RESEARCH NOTE

DEVELOPMENT COMPANIES – AN AID TO IRISH INDUSTRIAL EXPANSION

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In recent years, attention has been focused on the under-utilisation of available productive capacity in Irish indigenous industry. The question of whether we have over-invested in fixed assets has been raised. A more fundamental question, taking into account Ireland's tiny share of world trade, is whether we have neglected to market our productive capacity and focused on producing goods for local markets where demand for many products is very limited.

The size of Irish firms and their relatively small scale of operations give reasons why under-investment in marketing may be a major contributory cause of productive capacity lying idle. Indigenous Irish industry consists mostly of small and medium enterprises (SMEs). Because of their small scale of production, together with limited financial and managerial resources, SMEs find it difficult to grow beyond local markets. Their small output generally gives rise to a cost disadvantage when competing internationally. Trading for many firms results in little better than breakeven situations. Limited financial resources inhibit taking on overheads such as product and market development, research and development and innovation in production processes. As profitability is low, the necessary financial base is never built up to support such investment. Short-range perspectives are the norm with survival, not growth, a major concern. In small and medium businesses, managerial resources are stretched to cover all aspects of the business. As a result, the companies find themselves trapped in a no-growth situation. To escape from the trap relatively sophisticated strategic action, investment in research and development and long-terms market and product development is required. This demands managerial skill, specialisation, experience and finance.

The special problem of SMEs – their inability to support specialised 'knowledge' overheads – has been recognised by policy makers for

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decades. Specialised knowledge-intensive services, supported from state funds, have been made available to all Irish industry. With the growth in the number of firms in the economy, delivery of these services has become more difficult, and the difficulty is compounded by the increasing complexity of markets and technology. It is inevitable that relationships between many small companies and state agencies are short-term in nature, yet overcoming many of the SMEs special problems requires sustained support.

Recent discussion on industrial policy has raised the question of whether development companies could have a significant influence on the growth and development on the SME. A development company, as conceived in this context, is an independent, private company which stands between a number of small and medium sized companies and the market place. The development company has market and product development capability, but has no manufacturing capacity. The development company utilises the productive capacity of the small and medium companies. It undertakes those functions which SMEs have found it difficult to access – marketing, research, product design, R & D, and customer service. The development company would establish strategic, long-term close relationships with the producer companies. As several small firms would be involved, the scare national resource of experienced marketing personnel would be utilised more efficiently. A 'critical mass' could be achieved, allowing the development company and its associate SMEs to compete on individual manufacturing costs but shared costs of the 'knowledge' overheads. An escape from the trap in which so many SMEs currently find themselves is potentially available, and the possiblity of growth enhanced.

Fundamental Concepts

Basic to the development company idea are two interrelated ideas: the concept of specialisation of the functions and activities involved in the commercial process and the concept of interfirm dealing. The commercial process (from the sourcing of the raw material to the sale of the finished goods) involves a series of processes, each demanding a specific skill to ensure successful completion of the exchange between producer and customer. If it were possible to separate these processes each small firm could specialise in those activities to which its resources are most appropriate. We might then have firms which specialise in the purchasing of raw materials, others in transport, others in engineering services, others in assembly of components, while yet others specialise in the marketing of the product. So, if markets are well organised, the small firm can survive very well.

The advantages of specialisation become available to the small company within the framework of well organised markets. While this is a somewhat idealistic concept it is interesting that during the nineteenth century most markets were organised in this way. Firms specialised in one activity and there was mutual support between firms. Which brings us to the second fundamental concept involved in the development company idea – the concept of interorganisational dealing. The relationship between the producer companies and the development company must be one of trust and loyalty to ensure efficient completion of the exchange process between producer and customer. Mutual support and harmony of objectives is necessary.

Coase (1928) argues that the reason for the rise of the integrated firm is because inter-organisational dealing can result in conflict and uncertainty. The costs associated with this conflict can be minimised by organising to carry out all the specialised activities within the firm. While interdepartmental cohesiveness can be difficult to achieve, the integrated firm, argues Williamson (1979) has the distinct advantage of a wider variety and more sensitive range of control instruments to enforce intrafirm agreement. A hierarchy exists within the firm which makes for efficient resolution of conflict situations. Yet, many commentators suggest that the growth of the West German and Japanese economies may be associated with their ability to combine effective co-ordination with decentralised ownership. In these countries clusters of owner manager firms abound. These are federations of independent firms or co-operatives working with one major assembly unit and one marketing unit.

The Research

In early 1983, a study was launched to identify past and current attempts to create groups of firms similar to that described in the development company idea, and an analysis of their origins, operations and effectiveness in addressing the issues involved in specialisation of function and in inter-organisational dealing, was completed. All the development companies involved in the study were small and had a relatively short history. The inspiration for their founding was based more on an understanding of market forces than on indepth knowledge of any particular product area. The development companies were market driven, having identified a market need or a niche which they felt they could exploit, and they sought out producer companies – usually companies in existance for a considerable time, with proven expertise in production.

These associated producer companies, while having a particularly strong set of connections with one industry or one sector, could also include companies from other sectors as well. With a few exceptions, most of the associated producer companies were of reasonable size. It would appear that the development company moved away from the very small firms to these medium sized firms who could guarantee a continuing supply on a large volume basis. This was not unexpected as sufficient volume, and a certain level of production expertise, is essential to justify the expense associated with market development and product promotion.

Core Processes

The functions performed by the participating members of the development company cluster may be summarised by pointing out that the development companies performed as the marketing arm of the producer companies while the latter took care of production. The development company played an integrating role, initiating the product concept and taking title to the finished goods. It acted as an intermediary in introducing design and production expertise to the producer companies, and had a financing role. Costing of the product was carried out by the producer companies as well as all activities associated with manufacture. Quality was the responsibility of the producer companies. The development companies indicated that they could not supervise quality during production due to their small size and limited resources. This was a major weakness and caused problems with customers who interfaced not with the producer companies but with the development companies.

Relationships between development companies and associated producer companies varied from arms length sub-contracting in one group to an intense planning relationship in another. The relationships in other groups varied over time. The development company utilised 100% of the capacity of the associated firms in only one case. The latter usually produced other products and sold them themselves. Development companies spread their risk by involving several producer companies who had more or less the same skills, giving each a proportion of the business placed. Over time, as knowledge of their respective businesses grew, closer relationships developed between some producer companies and the development company. A period of getting to know each other's methods and procedures so that each participant knew how the other would react in particular situations was a necessary developmental step in the process.

There was evidence that the clusters comprising about six firms were the most successful, at least initially, but it is possible that more companies could be added to the nucleus over time. The size of firms within the group was important. Conflict arose for one 'cluster' where the larger firms felt that they were carrying the smaller members. When the firms were located close to each other, communication patterns were established and potential conflict situations (usually involving deadlines for delivery or quality requirements) were handled quickly and in a low-key fashion.

Involvement with a development company had positive effects for most producer companies. Improvements in methods, design and productivity were reported. Consultants and experts were identified by the development companies and were channelled towards the producer companies. In one case, turnover within the group increased by 600% in seven years. Production economies were made as development companies placed large orders. Market research was undertaken and products were modified to satisfy consumer needs more precisely. The individual products made by producer companies gained from being promoted as part of a range of goods. The producer companies' working capital needs were eased in some cases where the development company provided working capital finance. Most development companies had a policy of prompt payment. In fact, conflict could arise for the development company because at times they had to choose between satisfying working capital requirements of the producer company and those of market place development. There was a tendency to give security of supply the priority position.

The benefits to the development company itself took longer to show and were less clear-cut. Of the companies investigated, 30% were no longer operating, and 20% were in some difficulty. Under capitalisation; changes in market structure; failure of the producer companies to co-operate in increasing production to fulfil orders; a feeling among producer companies, when the development company was paid on a commission basis, that the same results could be achieved by employing a salesman; and a lack of knowledge on the part of the development company of its industry were some of the reasons given for dissolving the groups. The development company is in a very weak position. It is a new type of enterprise attempting to satisfy newly identified needs and it has few role models for guidance. Uncertainty and risk are very great and lack of information as well as inexperience can lead to mistakes. Producer companies were confused and uncertain about the future of the development company. Typically, they invested little initially in development company projects, and only when commercial success was seen were they prepared to commit resources.

Development companies acted as a link between producer companies and the state agencies. Producer companies are eligible for a variety of grants from various government agencies for product and process improvements and for investment in fixed assets. The development companies usually arranged for such grants to be paid to the producer companies by preparing plans and negotiating with state agencies. They then negotiated royalty agreements or exclusive distributorships for the products developed in this way. While the system is workable, it is time consuming, open to haggling and the development company may lose control of some aspects fo the development project. Apart from consultancy grants, no monetary recognition of the development company is forthcoming from state agencies. In Ireland, state agencies are a major legitimising force for new firms and with so little state support for development and marketing firms, their credibility suffers.

Lack of long-term finance was a constraint on longer term planning and development in the companies analysed. Product and market development requires sustained long-term investment. The intangible nature of the activities of the development company makes financing this type of company a high risk undertaking. It may be that, at least initially, state resources should be allocated to get such companies off the ground. Retrospective studies by Mansfield (1981) have shown that the social rate of return on innovation far exceeds the private rate of return on the same innovation. The high social rates of return are an indication of the linkages between the state of the economy and the rate of innovation. Some evidence also emerged from the analysis undertaken, that the relationship was more beneficial to producer companies than to the development company (at least based on the short time-scale studied). Several producer companies used the development company as a "pump-primer". Having absorbed newer technology, better quality management and market-led design and product innovation they took their new competences and enhanced resource base and began to deal directly with the market place. The development company then had to develop new relationships with new associated companies.

Conclusions

The empirical work suggests some factors related to success. Development companies are best organised around identified market needs rather than available under-utilised capacity. The pursuit of niche or specialty markets is more likely to be successful, as competition revolves around factors other than price. Sufficient volume within the group of companies to yield profits to support the necessary long-term market development is needed. Attention to social and psychological relationships between the associated companies are as important as purely economic relationships. The long-term aims of producer companies and development companies may not coincide. Thus the development company concept is no panacea. It is more suited to some industry and market situations than to others. Development companies probably need to take different forms and pursue different strategies in different contexts. This study could not hope to identify all the implications of the concept and success and failure factors are still only partially known. It is suggested that a period of experimentation and active learning would be the most appropriate way forward. The State could modify its wide range of policy instruments to include support for potential development and marketing companies, thus legitimising their activities and providing much needed finance. Such support could fairly be justified not only by the spin-off effect for producer companies and the economy as a whole (whose benefits tend to exceed those of the development companies) but also because of the risks which companies would have to take to enter this relatively new but potentially very productive area of activity.

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