Spring 2015

# Managing Strategic Alliances: The Risks and Rewards of IKEA's Purchasing Strategy in Trade Area Greater China Region (TAGC)

Emily Groh
*University of Portland*

# Managing Strategic Alliances

*The risks and rewards of IKEA's purchasing strategy in Trade Area Greater China Region (TAGC)*

**Emily Groh**

Fall 2014
Senior Honors Project

## Table of Contents

Managing the value chain is a key to success in any business organization. According to Jay B. Barney and William S. Hesterly, a firm's value chain can be defined as, "that set of activities that must be accomplished to bring a product or service from raw materials to the point that it can be sold to a final customer"(164). In choosing the best methods to operate each of these activities, the firm develops a corporate strategy, or, "theory of how to gain a competitive advantage by operating in several businesses simultaneously" through vertical integration, strategic alliances, diversification, and mergers and acquisitions (Barney and Hesterly 164). Vertical integration involves taking more steps of the value chain within the firm's own control, ideally providing the firm more opportunities to influence the full cycle of business operations. Vertical integration can be separated into the two directions a firm can chose to integrate: backward vertical integration and forward vertical integration. Backward vertical integration involves gaining control over the earlier stages of the value chain, in the direction of raw materials; forward vertical integration joins the firm more closely with customers (Barney and Hesterly 164). Vertical integration can be a highly advantageous method for many firms, in that it can be difficult and costly to imitate for potential competitors. In the following case of IKEA Group, their backward integration strategy is the result of high levels of investments, longstanding relationships with suppliers, and a good reputation in the industry.

## IKEA Purchasing Strategy

For some firms, managing the value chain is a small operation, with a few choice suppliers and limited distribution channels. However, as globalization expands operations and opens doors for a wider customer base, this chain becomes a complex web of relationships built, opportunities taken, strategic moves made, and alliances formed. For IKEA, a global retailer providing furniture and home accessories, the later is the case. With 1,046 manufacturers in 52 countries supplying to 345 stores in 45 counties, IKEA Group is tasked with managing and developing these key links in the value chain (IKEA Group, 32-33). The IKEA purchasing strategy is designed to keep costs low, allowing the firm to be a cost competitor. IKEA Group employs economies of scale, direct delivery to stores and long-term strategic relationships with suppliers as a part of their low-cost purchasing strategy.

IKEA uses economies of scale to encourage suppliers to sell at lower costs. A common question posed to an IKEA supplier: "What affect would a 10% increase in volume look like on the purchase agreement price?"(Groh). Through buying in multimillion-euro quantities, IKEA hopes to receive a better price from its suppliers. Economies of scale allow raw materials also to be purchased in "bulk" at lower costs, manufacturing line processes to change less frequently and production lines to run more hours per day, decreasing down time (McGrath 98).

Another approach IKEA uses when making procurement decisions is to form long-term relationships with its suppliers. Jim Wetekamp, Senior VP of Solutions Strategy at BravoSolutions writes that, "by involving suppliers early, procurement can accelerate the qualification, design, and contracting processes to shorten the product release timeline…[and offer] opportunity to shift capital expenditures, manufacturing line changes, and other production innovation costs to the supplier"(Wetekamp). For IKEA, this tends to be a spoken agreement between the regional manager from IKEA and the owner of the production facilities, as opposed to a formal long-term contract (Casino Royale). IKEA has the advantage of having a great reputation for on-time payments, large order quantities, and offer overall good publicity to the suppliers, thus few suppliers would be willing to turn down an order from IKEA, even without a formal long-term agreement (Groh).

Nonetheless, IKEA holds all of its suppliers- both those with long and short histories supplying to IKEA- to very high standards. Every IKEA supplier is required to follow the "IKEA Way" of doing business, or IWAY. IWAY is described as IKEA's, "Minimum Requirements for Environment and Social & Working Conditions when Purchasing Products, Materials and Services" (IKEA Services). IWAY consists of 8 primary "IWAY Must" requirements that are considered crucial for all suppliers to uphold: no child labor, no forced and bonded labor, proper business ethics, no severe environmental pollution, no severe health or safety hazards, transparent working hours, legal minimum wage rate, and the provision of workers' accident insurance (IKEA Services). While most of these requirements appear fundamental to any business, the business environment in which IKEA's largest single purchasing power operates in does not have such minimum standards. China: the world's largest producer and supplier of 23% of IKEA's products (IKEA Group 31). Moreover, IKEA's Trade Area Greater

China (TAGC) holds 33% of the group's purchasing power and is set to grow with the strategic expansion of IKEA into India slated for 2017 (IKEA Group 4).

## Competitive Advantages of Alliances in TAGC

For IKEA, alliances with suppliers are more than a smart business move; they are the key to IKEA's highly successful cost-cutting strategy. And excerpt from IKEA Group's 2013 Yearly Summary explains the elementary approach IKEA takes:

> "*We optimize the value chain of a product by asking ourselves three questions about its material, production, overhead and logistics:*
> *1) How can we reduce costs?*
> *2) How can we eliminate cost altogether?*
> *3) How can we work with high volumes to lower the unit cost?"*
> (IKEA Group 25).

These three questions are directly related to IKEA's suppliers and the levels of efficiency and cost-cutting strategies they can offer to IKEA. In the case of one light source supplier, the first question was answered in the form of a simple switch from glass bulbs to plastic, eliminating cost of poor quality nearly 100% (The Living Daylights). For most suppliers, eliminating costs means decreasing number of workers through increased automation. An office chair supplier is working to develop a uniform seat base for its different styles of chairs, allowing them to better apply economies of scale to that element of production (Skyfall). IKEA's "flat pack" technology allows not only for lower transportation costs, but also for decreased environmental impact (Hellström). By designing products in a way to minimize packaging dimensions, IKEA can fit more products in every pallet, container, and ultimately your car home. These lean manufacturing improvements and simple yet innovative approaches to home furnishing allow IKEA to create a competitive advantage in an industry that, up until recently, seemed fully established. And none of it could be done without full support and coordination from suppliers. TAGC teams work extremely closely with their suppliers, ensuring that they are meeting IWAY requirements, maintaining high levels of quality, and ceaselessly working to increase efficiency while simultaneously lowering costs (Groh). Similarly, IKEA works with suppliers to develop direct delivery from factories to stores, eliminating the costs and times associated with warehouse storage (Groh). Last year, IKEA worked with suppliers to improve direct delivery from 55% to 58% (IKEA Group 25). These alliances between IKEA and its suppliers exist because of IKEA's strong reputation in the industry and the large orders promised to suppliers who are willing to meet the demands. According to one lighting component's supplier, supplying to IKEA has been a large asset in attracting other customers, as many companies do not feel the need to conduct certain compliance tests, knowing that the supplier is meeting IKEA's strict criteria (Moonraker). Others have found that IKEA's strict standards have benefits internally, providing better living standards that result in better output for their workers; one hand tool supplier is voluntarily adopting IWAY practices across all of their business units, even those not supplying to IKEA (The Man with the Golden Gun).

## Threats Posed by IKEA's Alliance Strategy in TAGG

The competitive advantage offered by IKEA's purchasing strategy are undeniable with simple cost-cutting innovations redefining the industry, but these benefits are coupled with the responsibility to develop and manage the suppliers. Barney and Hesterly identify three major threats offered by strategic alliances: *moral hazard, adverse selection,* and *holdup* (259). A moral hazard occurs when one party takes more risks because another party has agreed to bear the burden of those risks (259). For IKEA, moral hazards oftentimes occur with regards to the work hours of their suppliers' employees. China's labor laws are considered complicated at best, absolutely opaque at worst. For many multinational companies who outsource production to China, this is an accepted reality of the nature of business that is frequently overlooked or blatantly ignored (Thunderball). For IKEA, a combination of genuine commitment to the everyday people coupled with constant scrutiny from the public eye means that they hold suppliers to very high standards regarding working hours and conditions. One owner of a large manufacturing company revealed the difficultly he faced, as a Westerner operating in China, finding managers to honestly report hours and overtime logs (Thunderball). Moreover, the Chinese government offers little support, oftentimes appointing corrupt officials to perform factory audits and review employee logbooks (From Russia with Love). Starting in 2013, IKEA's TAGC began the process of changing the regulation for working hours from sixty per week to forty per week. This is a preemptive move on IKEA's behalf, as China's Ministry of Human Resources and Social Security issued a draft of regulations making the same hourly change; the draft is still out for comments with no start date in sight (Yang). The moral hazards involved with this regulation affect all three parties involved: workers, suppliers, and IKEA. Workers are at risk of working over 40 hours without the factories logging and paying these extra hours. Suppliers are balancing the loss of working hours per worker, yet the same (if not greater) demand for output from IKEA. If the demand is not met, suppliers risk IKEA moving some of their business to other suppliers. Finally, IKEA faces the moral hazard posed by dishonest suppliers who may not be following the new workweek regulations.

Adverse selection exists when, "Potential partners misrepresent the value of the skills and abilities they bring to the alliance" (258). This is at particularly high risk in the context of the Chinese culture, where the concept of 面子 (miànzi- "face") largely controls the culture of people and business. "Face" can be roughly defined as "how one is perceived by others; pride; dignity," however, no translation quite describes the deeply-rooted effect face has on relationships. Relationships are upheld and maintained first, while addressing any problem will be approached secondly. This can manifest in small ways, such as a grand dinner with casual conversation before any business is discussed. And sometimes in potentially harmful ways, such as blatant lies to avoid letting a business partner down, thereby saving the lying partner from "losing face". This means that Chinese suppliers will oftentimes overestimate their capabilities, simply because they fear losing the relationship with IKEA and are not accustomed to having failures or weakness in their organization frankly addressed, as is the Western custom. For IKEA, many suppliers eagerly agree to make changes and improvements, but rarely follow through (or were never equipped to facilitate the change in the first place) without constant follow-ups and close monitoring by the hundreds of IKEA employees assigned to TAGC's supplier base (Casino Royale).

A third threat that can develop involves unequal transaction specific investments made by alliance partners, also known as a holdup. Transaction specific investments occur when an investment's value is higher within the context of the partnership than outside the partnership (260). During the summer 2014 INDUSTRY CHAMPS Project, I came across a few suppliers who felt that they were putting many resources into improving automation and meeting IWAY demands, but were not being properly recognized via increased orders from IKEA (Groh). Other suppliers hoped that IKEA could offer financial support to suppliers as they made the transition from a sixty hour work week to a forty hour work week (Thunderball). Likewise, some of IKEA's TAGC management feels that they constantly invest time, money, travel and effort into their suppliers, while suppliers resist making changes or neglect deadlines (Groh). A View to Kill made many investments in automation, under the impression that IKEA would place more orders; due to A View to Kill's slow and inefficient automation strategy, IKEA took most of the business elsewhere. IKEA felt that they were let down; A View to Kill felt that they were betrayed (A View to Kill). The glass supplier, Dr. No, utilized many resources to develop a lean manufacturing process to produce thinner glass for use in wardrobe doors, and was still waiting for IKEA to design products that will utilize their new technology (Dr. No). Without proper return on investments, the above cases exemplify how a holdup can be perceived differently by both parties.

## Monitoring Alliances: INDUSTRY CHAMPS Project Summer 2014

In an eight-week summer internship at IKEA's Trade Area Greater China, I visited twenty-one top suppliers nineteen in Mainland China, two in India. In addition to factory tours and show room visits, I conducted interviews with leaders of the production, ranging from CEOs to quality technicians. The goal of the interviews was to collect data- from an outsider's point of view- about the greatest points of improvement for IKEA to address in monitoring its alliances with suppliers. As an unbiased and new-to-the-firm interviewer, I was able to approach topics in an unthreatening way, allowing me to hear the supplier's point of view on an issue as well as maintain a generalist overview to the issues. Upon completion of the interviews, key areas for improvement were presented to TAGC management in Shanghai, Shenzhen, and Qingdao. Among the most common complaints from suppliers was the lack of long-term commitment from IKEA; only five of the nineteen Mainland China suppliers had a long-term (3+ years) contract agreement with IKEA, and all nineteen wished for more commitment from IKEA (Groh). Equally problematic to suppliers was a communication gap sixteen suppliers noticed between the TAGC offices in Asia and the IKEA of Sweden (IOS) headquarters in Älmhult, Sweden. Both of these problems stem from unsuccessful alliance management and can be resolved, benefitting both IKEA and its suppliers.

## Methods for Monitoring Alliances

Currently, IKEA uses non-equity alliances, meaning that it does not hold equity in its alliance partners (i.e. through a joint venture) (Culpan 87). Alternatively, IKEA offers its suppliers contracts for large orders and continued growth in purchases. These contracts are not written to be long-term agreements, however the average time supplying to IKEA for the twenty-one suppliers interviewed was over ten years (Groh). Another unique competitive advantage IKEA uses to develop and monitor its suppliers is reputation: other customers in the industry know that if a supplier can meet IKEA's tough standards and requirements, then their own methods for monitoring the supplier can theoretically be more lax. For the suppliers, this is a selling point used to attract other customers (Goldeneye). Additionally, IKEA works to develop and maintain trusting relationships with its suppliers, allowing the suppliers to understand IKEA's mission and priorities. Suppliers with this understanding are better prepared to meet IKEA's expectations regarding flat packaging, quality and reduced costs. Reaching this level of trust and understanding, however, is not easy for IKEA or the suppliers. As some of the suppliers revealed during interviews, IKEA is sometimes too involved in the processes and makes site visits too frequently. This heavy involvement is expensive for IKEA to maintain, using both human and capital resources. The close relationships that form between IKEA business teams and the staff at suppliers poses another obstacle, as parties need to act in regard to the best interest of their own business, despite feeling familiar and friendly with the alliance partner. For this reason, IKEA has rules in place that prevent a single employee from working with the same supplier for more than three years (Casino Royale).

Of the twenty-one suppliers interviewed, one was a part of “IKEA Industry”, the IKEA-owned industrial production firm. In an announcement on their website, IKEA Industry states that, “through IKEA Industry a new and more efficient organization is created, aligned to the rest of IKEA. The new organization with a simplified legal structure and new ways of working create possibilities for a strong and competitive organization to increase customer value” (“Home”). According to the IKEA Group Yearly Summary, about 12% of total purchasing power came from IKEA Industry (IKEA Group 33). The environment at the IKEA Industry factory was completely inline with that at the IKEA TAGC offices, including European management and similarly formatted documentation and power points (Groh). The interview with the factory’s management exposed that, despite the shared IKEA name, IKEA Industries still hoped for better cooperation between itself and TAGC. Specifically, IKEA Industries hoped that there would be more open sharing between all suppliers, allowing for better benchmarking and the exchange of innovative ideas (From Russia with Love).

Based off of the twenty-one interviews with suppliers as well as discussions with IKEA employees, there are definite opportunities for improvement in IKEA’s strategy for managing their strategic alliances with suppliers in TAGC. Suggested methods include equity investments, acquisitions, and greater levels of trust. Through equity investments, IKEA will be able to offer resources to suppliers that need to improve capacity and automation levels. IKEA accepts a level of fiscal risk through equity investments with its suppliers, as well as further clouding the boundaries between supplier and customer. Acquisitions can be used to bring key suppliers into the IKEA Industry portfolio and provide financing, while keeping management separate. Lastly, increased levels of trust between IKEA and its suppliers can be used to insure that both parties uphold their role in the alliance. For some suppliers, they hoped that IKEA could provide them with more information about the long-term goals and strategies of the company, so that they could better align their own strategy to IKEA's (Moonraker). IKEA employees reiterated that suppliers need to be trusted more, from giving them more influence in design specifications to encouraging suppliers to produce according to their own forecasting (Live and Let Die). Historically, corruption and Asian business culture were linked through a cultural acceptance of corrupt practices. Recently, however, China is making movements to end corruption and encourage the influence of Western business culture. According to a Bloomberg article on the matter, "Xi, who became president last year, is trying to unwind a culture of bribery and graft that has hurt the government's legitimacy and jeopardized economic growth (Oster). Considering the success of the anti-bribery campaign thus far, IKEA could gain a "first-to-market" competitive advantage in giving their Asian business partners more responsibility and greater influence in more stages of the value chain.

## Conclusion

For IKEA, the strategic alliances made with suppliers in the Trade Area Greater China region are crucial to the firm's cost-cutting strategy. In monitoring the alliances properly, IKEA has the opportunity to further grow its business operations in Asia and The Pacific. Current methods include nonequity alliance, contracts, and trust. Though effective, these methods require high levels of involvement in the supplier's operations, which can be costly and time-consuming. Suggested alternative methods can include equity investments, acquisitions, and greater levels of trust.

## Works Cited


Barney, Jay B., and William S. Hesterly. *Strategic Management and Competitive Advantage: Concepts and Cases*. Boston: Pearson, 2012. Print.

Culpan, Refik. "Global Business Alliances." *Google Books*. Quorum Books, n.d. Web. 07 Nov. 2014.

Hellström, Daniel, and Fredrik Nilsson. "Logistics-Driven Packaging Innovation: A Case Study at IKEA." *International Journal of Retail & Distribution Management* 39.9 (2011): 638-57. *ProQuest.* Web. 6 Nov. 2014.

"Home - Start." *Home - Start*. N.p., n.d. Web. 09 Nov. 2014.

IKEA Group. *IKEA Group Yearly Summary FY13*. N.p.: IKEA Group, n.d. *IKEA*. Inter IKEA Systems B.V, 2013. Web. 2 Nov. 2014.

IKEA Services AB. "IWAY Standard." *IKEA.com*. INGKA Holding B.V., 01 Dec. 2012. Web. 2 Nov. 2014.

McGrath, Michael E., and Richard W. Hoole. "Manufacturing's New Economies Of Scale." *Harvard Business Review* 70.3 (1992): 94-102. *Business Source Premier*. Web. 10 Nov. 2014.

Oster, Shia. "President Xi's Anti-Corruption Campaign Biggest Since Mao."*Bloomberg.com*. Bloomberg, 04 May 2014. Web. 09 Nov. 2014.

Wetekamp, Jim. "Long-Term Supplier Relationships Yield Short-Term Value for Manufacturers." *IndustryWeek*. N.p., 05 Dec. 2008. Web. 02 Nov. 2014.

Yang, Grace. "China's Forty Hour Work Week Is Mandatory. Except When It's Not. Part III." *China Law Blog*. N.p., 07 Aug. 2014. Web. 06 Nov. 2014.


## INDUSTRY CHAMPS Resources


Casino Royale. Personal Interview with IKEA employee. 7 August 2014.

Groh, Emily. Field Notes. INDUSTRY CHAMPS Project. June-August 2014. IKEA Trade Area Greater China.

Live and Let Die. Personal Interview with IKEA employee. 4 August 2014.

The Man with the Golden Gun. Personal Interview. 25 July 2014.

Dr. No. Personal Interview. 18 July 2014.

Moonraker. Personal Interview. 17 July 2014.

Skyfall. Personal Interview. 15 July 2014.

The Living Daylights. Personal Interview. 9 July 2014.

Goldeneye. Personal Interview. 4 July 2014.

From Russia with Love. Personal Interview. 3 July 2014.

A View to Kill. Personal Interview 1 July 2014.

Thunderball. Personal Interview. 20 June 2014.