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The Evolution of the Spin-off Relationship into a Partnership in Light of Innovation

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Abstract
This study aims to provide a comprehensive and precise explanation of the spin-off mechanism by addressing the most important concepts, forms, models, and core stages of this type of industrial partnership relationship. It also analyzes the capacity of spin-off and subcontracting small enterprises to innovate in products and processes—an ability that enables the parent or contracting firm to create added competitive value in the market. On the other hand, it allows the subcontracting spin-off firm to establish a long-term open partnership relationship. Finally, we propose a conceptual model for the transformation of the subcontracting relationship into a partnership based on innovation.

Keywords: Subcontracting, Spin-off, Partnership, Innovation, Small and Medium Enterprises (SMEs), Parent Firm.

Introduction:
Research and development activities, along with a focus on innovation and creativity, are no longer exclusive to large enterprises. There is now a growing trend among small businesses to embrace innovation, particularly after proving their effectiveness during times of recession and crisis, compared to larger companies. It would be incorrect to assume that small enterprises will no longer play their role simply because of the dominance of larger firms. As Peter Drucker observed, all innovative enterprises in the past 25 years began as small ventures and achieved much greater success than many corporate giants.

Subcontracting or small firms often emerge by introducing a new process, method, product, or service to a larger firm, establishing an economic link between them based on innovation. This relationship often grows and evolves into a full-fledged partnership.
Spin-off, in this context, is considered one of the most important strategies and methods for establishing partnership relationships through subcontracting. It involves encouraging employees who wish to advance their careers to pursue personal goals, while also contributing to the revival of subcontracting, especially in the case of dormant projects. These projects are often overlooked due to the high investment risks in certain sectors, direct state monopoly, or because such sectors attract few investors due to low profit margins. Therefore, many countries have adopted this strategy to revive dormant projects within the public sector that face disinterest.

Spin-off is regarded as an optimal method for creating new and more effective subcontracting units. At the same time, it offers practical solutions to numerous economic challenges faced by companies. It is worth noting that companies adopting this strategy often enjoy high success rates, estimated between 80% and 85% during the first five years of subcontracted activity through spin-off mechanisms.

The first recorded emergence of the spin-off (or business incubation) strategy as a novel mechanism for supporting and launching subcontracting SMEs occurred in 1976 in the United States. It was seen as a method for encouraging employees within large corporations to launch their own micro-enterprises, benefiting from the opportunity to externalize certain business activities. Spin-off later emerged in France in 1980 as a new business culture under the slogan: “Create something for yourself.”

I. Concept of Spin-off / Essaimage:
Many researchers, organizations, and institutions have explored the concept of spin-off. Below are some of the most notable definitions:

1. **According to M. Porter & C. Bussnault (1991)[i]:**
A spin-off involves a company encouraging its employees to create their own businesses, offering them financial and logistical support, with the right to return to their original job within the parent firm in case their new subcontracting venture fails.

2. **According to Eric Michal Laviolette (2005)[ii]:**
It is a method for creating businesses through an employee launching a new unit or reactivating a previously internal activity that now becomes independent of the parent company. This process is supported by various forms of assistance to reduce the likelihood of failure.

3. **According to the Organization for Business Creation through Spin-off[iii]:**
A spin-off is a set of procedures and incentives provided by the parent company to its employees, enabling them to establish a new business or participate in founding a successful new enterprise that operates independently but remains linked through outsourcing.

In this context, it is evident that most researchers emphasize the importance of the support provided by the parent firm to the employee in order to increase the success rate of the newly formed subcontracting enterprise. The key forms of support typically include:

- **Financial and logistical assistance** (e.g., equipment and machinery rental, etc.);
- **Technical, legal, and commercial consulting;**
- **Ongoing supervision and follow-up by the parent company;**
- **Securing a market share through subcontracting agreements for a defined period.**

Second: Forms and Models of the Spin-off Strategy within the Parent Company
As previously discussed, the parent company views the spin-off as part of an outsourcing strategy or a form of external contracting. In this context, it involves engaging a partner or subcontracting company to carry out specific tasks or projects on its behalf, while also providing the necessary equipment and workforce to do the job.

I. Forms of the Spin-off Strategy from the Parent Company's Perspective

According to the parent company, the spin-off process takes two main forms[iv]:

1. **Indirect Spin-off:**
This occurs when labor and equipment are transferred from the parent company to an already existing subcontracting enterprise with which it has an outsourcing agreement. This usually happens because the subcontracting SME requires additional resources to meet the growing demands of the parent company—demands that exceed its current capacity.

2. **Direct Spin-off:**
In this strategic form, the parent company plays a central role in creating the subcontracting SME through one of its former employees. This employee, previously part of the parent company, becomes an independent subcontractor and benefits from material and non-material support provided by the parent company during the startup phase. This model is referred to as a **direct spin-off**.

It is worth noting that parent companies generally **prefer** to work with directly spun-off subcontractors (the second model) when selecting core partners, instead of relying on traditional external suppliers (the first model), for several key reasons:

- **Streamlined supplier identification and evaluation:**
Spin-off simplifies the process of finding and assessing subcontractors or suppliers. It shortens the selection path, as the parent company can choose the most suitable employee—whose skills are already known—instead of going through time-consuming and often tedious supplier vetting procedures.

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- **Enhanced coordination and compatibility:** Direct spin-off fosters better alignment between the new enterprise and the parent company. This is due to the employee's prior knowledge of the parent company's needs and the strong relationships they maintain with former colleagues, making the subcontracting relationship more meaningful than a typical external arrangement.
- **Greater control and influence:** Direct spin-off allows the parent company to exert more control over how the subcontractor uses equipment and resources. Since the new enterprise is just getting started, it is more receptive to accepting resources provided by the parent company—unlike existing firms in indirect spin-offs, which may be more selective due to their own existing capacities.
- **Stronger employee confidence and fallback assurance:** Employees in direct spin-offs often feel more secure knowing they have the option to return to the parent company if their independent venture fails. This keeps the bond between the employee-turned-entrepreneur and the parent company strong, unlike in indirect subcontracting relationships, where ties between the two companies are typically weaker, more limited, and prone to tension.

II. Spin-off Models in Parent Companies

We can say that there are two situations in which a parent company resorts to outsourcing activities through spin-off. Both are directly linked to the company's economic condition and help explain its state during this phase[v].

1. First Model – "Hot Spin-off"

This model reflects a **poor economic situation** of the parent company. The main objective here is **organizational restructuring**, primarily by **reducing the number of employees**, albeit through a negative approach.

Table 1: Illustration of the Hot Spin-off Model

For the Parent Company	For the Employee-Entrepreneur
Pre-establishment phase	- Economic restructuring; - Strong push strategy to encourage workers to establish their own businesses.
Legislation phase	Slow progress of the project.
Post-establishment phase	One-sided relationships are established, leading to the subcontracted/spun-off firm becoming dependent.

Source: *Rapport : État de l'art de l'essaimage, op. cit., p. 17*

2. Second Model – "Cold Spin-off"

In this case, the **company is in a good economic position**, hence the term *cold spin-off*. The goal is to **motivate employees** as part of a broader **developmental economic strategy** that benefits all parties involved.

Table 2: Illustration of the Cold Spin-off Model

For the Parent Company	For the Employee-Entrepreneur
Incubation phase	- Instilling entrepreneurial spirit and promoting a culture of entrepreneurship among employees; - Designing and adopting a long-term strategic plan.
Maturity and legislation phase	- Significant progress of the project by the spin-off coordinator.

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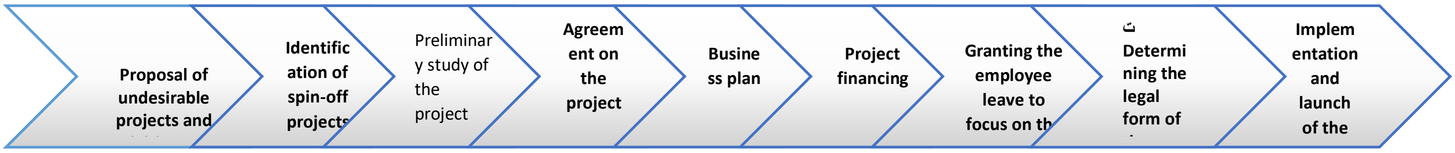
For the Parent Company	For the Employee-Entrepreneur
Development and support phase	- Administrative and commercial support; - Logistical assistance; - Organizational learning; - Relationship development.

Source: *op. cit., p. 18*

III. Stages of Establishing a Subcontracting SME through Spin-off

The process of spinning off subcontracting SMEs involves a series of stages, as illustrated in the figure below (not included here), which outlines and depicts the different practical phases of implementation.

Figure 1: Illustration of the Forms and Classification of Activity Outsourcing



Source: *Rapport : État de l'art de l'essaimage, op. cit., p. 17*

Spin-off enterprises must comply with the stages of this process, which may sometimes vary depending on the laws and agreements signed between the parties. It is important to note that these stages are largely similar and consistent across all spin-off models—whether "cold" or "hot" (i.e., defensive and resulting from imposed policies). Some stages may be omitted, such as the "leave of absence" or "entrepreneurial leave" granted for the creation of private sector businesses. This practice remains in effect mainly within public institutions. It is also worth noting that, in Algeria, no recorded case of spin-off has originated from a parent company in the private sector.

IV. Types of Subcontracting Enterprises Created through Spin-off

It is well known that spin-off is merely a specific method of outsourcing and launching projects. Like any other project, its goals include:

1. Accessing skills and expertise;
2. Accessing markets;
3. Accessing financing.

By analyzing these challenges, eight forms of spin-off relationships can be identified between the parent company and the newly spun-off subcontractor, as presented in the following table:

Table 3: Forms of Subcontracting Enterprises Created through Spin-off

Type of Spin-off	Primary Challenge	Value Chain	Description	Purpose / Objective
Innovation (valorization of scientific research)	Knowledge	R&D	Creating a new unit to develop or commercialize a patent	Developing a new product
Licensing (technological or commercial)	Knowledge	Marketing / Production	Creating a new unit to produce under a technological or commercial license	Business development

Type of Spin-off	Primary Challenge	Value Chain	Description	Purpose / Objective
Relocation (activity transfer)	Knowledge	Production	Creating a new unit by relocating an existing unit or production line and transferring competencies	Reducing costs and getting closer to distributed clients
Subsidiary creation	Knowledge	Production / Distribution	Creating a legally new unit that remains dependent on the parent unit	Professional specialization and external growth
Divestment (sale of services)	Market	Production / Distribution	Creating or resuming activity in a unit through sale or lease	Asset restructuring
Outsourcing (external contracting)	Market	Production / Distribution	Creating a new unit through external contracting with employee transfers	Enhancing operational efficiency and workforce restructuring
Subcontracting	Market	Production / Distribution	Creating a new unit following the cessation of internal activity within the parent unit	Cost reduction and service performance improvement
Franchising (agency)	Market	Distribution	Creating a new unit via commercial license or agency to distribute products or services	Strengthening commercial presence and distribution networks

Source: Prepared by the researcher.

Second: Innovation as a Driver for the Development of Subcontracting

In recent years, many researchers have paid increasing attention to the concept of **innovation**, which has become widely used among scholars and practitioners—even though many lack a clear definition of what innovation truly entails. To accurately define this concept, it is necessary to distinguish innovation from other similar terms, while also clarifying its sources, types, and stages.

I. Concept of Innovation

The term *innovation* first emerged in the 1930s through the economist **Joseph Schumpeter**, who defined it as follows:

"Innovation is the production of a new good using a new method of operation, the introduction of a new production system, the discovery of new markets, or the acquisition of a new source of inputs."

From this definition, Schumpeter identified five types of innovation:

1. Introduction of a new product;
2. Adoption of a new production method;
3. Entry into a new market;
4. Implementation of new production systems or processes;
5. Discovery of new sources of raw materials or inputs.

According to **Peter Drucker**, innovation is:

"The outcome of resources and the satisfaction derived from the use of these resources by the consumer."

This definition highlights that innovation entails a change from the previous state of the enterprise by introducing entirely new products or production methods. Drucker also outlined **seven (7) main sources of innovation**[vi]:

1. **Unexpected events:** Arising by chance or accident;
2. **Incongruities:** Resulting from discrepancies between reality and expectations;
3. **Process needs:** Based on the principle that necessity is the mother of invention;
4. **Industry and market changes:** Due to evolving market competition or changing consumer needs and preferences;
5. **Demographic shifts:** Linked to changes in age, gender, income, education, etc.;
6. **Changes in perception:** Evolving worldviews and future outlooks;
7. **New knowledge:** Representing a source of ideas for new products and services.

From these two definitions, we can conclude that **innovation** is a set of procedures through which a firm generates and applies ideas that ultimately lead to the development of new products or production methods, while optimizing the use of tangible and intangible resources.

II. Characteristics and Drivers of Innovation in Subcontracting Firms

Innovation is characterized by several key features, which include[vii]:

- Innovation may result in a tangible product, a process, a procedure for the parent company, or even a service;
- It must represent something new (e.g., a reputation, method, market, structure, or service);
- Innovation spans all levels: individual, group, and organizational;
- Unlike creativity, innovation must be **intentional** and not accidental;
- Innovation must provide value to both the **subcontracting** and the **parent** company.

Several reasons explain why **small subcontracting firms** are often more innovative and creative[viii]:

- They are usually led by **entrepreneurs** who are proactive and skilled in scanning the environment and identifying opportunities; subcontracting is closely tied to exploiting business opportunities;
- Their **simple organizational structures** and focus on core activities enable faster innovation in products or services;
- Their **small size** and limited investments reduce the risks involved in innovation and make change easier;
- Their **close proximity** to both the parent company and the market allows them to respond more swiftly to rapid market changes.

Third: Analysis of the Evolution of the Subcontracting Relationship into a Partnership

I. Analyzing the Relationship between Subcontracting and Innovation

In his Transaction Cost Theory (1985–1999), **Williamson** argued that subcontracting is primarily a means of reducing costs. However, this does not imply that innovation and creativity are absent in subcontracting processes; rather, they are a natural outcome of the principle of labor division. Other scholars suggest that traditional forms of subcontracting—namely **volume-based** and **specialization-based**—influence both the **level of mutual trust and dependence** between the parties, and the **degree of uncertainty** in the relationship[ix].

For instance, when a parent company engages in **volume subcontracting** (i.e., capacity-based), the subcontractor is not expected to innovate, as the primary objective of the parent company is cost reduction. Consequently, the subcontracting relationship is purely contractual in nature. On the other hand, when the parent company opts for **specialization subcontracting**, the subcontractor is more compelled to adopt an **innovation-driven approach** in order to maintain its status and relationship with the parent company. In this case, the subcontractor's key challenge becomes achieving **a transition toward a partnership** with the parent company as soon as possible.

In this light, **Transaction Cost Theory** and the **type of subcontracting** used are highly relevant for analyzing the dynamics between the two parties and for understanding how a subcontracting relationship might evolve into a partnership.

As for **second-tier subcontractors** (secondary or indirect), they typically are not responsible for product design—often considered too risky for them. As a result, they lack incentives to innovate, even if they have the capacity to improve their operational processes. By contrast, **knowledge-based subcontracting**, which draws on skills and talent, has played a significant role in knowledge creation. These secondary subcontractors have begun to learn and develop capabilities by leveraging relationships with first-tier subcontractors.

Furthermore, in specialization subcontracting, **the type of contractual agreement** often serves as the **primary incentive** for innovation. Medium- and long-term contracts are more reliable than open-ended or repeat contracts. Therefore, parent companies often promote innovation at all levels of subcontracting to enhance profitability, while subcontractors benefit by securing **longer contract durations**[x].

A study in the **aerospace sector** found **limited innovation** within subcontracting relationships, with only 2 out of 10 subcontractors involved in innovation, despite the industry's sensitivity and fast-paced innovation requirements. Another study involving 18 subcontractors revealed that **commitment-based relationships** tend to be more stable than those based on **R&D**, which often end prematurely.

II. Analyzing the Evolution of Subcontracting via Spin-off into a Partnership

There is a scholarly debate on whether spin-off-based subcontracting can evolve into **long-term strategic partnerships**. Researchers are divided into two main camps:

- According to **D. Dupont** and **T. Chément (2002)**[xi], firms created through spin-off mechanisms can **establish strong industrial and commercial ties** with the parent company. Spin-offs can generate networks of subcontractors that maintain privileged relationships with the parent firm.
- On the other hand, **H. Daval (2000)**[xii] took the argument further, stating that **spin-offs enable the emergence of highly desirable partnerships** from the parent company's perspective, as part of their outsourcing and expansion strategy. According to Daval, these partnerships are **more solid and sustainable** in the long run, especially between large firms and SMEs.

For this group of researchers, embedding a culture of cooperation and partnership within the spin-off process is **essential** for the parent firm, especially given the financial and human investment made to ensure the relationship's success—for at least 3 to 4 years.

Conversely, **Thomson and Michin (1994)**[xiii] argue that **cooperation is rare**, as the parent company's core activity is often unrelated to that of the newly created (spun-off) firm, which holds no strategic relevance for the parent company. They claim that, although a relationship may initially exist, it is **unlikely to be sustained**. The spin-off model inherently involves temporary support, and once that period ends, the relationship tends to weaken. According to this perspective, the **primary objective of spin-off** is **not** to create long-term partnerships, for two main reasons:

1. **The expected outcomes of such partnerships are limited**, as the newly created enterprise is vulnerable and faces high risk;
2. **It is easier for large companies to form partnerships with existing SMEs** that already provide high-quality services with greater returns and lower risks compared to spin-off firms.

Nevertheless, this does **not entirely rule out the effectiveness of spin-off**, particularly when the **workforce possesses unique and highly qualified skills** that are not readily available in the labor market.

III. Analysis of Subcontracting Firms' Capacity for Product and Process Innovation

Most studies indicate that **product and process innovation are closely interlinked** and often occur simultaneously. In the case of small enterprises, innovation tends to be **more process-oriented**, typically driven by the **need to reduce costs**, which is the main goal of volume subcontracting. However, when the level of **product innovation is high** and requires advanced technical expertise and sophisticated equipment, **product and process innovations become increasingly interdependent**[xiv].

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In a study by **Krofit (1990)** on whether these two types of innovation drive or complement each other, it was found that **product innovation has a significant impact on process innovation**, although there was **no evidence of the reverse effect**[xv].

By contrast, **Martinez-Ros (2000)** concluded that **product and process innovation are two mutually reinforcing and complementary processes**.

Despite employing different methodologies, these empirical studies suggest that **product and process innovation are not necessarily independent phenomena**. The interaction and synergy between them cannot be assumed in advance, as numerous factors influence and govern this relationship. In the context of **subcontracting agreements**, the nature of interaction between product and process innovation remains **unclear to date**.

It should also be noted that the presence of **innovation in both product and production methods significantly enhances the competitiveness of subcontracting firms**, thereby increasing their chances of securing more contracts. Accordingly, innovation is considered **one of the key drivers of competitive advantage**, particularly when subcontracting firms possess high innovation capacity, especially among their researchers or technical experts.

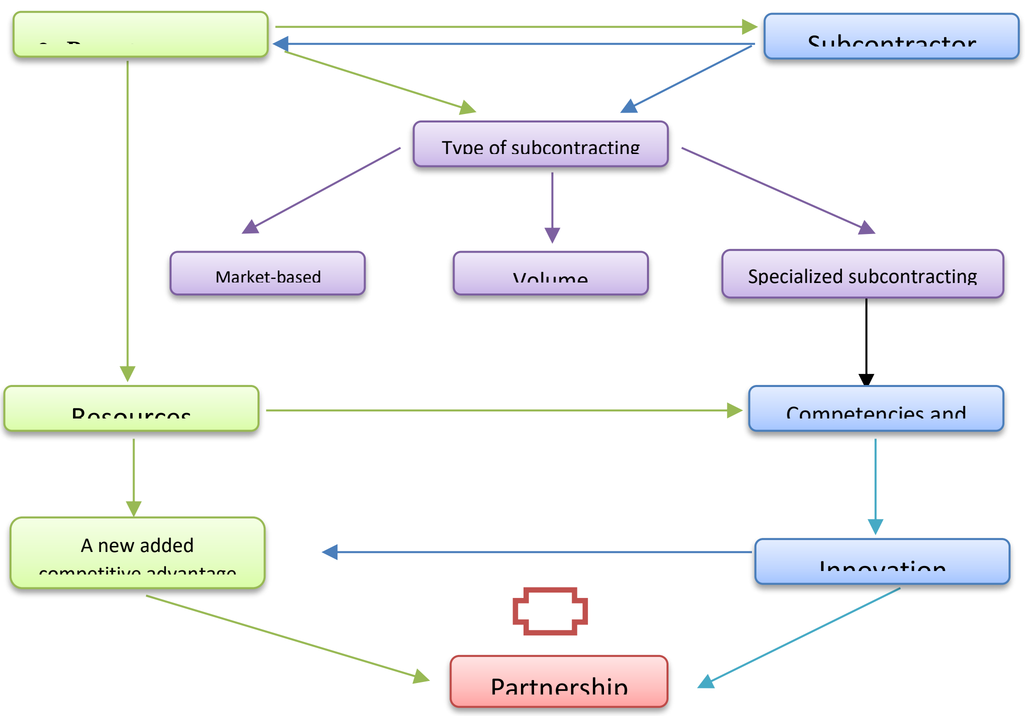
This is particularly evident in fields like **technological programming and IT outsourcing**, where a subcontractor's ability to develop specific communication systems or software can be pivotal. For instance, the development of a locally manufactured software system—such as (*name of a widely-used system*)—by a subcontracting firm operating in Algeria's hydrocarbon sector enabled that firm to **increase its market share and expand internationally**. This innovation also **boosted profitability and ensured contract renewals**, all of which stemmed from the firm's innovation capacity and its year-over-year improvement in innovation performance.

In Conclusion

Although relatively **few studies exist**, and even fewer directly address **knowledge creation through innovation by subcontractors**, the general consensus is that **such highly innovative subcontractors are more idealized than real**, except in rare or exceptional cases.

The following figure presents a **conceptual model of the ideal evolution from subcontracting to partnership, driven by innovation**:

Figure 2: Conceptual Model of the Transformation from Subcontracting to Partnership in Light of Innovation



Source: Conceptualized by the researcher

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