserves, can provide buffers to economic uncertainty from risky projects. Low debt and large equity enables an organization to gain additional funds from debt financing. As such, low financial leverage encourages strategic alliance building. High debt, conversely, reduces financial flexibility and buffer. High financial leverage therefore discourages strategic alliance building. This allows Bizzi (2017) to present the following hypothesis:

H2. Financial leverage is negatively associated with alliance formation.

The interactive effect of internal and external funding on alliance formation is important to consider. Low financial leverage reduces the importance of cash holdings, as does the reverse. Yet, when an organization has large cash reserves and low financial leverage, it may embark on a more strategically coherent strategy for forming alliances. As such, Bizzi (2017) hypothesizes that:

H3. Cash holdings and financial leverage have an interactive effect on alliance formation. When financial leverage is low, the positive relationship between cash and alliance formation is weaker. Similarly, when cash is low, the negative relationship between financial leverage and alliance formation is weaker.

The findings of Bizzi (2017) support each hypothesis. Cash holdings exercise a positive effect on alliance formation, while financial leverage exercises a negative effect. The interaction between cash holdings and financial leverage can be used to predict alliance

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formation. Importantly, large cash reserves change from a benefit to a cost when an organization has high financial leverage, and the costs of financial leverage become benefits when cash reserves are low. Therefore, the costs of a mismatch between these two are better than either one on its own.

Commentary

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Strategic alliances are becoming a common practice between organizations in the global economy. They are seen as being able to improve performance and help keep organizations competitive. Bizzi (2017) argues that an integral aspect of forming a strategic alliance is the level of financial slack resource an organization has. The greater the financial headroom, the more likely an organization is to engage on a potentially risky alliance. In a global market place where resources and funding are becoming increasingly scarce, organizations that can have largely unallocated resources can be seen as ideal partners. And the key resource in today's economy for alliances is finance.

Reference

Bizzi, L. (2017), "The strategic role of financial slack on alliance formation", *Management Decision*, Vol. 55 No. 2, pp. 383-399.