SMALL FIRM-LARGE FIRM RELATIONSHIPS AND THE IMPLICATIONS FOR SMALL FIRM INNOVATION: WHAT DO WE KNOW?

Andrew James  
Manchester University  
Manchester Business School  
andrew.james@mbs.ac.uk

Sally Gee  
Manchester University  
Manchester Business School  
sally.gee@mbs.ac.uk

Jim Love  
Aston University  
Aston Business School  
j.h.love@aston.ac.uk

Stephen Roper  
Warwick University  
Warwick Business School  
stephen.roper@wbs.ac.uk

Jack Willis  
Manchester University  
Manchester Business School  
jack.willis@postgrad.mbs.ac.uk

Abstract

This paper provides a review of existing research on small firm-large firm (SF-LF) interactions for innovation structured around a new typology of linkages. Such linkages are important in local and global supply chains and in terms of public policy initiatives in areas such as procurement. The typology distinguishes between Supply-chain or vertical...
relationships which originate with the flow of material goods but which also create opportunities for innovation; and, knowledge creation and exchange or horizontal relationships that are created specifically to co-produce or access the knowledge necessary for innovation. Significant case-study and supply-chain analysis does exist but broader econometric or statistical analysis of SF-LF interactions is limited, in part due to limitations in most innovation surveys such as the Community Innovation Surveys. The review leads to an agenda for future research.
SMALL FIRM-LARGE FIRM RELATIONSHIPS AND THE IMPLICATIONS FOR SMALL FIRM INNOVATION:
WHAT DO WE KNOW?

Abstract:

This paper provides a review of existing research on small firm-large firm (SF-LF) interactions for innovation structured around a new typology of linkages. Such linkages are important in local and global supply chains and in terms of public policy initiatives in areas such as procurement. The typology distinguishes between Supply-chain or vertical relationships which originate with the flow of material goods but which also create opportunities for innovation; and, knowledge creation and exchange or horizontal relationships that are created specifically to co-produce or access the knowledge necessary for innovation. Significant case-study and supply-chain analysis does exist but broader econometric or statistical analysis of SF-LF interactions is limited, in part due to limitations in most innovation surveys such as the Community Innovation Surveys. The review leads to an agenda for future research.

Keywords: Innovation; linkages; small firm; SME; typology

JEL Codes: O31, O33, O34
SMALL FIRM-LARGE FIRM RELATIONSHIPS AND THE IMPLICATIONS FOR SMALL FIRM INNOVATION: WHAT DO WE KNOW?

1. Introduction

There has been a long-standing debate on the relative innovativeness of large and small firms.\(^1\) The aim of this paper is not to examine this question but instead to examine an important yet less well researched topic, namely the impact of relationships between large firms and small firms on innovation in smaller firms. Such relationships may be important in a number of contexts – supply chains, sub-contracting or sub-supply relationships, procurement and/or more developmental relationships where small firms have otherwise unavailable capabilities or technologies. Surprisingly perhaps given the extensive literature on SME innovation (and increasingly on open innovation in SMEs) there have been relatively few explicit studies of this topic. The seminal work of Roy Rothwell, despite having been published some 25 years ago, provides the starting point for much of what follows.

The idea for this paper developed from a discussion between the authors as part of a broader conversation about the determinants of innovation in smaller firms it became clear that while good econometric evidence exists on the role of inter-firm linkages on SME innovation we know relatively little about the specific impact of relationships between smaller and larger firms. Good quality and insightful sectoral and individual case studies do exist but to date there has been little synthesis or integration of this evidence. The aim of this White Paper is therefore to review the academic literature on the nature of relationships between large and small firms (during the innovation process) and the implications of these relationships for small firm innovation. This helps to clarify what we do and do not know, to identify gaps in our knowledge, and suggest areas for future research.

1.1 Small firm-large firm relationships in innovation – a typology

Our point of departure is the recognition that the innovation process is becoming increasingly distributed across organisations with related changes in the patterns of relationships between firms participating in the innovative process. There has been a shift from traditional relationships such as sub-contracting, research associations and government R&D
programmes to more integrated forms of collaboration, reflecting increasingly ‘open’ innovation. Networks of collaborative relationships, especially in high growth, technology intensive industries (are) devices for the coordination of heterogeneous learning processes by agents with different skills, competencies, access to information and assets. Even the largest companies engage with a complex network of relationships for the creation of new knowledge, its development into new products and services and the marketing and distribution of those products and services.

Table 1 provides a typology of these small firm-large firm (SF-LF) interactions for innovation developed from that originally proposed by Rothwell. The SF-LF interactions represented in Table 1 are primarily formal relationships and we can usefully distinguish between:

1) **Supply chain or vertical relationships** which originate with the flow of material goods but which also create opportunities for innovation; and,

2) **Knowledge creation and exchange or horizontal relationships** that are created specifically to co-produce or access the knowledge necessary for innovation. Here, we might also distinguish between those SF-LF relationships that are created to internalise knowledge (e.g. collaborations, licensing and acquisitions) and those which aim to establish or formalise a division of innovation activities (e.g. contract research, corporate venturing, open innovation eco-systems).

The implications for small firm innovation vary across these modes of interaction, yet much of the quantitative evidence on the role of inter-firm relationships in shaping innovation outputs does not distinguish between them. In the various waves of the UK Innovation Survey, for example, firms are asked to indicate simply whether they have innovation co-operation with other firms (or other organisations) but do not provide any information on the nature, governance or content of those relationships.

The particular interest of SF-LF interactions is that they are partnerships of un-equals. In particular, writers have contrasted the material advantages of large firms with the behavioural
advantages of small firms. Large firms have relatively greater financial and technological resources for innovation and their resources and capabilities mean that they are better placed for innovations that require large teams, specialised equipment, large scale investment in production facilities, extensive distribution networks or relatively long-time-to-value investments. In contrast, small firms’ advantages are those of entrepreneurial dynamism, internal flexibility and responsiveness to changing circumstances. The inter-play of the resources and capabilities of large and small firms gives rise to the possibility for innovation. Indeed, Rothwell himself observed how certain small firm-large firm (SF-LF) relationships can most effectively combine the advantages of large and small firms in technological innovation. These ‘dynamic complementarities’ mean that small firms can play a crucial role in the distributed innovation processes of large firms, especially in an environment in which large firms are increasingly engaged in a variety of ‘open innovation’ practices.

At the same time, large firms can play an important role as a route to commercialisation for technological innovations from small firms. A substantial body of research also demonstrates how networks can contribute to the innovative capabilities of small firms by exposing them to novel sources of ideas, improving access to inputs and enhancing the transfer of knowledge. In order to thrive, small businesses are often advised to develop relationships with external organisations that have the potential to assist business development and growth. A focus on the external relationships of the small business underlines the vital importance of external resources in moving a small business toward increased success and profitability. However, as we suggested previously we know rather less about the specifics of SF-LF relationships and their implications for small firm innovation.
2. Vertical SF-LF relationships and innovation

Supply chain relationships are vertical relationships which originate with the flow of material goods, and where opportunities for learning and innovation can arise because of the existing commitment of the two parties to the trading relationship. Vertical relationships may include downstream links with customers and users as well as upstream links with suppliers. Two main modes exist in this category:

- **Producer-customer relationships** - whether B2B or with end-users can have a significant impact on small firm innovation. The evidence that supply-chain linkages have a greater impact on innovation among small firms than large firms is presented in Section 2.1. Some of the reasons for this, including proximity to end-users and firm responsiveness are discussed in Section 2.3.

- **Manufacturing sub-contracting relationships** are often arm’s length and the opportunities for learning by either party in this mode are relatively low. However, some sub-contracting relationships are close and stable (e.g. the Japanese Keiretsu model). When this is the case there is some evidence that there are more opportunities for learning for both the smaller sub-contractor and the large client.

2.1 The role of demand networks and value chains in SME innovation

The first naturally occurring knowledge linkages typically form with SME’s clients and suppliers with whom there tends to be regular contact. For these reasons, we can expect the most frequent and beneficial innovation linkages for small firms to be with customers and suppliers. This may be B2B or end users. In addition, one would expect that supply-chain linkages will have a greater impact on innovation among small firms than among larger firms.

There is substantial empirical support for both of these contentions. For example, a recent study of circa 1500 European SMEs suggests that customers are the most attractive source of innovation inputs for them.\(^\text{10}\) Similarly, in an analysis of the innovation value chain for UK-based hi-tech SMEs\(^\text{11}\), supply-chain linkages were most likely to be associated with (product) innovation performance, a finding replicated for Irish SMEs.\(^\text{12}\) The latter study also finds that supply chain linkages have a much stronger effect on innovation outputs for establishments in the 10-49 employee range than for larger establishments, suggesting that customers and
suppliers have an especially important role for SME innovation. A study of technological collaboration as an input to the innovation process, using a large longitudinal sample of Spanish manufacturing firms, also found that vertical collaborations with suppliers and clients had the greatest impact on firm innovativeness, though this effect is clearer for medium-sized enterprises than for the smallest firms.\(^{13}\)

A survey of 436 firms on the impact of co-operative ties on product and process innovation across five UK industrial sectors \(^{14}\) provides further evidence that vertical co-operative ties are more significant than horizontal co-operative ties in explaining firm levels of innovative performance. From a small firm perspective, technological collaboration is a critical mechanism for small firms to improve innovativeness\(^{15}\) and vertical (as opposed to horizontal) collaboration with suppliers and clients has the greatest impact (though this effect is clearer for medium sized enterprises).

In combination, the evidence suggests that small firms benefit from wider inter-organisational linkages, and that customers are the most important source of new innovation. However, this quantitative research does not distinguish between individual consumers and large organisational clients. Typically, quantitative studies also do not distinguish between end-users and intermediate products despite the potential that the relative importance of such relationships differs according to the position of the SME in the value chain.

2.2 Governance of value chains and the opportunities for SME innovation

Large firms often act as lead firms in demand networks, performing an intermediation role as the primary channel to market. The decisions made by lead firms can have important implications for innovation at small supplier firms. Yet, there is surprisingly little evidence about the position, opportunities and constraints of SMEs to develop and sell innovation in those networks, or the impact lead firms have on downstream innovation.

Research on Global Value Chain (GVC) models the location of value-adding activities across firms and geographic regions. The GVC approach prioritises the links between powerful lead firms and their suppliers, considering how the governance of those relationships can lead to
opportunities for upgrading through innovation (producing better products, making existing products more efficiently or moving into higher skilled activities\textsuperscript{16}). Different vertical relationships and governance structures affect opportunities for small firm suppliers to upgrade their activities.

Gereffi et al. propose three factors which determine how relationships are governed\textsuperscript{17}:

i) the knowledge that exists in the supply base and hence a measure of the capabilities of suppliers;

ii) the codifiability of the knowledge required by suppliers to perform the required work; and,

iii) the complexity of the information that needs to be exchanged between the lead-firm and their supplier in performing the required work.

From these three variables five governance ‘types’ emerge in which firms co-ordinate the linkages between value chain activities. These five types and how they provide different opportunities for small firms are briefly discussed below:

1. **Market linkages** – are value chains characterised by arm’s length or short-term contractual relationships between large buyers and small suppliers, generally governed by price alone. Low complexity of products enables relatively easy communication, less coordination effort and risk for lead-firms. Barriers are low for SMEs to upgrade, yet complementary assets may be required (e.g. technical knowledge exchange, financial support, market information, market access etc.).

2. **Modular linkages** - Where products are more complex but sufficiently modular that technical standards and information can be specified and communicated to a third-party. In this type of value chain, lead firms may outsource manufacturing, with product and quality guidelines. Smaller firms undertake production autonomously, possible sub-contracting.

3. **Relational linkages** – here interactions between the lead-firm and supplier are complex, iterative and long term. Tacit knowledge and learning are important. Examples of such linkages are found in high-tech industries including biotech\textsuperscript{18},
motor sport\textsuperscript{19} and electronics\textsuperscript{20} where capabilities of suppliers are high. Geographic co-location is important, though not always critical.\textsuperscript{21}

4. **Captive linkages** – here the lead firm provides detailed specifications to low competence small suppliers. A high degree of coordination, monitoring and control is observed. The small supplier may become ‘locked in’ to the lead firm’s supply chain with a potential for the hollowing out of higher level functions and innovation capabilities in SME suppliers in response to cost pressures. This can have negative implications for SME innovation, and revenue can be extracted disproportionately by the large firm. However, lead firms can assist suppliers in upgrading without any associated conflict of interest.

5. **Hierarchy:** Vertically integrated organisations are preferred when products are complex, not standardised and smaller suppliers have limited capabilities. The innovative activities of SMEs, often recognised through collaborative arrangements, can lead to acquisition opportunities for lead-firms of their smaller partners.

The GVC approach provides an insightful approach to understanding the power relations between small and large firms in supply chains, suggesting the type of structural factors which may influence small firm innovation. Research adopting this perspective focuses mainly on qualitative case studies often focusing on a particular sector or value chain.

There are clear advantages to small suppliers operating within global value chains that stem from the access to knowledge and resources that larger firms can provide. Despite such advantages, research also suggests that lead firms do not always have a positive effect on their suppliers’ opportunities for upgrading. One study examined the modular value chains found in the automotive component production industry in Turkey whose suppliers serve the industry at a global level. Despite the success of Turkish suppliers in taking on certain design and product-development tasks, their buyers are found to restrict the types of upgrading strategies pursued in order to prevent encroachment on their core competences.\textsuperscript{22} A similar result was found in separate a study of the globalisation of R&D, focussed on the Czech automotive industry\textsuperscript{23}, where suppliers’ activities aligned to the strategic direction of the core transnational corporations.
Learning and knowledge exchange between buyer and supplier provides the small firm with opportunities for upgrading. Within a GVC context, upgrading refers to a firm innovating in some way to increase their value-added within the chain, not necessarily a product of process that is new to the world, more often the introduction of a new product or process that is new to the firm.24 Research focussed on electronic components manufacture in the automotive sector suggests that there is a positive relationship between the process of industrial upgrading and the innovation performance of supplier firms25 but more work needs to be done to understand how the different relationships and modes of governance that develop within GVCs foster or inhibit the capabilities of suppliers to innovate.

2.3 Responsiveness of lead firms to innovation from SME suppliers

Although there is broad recognition of the inter-dependencies between large and small firms in the innovative process, limited attention has been paid to the factors that may support or hinder the engagement of small firms in the supply chains of large firms or to the responsiveness of lead firms to innovation from SMEs.

A renewal of the (large) firms purchasing function has been informed by ‘lean’ supply chain management (SCM) practices. Lean supply chain management emphasises the engagement of a smaller number of highly competent suppliers.26 Large firms have pursued a strategy of vertical disintegration in which they increasingly act as a system integrator27 (or lead firm), orchestrating the integration of sub-systems and components that are the product of intellectual property generated and owned by suppliers.28 A key element of this type of corporate strategy has been the rationalisation of supply chains and the outsourcing of risk and capability to suppliers. Outsourcing by prime contractors and their dependence on suppliers has increased dramatically as lead firms establish partnerships with key suppliers and creating increasingly global supply chains. Such developments have reduced the number of SMEs that play a role in their supply chains.29 However, in some sectors (such as defence and pharmaceuticals), this is accompanied by considerable emphasis on the importance of supplier involvement in new product development.30
There is also some evidence that the extraction of value by large firms in some supply chains has an overall negative effect on innovation. In food retailing, the shift in power within food marketing channels towards the multiple retailer has generated considerable academic, industry and policy debate globally about the governance of the food retail supply chain and its implications for suppliers and customers.\textsuperscript{31}

Similar questions have emerged regarding public procurement, not least the role of prime contractors, their power within the defence procurement supply system and the influence of their behaviours and commercial decisions on opportunities for SMEs.\textsuperscript{32} In discussions about the engagement of SMEs in public procurement, the policy narrative about the prime contractor-SME relationship has been almost entirely negative in tone.

Asymmetry and power imbalances face SMEs that collaborate with large firms.\textsuperscript{33} The relative bargaining power of participants affects the division of profits along the supply chain\textsuperscript{34} and the bargaining power of lead firms is higher when there are only a few large buyers. Despite this, there are many advantages for small firms to enter into supply chains dominated by large firms. Aside from access to mass markets, many supply chains generate enough profits to support investment and innovation by participants, and once suppliers are positioned, high switching costs can give a smaller supplier greater bargaining power.\textsuperscript{35}

Research drawing on 18 case studies attempted to identify the dynamic capabilities\textsuperscript{36} that enable small firms enter mainstream markets by operating as suppliers to large purchasing organisations\textsuperscript{37}. This study confirms the importance of dynamic capabilities, such as to “sustain its ability in strategically positioning itself within the new marketplace” (p. 508) but again provides further evidence of the difficulty (from the perspective of small firms) of establishing collaborative, knowledge-sharing and reciprocal relationships with large purchasing organisations. Key issues reported by the smaller firms included unequal relationships with senior managers and the complexity of contractual procedures. Interestingly, the survey on co-operative ties\textsuperscript{38} finds that it is not just the existence of co-operative relationships between buyers and suppliers but the quality, or strength, of these relationships has a significant impact upon levels of innovation. Trust\textsuperscript{39} and appropriate relational contacting, specifically long term contracts, a high volume of exchange and frequency of interaction between firms likely to be important for innovation.\textsuperscript{40}
3. Horizontal relationships
There is a growing recognition that innovation depends on firms’ ability to absorb external knowledge, combine it with their own proprietorial knowledge and develop new market offerings.\textsuperscript{41} Open innovation has captured the attention of academics and practitioners but it has long been recognised that firms’ external linkages or networks may play a potentially important role in the innovation process.\textsuperscript{42} Horizontal relationships for innovation are created specifically to co-produce or access the knowledge necessary for innovation. Here, we can distinguish between (a) those SF-LF relationships that are created to establish or formalise a division of innovative activity, e.g. contract research, corporate venturing, open innovation ecosystems; and (b) those horizontal relationships intended to internalise knowledge, e.g. collaborations, licensing and acquisitions.

3.1 Activity structuring relationships
The large firm is the primary focus of most research in this area, however, internal knowledge resources and lower ability to invest in in-house knowledge creation make outside-firm sourcing of knowledge especially important and attractive for small firms. As small firms typically start with a lower overall level of knowledge resources than large ones, adding more or new types of external knowledge linkages is likely to have larger effect on small firms: in other words, starting from a lower level means higher marginal benefits from adding each new knowledge linkage.\textsuperscript{43} For small firms the search for knowledge created elsewhere is also a viable alternative source of new knowledge and technologies relative to in-house generation. This is the case as some linkages, such as customers and suppliers, are likely to involve lower ‘entry’ costs than R&D. Knowledge creation through in-house R&D involves substantially larger fixed costs than sourcing knowledge from customers or suppliers. Smaller firms are on average, less capable of covering these fixed costs, simply because of their lower scale and sometimes also because of their lower productivity.

SMEs might also benefit more from external linkages because of their flexibility and speed of decision making. Typically, they can adapt their activities significantly faster based on the
new knowledge sourced from outside the firm. Quick decision-making benefits also from less organisational rigidities and bureaucracy than in large firms. Due to this and their ability to specialize to narrow market segments that are unattractive to larger firms, SMEs may be better at quickly adopting the ideas and suggestions by the lead users into the product development phase.

In a study of circa 3000 Irish manufacturing plants, Vahter et al (2012) find that the effect of ‘breadth’ of openness (i.e. the variety of innovation linkages) on innovation performance is indeed much stronger for small plants than for larger ones. For small establishments (10-49 employees) external linkages account for around 40 per cent of innovative sales compared to around 25 per cent in larger firms. They also find that small plants reach the limits to benefitting from openness at lower levels of ‘breadth’ of openness than larger firms. Similarly, a study of Australian SMEs suggested that SMEs may rely more heavily on external knowledge networks as an input to innovation than do large firms. An analysis of the performance of start-up companies in the Canadian biotechnology sector suggests that variation in the alliance networks of start-ups produces significant differences in their early performance, and especially their innovative performance.

In this respect, the literature on innovation stresses the role of horizontal relationships focussed on cooperative R&D in overcoming the lack of internal resources and in improving innovativeness and competitiveness, particularly for SMEs. Indeed, SMEs engaged in technological innovation have used cooperative R&D for information exchange, resource acquisition, technology transfer, and risk management. The collaborations, though, are not homogeneous and their impact is not uniformly positive. As Freel (2003, p.766) points out, the impact of such technological collaborations varies among sectors and the type of innovation pursued.

Small firms may be attractive partners if they possess distinctive technological capabilities but it is a commonplace observation that they are often hampered by limited management experience and suffer a power imbalance when collaborating with large firms. Relationships between large firms and SMEs are asymmetric not only because of their respective sizes, but also because their power, management, capabilities and organizational cultures differ.
substantially. Starting from this observation, Blomqvist and colleagues argue that; ‘the evolution of inter-firm trust is critical in enabling the creation of a common ground and compatible cultures between the partners’. They argue that the process of successful contract negotiation can – if handled appropriately – lead to the development of that trust. Another study emphasises the importance of personal contact between key actors as pivotal in creating a successful large firm-SME relationship. Such relationships, the study argues, may face ‘cultural and institutional rigidities’ of ‘traditional’ large firm business practices. Champions of the relationship may need to overcome large firm scepticism and the ‘Not Invented Here syndrome’. Informal personal networks between scientific and engineering personnel on both sides was argued to be key to success. Another study notes that vulnerability due to smaller size means that SMEs have to be wary of alliances, not least because of the high risks and costs of managing an alliance, along with an understandable wariness about choosing a partner when there may be few opportunities to rectify a bad choice.

**Contract Research**

Contractual relationships between smaller and larger firms may arise in a number of ways: as a result of a broadening of a supply chain relationship; as an alternative to acquisition or merger; or, as a new collaborative alliance. A key issue with any contractual approach to organising joint innovation or R&D activity, however, is the implicit uncertainty and the risk of cheating or moral hazard. This situation is exacerbated where technical, legal and market resources are unevenly distributed between the parties as they might be in the context of SF-LF relationships. In supply chains the incentives to cheat can be reduced by ‘braiding’ explicit contractual requirements and more implicit or informal agreements. This reflects evidence of the importance of trust and continuity of personnel in the broader success of the management of SF-LF relationships within the supply chain. Outside the supply chain, evidence suggests that at least some of these difficulties can be overcome where appropriation rights (patents) are granted to the R&D supplier and appropriate KPIs are adopted to measure R&D progress.

Contractual R&D may act as a substitute for internal R&D activity, and there is some evidence for this in small firms in biopharmaceuticals and software. More broadly, little research exists on the implications of contractual v collaborative innovation links between larger and smaller firms. There is however, some related evidence on the impact of
contractual and collaborative innovation between firms and universities. Among German firms, for example, there is evidence of a complementary relationship between contractual and collaborative (informal) linkages suggesting ‘the management of the firm should therefore strive to maintain close informal relationships with universities to realize the full potential’.\textsuperscript{57} A Spanish study also considered the key success factors in SME research contracts with universities. Based on an analysis of 81 such contracts with the University of Navarre success depended primarily on the characteristics of partners with the specificities of the research contract being less important.\textsuperscript{58}

Contracting for R&D and innovation can be difficult in dyadic relationships and may pose even greater challenges where networks of partners are involved.\textsuperscript{59} An interesting national initiative to promote contractual network relations among small firms or between small and larger firms is the Italian Business Network Contract Law introduced in 2009.\textsuperscript{60} This allows the legal establishment of network relationships between companies based on a common innovation programme, a common project fund and exit and closure rules. Commentary on the Italian Law, however, suggests that ambiguities in the legislation may be undermining its effectiveness, and some research suggests that contracts are being used simply to formalise existing informal relationships. Use of the statute also seems to be stronger among larger firms perhaps due to the lack of legal resources or expertise in smaller firms.\textsuperscript{61}

**Corporate Venturing**

Corporate venture capital investments – equity investments in small entrepreneurial firms by large firms - are one means for corporations to seek to leverage inter-organizational relationships to acquire, transfer, exploit, and explore external knowledge from young technology-based firms.\textsuperscript{62} There is a substantial literature on corporate venture capital investment that examines such issues as who makes corporate venture capital investments and their motivations\textsuperscript{63,64} and the conditions under which corporate venture capital investments generate value for the investing company.\textsuperscript{65,66}

The focus of this research has primarily been on the outcomes for the large firm investor rather than the consequences for the innovative performance of the small firm. For instance, one study found that corporate venture capital programmes “may be instrumental in
harvesting innovations from entrepreneurial ventures and thus an important part of a firm’s overall innovation strategy”. The study argued that they were especially effective where the intellectual property regime was weak and where the firm has sufficient absorptive capacity. The study’s analysis of a large panel of firms over a 20-year period found that increases in corporate venture capital investments by large firms were associated with subsequent increases in firm patenting.67

Open innovation ecosystems

Large firms that pursue an open innovation strategy require the effective engagement of external firms and organisations as a source of complementary knowledge and capabilities.68 Open innovation researchers have observed that this may require the creation and management of networks of external organisations and SMEs play a role in these business ecosystems as sources of technological innovation.69 Engagement in open innovation ecosystems raises particular challenges for SMEs, however. Typically small firms are less likely to generate the internal knowledge on which innovation may be based through R&D, and are therefore potentially more dependent on outside sources of knowledge for innovation, whether university spin-outs or small specialised firms in mature sectors. In addition to lacking existing in-house knowledge resources, small firms often lack the ability and resources to efficiently protect their intellectual property.70

In addition, the lower absorptive capacity of smaller firms, as proxied by own R&D expenditure or share of skilled workforce, may hinder not only the capacity to build external linkages, but also to benefit from such linkages. Open innovation therefore poses challenges for SMEs partly because their shortage of abilities that are needed both to build organisational structures for identification of useful external knowledge and to absorb externally developed ideas and technologies. In addition, the low level of knowledge resources at SMEs means that they may be unattractive collaborative partners for others, further reducing the chances of building ‘openness’71.

Amongst the disadvantages for small firms in innovation are that they may lack the time and resources to forge suitable external S&T networks.72 In a survey of innovative SMEs in the Netherlands, it was found that the most significant challenges for small firms relate to organizational and cultural issues as a consequence of dealing with increased external contacts.73 There has been some attention paid to the role of intermediaries in trying to help
SMEs overcome such challenges. The role of intermediaries in facilitating open innovation amongst Korean SMEs suggests that a network model emphasising the role of intermediaries in linking SMEs may be an effective strategy for enabling collaboration and specialisation. A study of ‘traditional industries’ in Belgium observes that small firms have little or no absorptive capacity and emphasises the role of technology intermediaries in helping small firms take advantage of distributed knowledge through scanning the market for emerging technologies, helping SMEs develop the ability to absorb acquired technologies and performing complementary R&D activities.

3.2 Knowledge Creation & Exchange Relationships

Other horizontal relationships orientated around learning are characterised by their knowledge creation and exchange objectives. Here the key objective is the internalisation of knowledge with three main modes being identified:

1) Purposive SF-LF collaborations

Collaboration for innovation is a strategy for exploiting external sources of innovation and internalising knowledge. Collaboration usually requires a level of absorptive capacity at both the small and large firm. Small firms often have limited managerial resources, however, may struggle to identify opportunities for collaboration with larger firms, and often have more to lose within the relationship. There is some evidence that small innovative firms are willing to form strategic alliances if the relationship reduces their customers’ perceptions of risk in the adoption of their innovation and that the small firm is confident that the collaboration does not diminish control or autonomy. Beyond combining distinct sets of knowledge and skills to create new knowledge, or applying existing knowledge to products or processes, small and large firms collaborate to assess the complementary assets necessary to innovate, for example, large firms are more likely to have greater experience of regulatory systems, access to finance and well developed distribution channels. Most research has been undertaken from the perspective of the large firm, often in periods of technological discontinuity.

A number of studies provide evidence on the innovation returns from SMEs purposive links generally differentiating between links on the basis of partner types. Horizontal relationships
with partners outside the supply chain are often differentiated from either forwards or backwards linkages, although the evidence suggests both can be positive for innovation. One recent study of Swedish IT firms, for example, examines the impact of horizontal and vertical technology collaboration alongside the benefits of technology sourcing. Each of these activities is found to have a positive link to either incremental or radical innovation. Other studies have suggested that the benefits to different types of innovation from different types of purposive links may vary. While the evidence suggests such linkages are potentially important for SMEs there is less direct evidence on the contribution of LF-SF linkages. Clear evidence does exist, however, on differences in the open innovation practices of small and larger firms and their IP protection strategies which might create tensions in such linkages.

2) Licensing agreements

Licensing is one of the most widely used methods for acquiring a technology. In contrast to collaboration, licensing is a relatively arms-length and discrete form of exchange between agents and enables firms to rapidly establish positions in new technical areas. Technological knowledge can ‘flow’ either from the large firm to the smaller firm, or from the smaller firm to the larger firm. Licensing can be a key element of the business model of an innovative small firm, or a necessity to operate in a particular market area (e.g. in the case of defensive licensing). The implications for small firm innovation vary according to the sector, maturity of the technological field and strategy of both the large and small firm.

General evidence on licensing in technology suggests that it allows SMEs to avoid technological uncertainties and potentially to accelerate the growth process. Technology licences may, however, also be restrictive in nature limiting the way in which any technology can be used. In terms of inward technology licensing for technology acquisition the evidence for SMEs is positive albeit relatively limited. A recent Korean study, for example, which compared various modes of internal R&D and external collaboration in services SMEs found that both collaborative R&D and licensing made a positive contribution to SMEs’ technological development and that 'technology acquisition may be one of the most efficient collaborative activities when this activity can be simply conducted to complement insufficient resources'. An essentially similar study which focussed on Swedish IT firms also found that technology licensing made a significant contribution to both radical and incremental innovation activity alongside firms’ purposive linkages. For small firms
outwards licensing can also be particularly challenging due to internal resource constraints. It has been suggested however that out-licensing can be an important strategy for SMEs to increase their economic benefits from proprietary knowledge without having to develop downstream commercialisation activities.\textsuperscript{85} Research into out-licensing has largely focussed on larger firms and where research has been conducted it suggests the returns to technology licensing are greater for larger firms.\textsuperscript{86} One recent paper makes a useful practical contribution, however, by outlining a toolkit for out-licensing in SMEs.\textsuperscript{87}

Both the evidence on inwards and outwards licensing in SMEs has little to say about the specific issues involved in either inward or outward licensing in the context of SF-LF relationships. By implication, however, it is reasonable to suggest that such relationships may pose more significant issues than perhaps SME-to-SME relationships due to the contrasting resource capabilities of small and larger firms, differences in IP management strategies\textsuperscript{88} and broader approaches to boundary spanning activities in innovation.\textsuperscript{89}

3) Knowledge-informed acquisitions

Merger and acquisition (M&A) is used by companies to increase their market power, enter into new markets or enhance their capabilities\textsuperscript{90} and is growing in importance as part of a firm’s knowledge acquisition process.\textsuperscript{91} From an innovation perspective, M&A can be used to absorb the complementary external technology capabilities needed to compete successfully in radically changing areas\textsuperscript{92} and often the motivation behind an acquisition is to establish a position quickly in a particular technical area. Such activity may be related to corporate venturing which is discussed earlier.

For large firms, the acquisition of small firms is one means to access new technological capabilities. There is considerable evidence on how large multi-technology firms, build up and exploit their technological capabilities by acquiring small technology based firms. Indeed, a survey of 38 UK and Japanese firms in a variety of sectors, found that roughly half of them had purchased stakes in other firms as a means of accessing a new technology. The targets for these minority stakes or full acquisitions were mainly small entrepreneurial firms. The acquisition of small firms has been used by large firms as a “catch-up” strategy in some emerging technology fields.
From the perspective of smaller firms, the sale of the business to a larger firm may be used by small firms as a means to overcome their barriers to growth. Acquisition may be a means to access to the superior financial resources, production capabilities or marketing and distribution channels available within a large company. Equally, acquisition can be a means for the owners of the small firm to realise value from their innovative activity. Indeed, the business models of many new technology based firms – especially those who receive venture capital funding – include an exit strategy based on the eventual sale of the business.

The expectation of such transactions is typically that the acquisition of small high technology firms by large firms will generate synergies between the technological capabilities of the SME and the established marketing infrastructure, distribution networks and corporate brands of the larger firm. However, there is a substantial body of empirical evidence that highlights the challenges presented by the acquisition of a small firm by a large firm and the negative consequences that can have for the innovative capability of the small acquired firm. A number of studies have found that where the acquirer is large relative to the acquirer this can lead to a decline post-acquisition innovation output. This body of research emphasises that the acquisition of high technology small firms presents distinctive managerial challenges, related to the organisational characteristics of such firms and their technology. The success of R&D integration has been found to be related to the relative size of the acquirer and the acquired business with large firm acquisitions of small firms proving less successful.

High-tech firms may prefer collaborative relationships to acquisition (due to associated costs and potential negative outcomes) however increased control through integrative modes may be necessary to protect interests in external relationships affecting their core business. However, this research does not distinguish between small and large firms. Additionally, small firms may have less explicit and codified knowledge than large firms so knowledge embodied within skilled people, teams or the firm as a whole may only be transferable by a complete take-over. When this is the motivation, new-technology-based firms (NTBFs) may be acquired by larger firms.

There is some evidence that active M&A markets may induce innovation in small firms and that although innovation activity increases with demand, competition and industry in all firms, this effect is stronger for small firms. This research is concerned with innovative
activity at the small firm prior to, and to encourage, acquisition by a larger firm. Once acquired the evidence on innovative outcomes is mixed, and not specific to the new subsidiary.

4. Towards a research agenda on SF-LF linkages in innovation

Significant progress has been made in recent years in our understanding of the profile and contribution of external relationships to small firm innovation. First, perhaps because of managerial constraints, while SMEs do engage in innovation partnerships they tend to have fewer linkages with less diverse organisations than larger firms. Second, these linkages add significantly to SMEs’ ability to innovate. Thirdly, supply chain linkages, particularly to customers, seem to contribute most to SMEs’ product innovation. Finally, the nature of SMEs’ innovation linkages differs significantly by sector, location and the strategic orientation of the SME.

The vast majority of this research relies, however, on national variants of the Community Innovation Survey (CIS) and some non-EU counterparts. This provides useful if rather specific information on the innovation partnerships of different companies. The three main data items available are:

- First, an indication of whether a firm collaborated with suppliers, customers etc. as part of its innovation activity and whether these partners are local, national or international. No information is available on the duration of these linkages, their intensity in terms of say frequency of contact, the nature of the contact between firms and/or the nature of the knowledge or information exchanged or acquired.

- Second, a subjective indication of the importance of each of these types of linkage for firms’ innovation activity. This provides information at firm level and little indication of the importance of linkages for any specific innovation project or type of innovation project. No indication is provided whether these links are contractual or collaborative.
Third, an indication of other sources of information for innovation such as trade shows, patents, standards, journals etc. This is potentially useful data but again provides only a very broad summary of the breadth of firms’ non-interactive linkages.

Business-to-business linkages are reflected most fully in the first and second indicators, with the differentiation being by the relationship to the focal firm (i.e. customer, supplier etc.) rather than size or sector. No information is therefore available from the CIS on whether small firms’ innovation linkages are with other small firms or larger companies. As a result, research based on CIS data provides little information on the specific impact of larger customers or suppliers on the innovation activities of smaller firms. Evidence on the impact of particular purchasing or supply chain strategies by lead contractors on supplier innovation is also largely limited to case study or qualitative investigations. As a result we know surprisingly little about the role, position, opportunities and constraints facing many SMEs as they seek to develop and sell innovation in demand networks.

Addressing these issues is likely to require new data collection beyond the existing CIS. Studies in the GVC and supply chain literatures suggest a number of factors which may also be important to consider, factors which may not be so important in horizontal relationships. These are primarily linked to the governance of supply chain relationships and the positional advantages of larger customers and suppliers within the supply-chain. In particular, the factors which shape governance relationships in GVCs and the technological characteristics of particular supply-chains may be influential in shaping SF-LF influences on innovation. The supply-chain related incentives for SME innovation may also be related to the regulatory environment within the sector and the receptiveness of larger customers to SME innovation. In a sector characterised by open innovation, for example, the incentives for SME innovation may be much greater than those where supply chains are hierarchic with innovation concentrated in primes.

Evidence on the horizontal linkages of SMEs also remains limited due to the structure of the CIS data. Commenting on their own analysis Van de Vrande et al. (2009: 436) note that:

‘… the current survey does not study how large and small firms interact in open innovation. Christensen et al. (2005) shows that large, established companies and small start-ups manage open innovation differently, reflecting their differential
position within the innovation system. Hence, future research should focus on the requirements of open innovation on differences in culture, structure and decision making between partners of different sizes and from different industries’.

Existing research also provides little insight into the objectives of particular SF-LF innovation relationships – activity structuring or knowledge acquisition/exchange – or about their benefits. In terms of activity structuring relationships, for example, we have limited evidence on the relative benefits of contractual v collaborative frameworks for SF-LF innovation relationships; the impact of corporate venturing on the innovation activities of small firms or the impacts of participation in open innovation-eco-systems. In terms of knowledge acquisition and exchange relationships we know more about purposive links but less about the barriers and enablers of technology licensing (inwards and outwards) in small firms. The impacts of acquisition on SME innovation are also unclear.

The typology outlined in Table 1 provides a starting point for any future study of SF-LF interaction and its impacts on SME innovation. To address gaps in our understanding the other key issues which will need to be addressed are:

- The innovation strategy or objectives of the SME and its larger partner and their willingness and ability to collaborate with suppliers and customers. Absorptive capacity may also be important here;
- The nature, context and content of SF-LF relationships as well as their contractual and/or collaborative frameworks;
- The governance structures involved in SF-LF relationships within the supply chain and how these either reinforce or mitigate power differentials within supply relationships;
- The regulatory and competitive environment within the sector, the availability of alternative suppliers or customers and the appropriability regime. Each may influence SMEs’ incentive to innovate.

Synergies between linkages may also be important reflecting the potential for complementarities or managerial learning in working with boundary-spanning linkages.
Table 1: Typology of modes of large-small firm interactions for innovation

<table>
<thead>
<tr>
<th>Supply Chain Relationships: Orientated around the flow of material goods</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Manufacturing sub-contracting relationships</strong></td>
</tr>
<tr>
<td>Small firms supply components and sub-assemblies to large companies. As part of this process, large companies frequently transfer technological, manufacturing and quality control know-how to their small suppliers. Stable relationships can develop which are mutually advantageous.</td>
</tr>
<tr>
<td><strong>Producer-customer relationships</strong></td>
</tr>
<tr>
<td>Small firms supply finished products to large companies. Large companies can transfer technological know-how and supply suggestions for improvements to small suppliers based on user experience. This mode can involve collaborative development of new products for the large firm: e.g. small software or design houses collaborating respectively with large computer and automobile manufacturers.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Knowledge Creation &amp; Exchange Relationships: Internalising knowledge</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Large-small firm collaborations</strong></td>
</tr>
<tr>
<td>Large and small firms collaborate for the development of an innovative new product or process. This involves the production of knowledge. e.g. large firm provides financial, manufacturing and marketing resources; the small firm provides specialist technological know-how and entrepreneurial dynamism (complementary assets), e.g. small-large firms combine knowledge resources to create new knowledge.</td>
</tr>
<tr>
<td><strong>Licensing agreements</strong></td>
</tr>
<tr>
<td>Large firms licensing to small firms: e.g. involving knowledge that the large company does not wish to exploit in-house but which may be utilised to gain a financial return on/or subsequently purchase the commercialised product.</td>
</tr>
<tr>
<td>Small firms licensing to large firms: e.g. small firms in periods of technological discontinuity or for niche technologies when new knowledge primarily resides with small firms.</td>
</tr>
<tr>
<td><strong>Knowledge-informed acquisitions</strong></td>
</tr>
<tr>
<td>An alternative to collaboration, used by large firms to directly internalise knowledge, skills and capabilities held by small firms. e.g. large firms acquire New Technology Based Firms (NTBFs) to maintain competitive advantage, e.g. bio-pharmaceutical sector, ICT sector.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Knowledge Creation &amp; Exchange Relationships: Stabilising divisions of innovation activity</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Contract Research</strong></td>
</tr>
<tr>
<td>Large firms fund targeted R&amp;D in small specialist consultancy companies (contract research organisations, or CROs): e.g. automobile companies funding R&amp;D in specialist engine developers; pharmaceutical companies funding R&amp;D in small biotechnology companies.</td>
</tr>
<tr>
<td><strong>Corporate Venturing</strong></td>
</tr>
<tr>
<td>Large firms offer financial backing for small firms, with the aim of generating income, cost savings or accessing external innovation. May not involve financial investment, can involve payments in-kind. May involve access to managerial, marketing and manufacturing expertise and to channels of distribution. Includes supporting corporate spin-outs to exploit technology developed within the parent company, but which is deemed unsuitable for in-house exploitation.</td>
</tr>
<tr>
<td><strong>Open innovation ecosystems</strong></td>
</tr>
<tr>
<td>Large firms are increasingly outsourcing their research and innovation activities ecosystems of (often) smaller firms. Research corridors, science parks and regional areas are one mechanism through which large firms are accessing cutting edge research. Research on clusters relates to this mode.</td>
</tr>
</tbody>
</table>

(adapted by the authors from Rothwell 1989)
Notes

3 Powell et al, 1996
9 Street and Cameron (2007
10 Brunswick and Vanhaverbeke (2011
11 Ganotakis and Love (2012


Dynamic capabilities are identifiable and specific routines that impact on the resource base of the firm. The authors identify 1) entrepreneurial capability; 2) networking and bridging capability; 3) resource integrating capability; and 4) strategic service delivery capabilities, as dynamic capabilities that enable small firms to enter mainstream markets.


Trust and reciprocity are important for learning and innovation.e.g. Child, J. and Faulkner, D. (1998) Strategies of Cooperation; Managing Alliances, Networks and Joint Ventures.


Hewitt-Dundas 2006; Rogers 2004; Bougrain and Haudeville 2002; Nooteboom 1994; among others


Helen Lawton Smith, Keith Dickson and Stephen Lloyd Smith (1991) There are two sides to every story’: Innovation and collaboration within networks of large and small firms, Research Policy


58 Bayona-Saez, C. and R. Gonzalez-Eransus. 2011. Linking Industry-University in Proximity: The Innovative Outcome of R&D Contracts in SMEs. Nr Reading: Acad Conferences Ltd. It is important to note however that this research related to relationships between firms and a university where the risk of moral hazard is perhaps lower than in a business-to-business relationship.


63 Birkinshaw and Hill


Tidd et al, 1997; Leonard Barton, 1995

Maxxarol & Reboud (2008)


Tidd et al, 1997


Hagedoorn and Duysters, 2002

