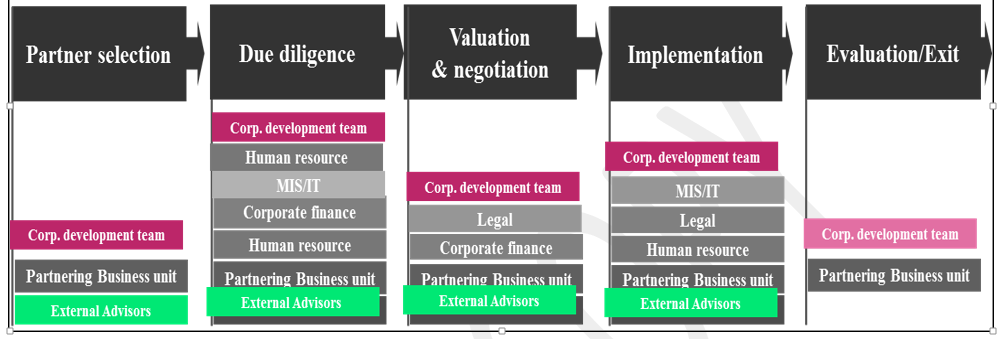
|  |
| --- |
| *Burger Behemoth Public Limited has decided that the best way for it to diversify into the theme park business is to form a non-equity alliance with Mighty Monkey Inc. Burger Behemoth is a successful chain of fast-food restaurants – with a large network of restaurants around the country, some of which are franchised and others are fully owned. Its brand has come to stand for standard, tasty, convenient, and quick meals – and it has enormous customer loyalty among families with young children below 12, and also among busy executives on the road. Mighty Monkey is an experienced player in the theme park business. How should this alliance be implemented?* |

Strategic alliances are ***temporary***, ***lateral*** forms of collaboration between organizations. They are temporary because the alliance typically has a finite life (after which it may or may not be renewed). It is lateral because neither partner has final authority over the other (unlike in an acquisition, when the acquirer managers effectively have authority over the target firm employees after the deal is completed). Alliances lie between simple arms-length market relationships and a merger or acquisition. Unlike in M&A’s, in alliances the involved parties remain legally independent and both sides know that the relationship is not necessarily permanent. Unlike in simple market relationships, in alliances intensive collaboration between partners is essential, and a contract alone does not suffice. Something additional is needed in the form of organizational linkages between partners, which may be based on prior or expected interactions between the partners, or equity stakes of one (or both) in the other. The term “alliance” thus covers a wide spectrum of non-equity and equity based relationships (including joint ventures), as shown in Figure 13.1. This section covers general principles that apply to all of them.



*Figure 13.1: A continuum of governance forms*

There are several stages in the process of setting up an alliance involving several people from within and outside the partner firms (see Figure 13.2). Much of the strategic thinking on diversification described in sections 4, 5, and 6 must be completed before and overlaps partly with step 1 (*partner selection*) of the alliance process. In the remainder of the section we assume that this thinking has been done, i.e. there’s an understanding of the potential synergies (Section 2) and transaction costs (Section 3), and an alliance is deemed a superior alternative to M&A or organic growth (Sections 4-6).



*Figure 13.2: Stages and stakeholders in an alliance process*

*Due diligence* in an alliance process refers to a period in which the partners may exchange more information (beyond what was available in the public domain) with each other to confirm that the partnership is based on valid assumptions. The key decision here is whether to proceed with the alliance with the selected partner, or not. Unlike in M&A, this step typically precedes the valuation and negotiation of alliance terms. The key decisions in *valuation & negotiation* pertain to the structuring of the alliance and how to split the gains between partners. *Implementation* refers to the process of achieving the desired level of integration of activities across partners in order to extract synergies. Which activities to integrate and to what extent, are the key decisions at this stage. The valuation and negotiation of the terms of the alliance as well as implementation activities depend on the underlying synergies in the partnership. Ideally, these activities should also depend on each other—the terms of the alliance must take into account the anticipated implementation challenges, and the implementation activities must be mindful of the value drivers assumed in the valuation and alliance terms. *Evaluation* refers to a periodic review of whether the alliance is meetings its objectives, and may lead to decisions to terminate the alliance. This is also particularly useful for companies that do a lot of alliances that tend to be similar enough to apply learning from prior alliances onto future alliances. Uniquely, the evaluation phase in an alliance is not just about learning to do better in the future (as is the case in the M&A process), but also a decision on whether to continue or terminate the focal alliance itself.

While the basic steps for an alliance resemble those for an M&A, the emphasis in each is different (see Table 13.1).

*Table 13.1 Differences between M&A and alliances*

|  |  |  |
| --- | --- | --- |
|  | **M&A** | **Alliances** |
| Partner / target Selection | Binary and one-time decision | Continuous and ongoing decision (scale up or scale down the relationship, exit, or continue) |
| Due diligence | Heavy emphasis on financials to justify price for target. | Less focused on financials (because you invest less and take on less risk), more focus on competitive landscape and cultural issues (because collaboration is key). |
| Valuation & negotiation | Distribution of gains: at the beginning of the transaction | Distribution of gains: during the life of the alliance. May change over the course of the relationship |
| Implementation | * Ability to handle one-sided synergies: high * Trade-off is between collaboration and disruption created by post-merger integration * Transfer of capabilities: often explicit goal. | * Ability to handle one-sided synergies: low * Trade-off between collaboration and competition (even if in different industry, partner may use the alliance to enter industry independently) * Transfer of capabilities: sometimes the hidden goal. |
| Evaluation | Continuation of the relationship is the default (the alternative is divestiture) | Continuation is an explicit criterion (the alternative is termination of alliance). |

There are many complexities at each stage of an alliance, and in all likelihood, professional advisors (consultants, lawyers and technical experts) will be involved. The complexity increases if equity shares or a joint venture is involved. This is because the valuation of the partner who is being invested in becomes a much more serious exercise, and in the case of joint venture, a new legal entity must be created. Our aim is to give the reader a map of the terrain, and a broad framework to bound and manage this complexity from the perspective of a corporate strategist. Our focus in this section will therefore be on the key decisions involved in partner selection, valuation & negotiation, and implementation.

**Partner selection: Should we work with this partner?**

While synergies between their value chains may attract partners to each other, how to share these can be extremely contentious in alliances. In an M&A context, this sharing of synergy value between target and acquirer happens up-front, through payment of the acquisition premium. This is not so in the case of an alliance, as both partners continue to operate as autonomous entities pursuing their own goals. Because unity of interests cannot be presumed (i.e., one partner typically has no authority over the other) and the relationship itself is temporary (i.e., it has a finite life, and interim reviews can lead to termination) several problems related to synergy valuation and distribution between partners become significant:

1. Managing one-sided synergies: Recall from section 2 that synergies between businesses may be one-sided (one business benefits but not the other) or two sided (both businesses benefit). One sided synergies, particularly, those that require ongoing efforts to extract, are particularly difficult to manage in alliances. This is because it is difficult to force the partner who must make these efforts to do so because benefit to themselves is minimal.
2. Ongoing competition between alliance partners: Alliances between competitors are common (and may evoke scrutiny by anti-trust regulators when the partners jointly have significant market share). Partners may compete in the same business as the alliance or may have other businesses that are in competition with each other. Because each partner remains independent and has its own goals, conflict may be unavoidable within an alliance. This can negatively impact partners’ willingness to collaborate, without which alliances are typically doomed.
3. Learning races: Partners in an alliance sometimes have hidden agendas. In particular, each side may have an incentive to copy the capabilities of the other through the alliance. This is more relevant for synergies involving dissimilar resources (i.e. Connection and Customization) than those involving similar resources (i.e., Consolidation or Combination). Such “learning races” may occur behind the veneer of collaboration, where the goal of each partner is in reality to make the other redundant to itself as quickly as possible.

Thus, collaboration between partners in an alliance may often be difficult to achieve, even if there are clearly synergies from doing so. This is because collaboration cannot be enforced, and incentives may not be aligned. Perhaps just as significant as misaligned incentives though, may be the *suspicion* of mis-aligned incentives. In any case, when we are uncertain about the partner’s likelihood of collaborating, what should we do?[[1]](#footnote-1)

*Assessing the robustness or fragility of collaboration in an alliance*

We describe a simple analytical framework that helps you understand whether collaboration by each side may be expected to arise in a robust manner (i.e. collaboration is not sensitive to the private motivations of the partner), and offers some suggestion on what to do if it is not. To be clear, by collaboration, we mean the actions each partner takes towards working together that **cannot** be commanded by contracts or authority. Take the example of an alliance between two companies set up to develop new products. Successful new product development requires that both parties make available the necessary funds and people to do research. If a party provides all essential inputs, then in this case it is said *to collaborate*. If a party withholds the required resources (e.g. not putting the best people at the disposal of the partner), then it does *not collaborate*. Contractually, this may be hard to do anything about. Checking the collaboration conditions involves three steps.

**Step I—Define and compare scenarios**: The first step in this analysis is to define collaboration—What you or the partner would do if you/they were to deliver the spirit and not just the letter of the agreement. Given that each party has two options (collaborating or not collaborating), four scenarios are possible for a given relationship: (A) both parties do not collaborate, (B) only you collaborate, (C) only the other party collaborates, and (D) both parties collaborate. In this step you estimate how attractive each scenario is for yourself. These payoffs will help to assess which choices are optimal for you.

Although hard numbers are ideal, even subjective assessments of payoffs can be useful because what matters is the relative, not absolute magnitude of these payoffs. With a subjective assessment it is helpful to pick one base scenario that is assigned a score of zero (e.g. scenario A). The other scenarios are rated on a scale of -10 to 10. A positive number for a scenario indicates how much it is preferred over scenario A. A negative number implies by how much a scenario is less preferred than scenario A (see Figure 13.3).

|  |  |  |
| --- | --- | --- |
| **You collaborate** | B  You:\_\_\_\_\_ | D  You:\_\_\_\_\_ |
| **You do not collaborate** | A  You:\_\_0\_\_ | C  You:\_\_\_\_\_ |
| *You* | **Other does not collaborate** | **Other collaborates** |
| *Other* |

*Figure 13.3 Determining the attractiveness of each scenario*

**Step II—Analyse scenarios**: The second step is to calculate two measures from your payoff matrix: your gains from free-riding and your costs to one-sided collaboration. Free-riding means not collaborating when the other does. In our initial alliance example this happens when one party decides not to contribute resources to new product development, while the other does. *Gains from free-riding* (written as “*F*”) occur if a party does not make any investments, yet is still able to take some or most of the benefits. Losses from free-riding may occur because any benefits from the relationship can only be claimed if a party collaborates. Whether free-riding results in gains or losses for you, follows directly from the payoff matrix above. Scenario C is the scenario in which you free-ride: the other collaborates but you do not. Scenario D is the scenario in which you do not free-ride, because you collaborate (just like the other party). If your payoff in scenario C is higher than in D, then you have gains from free-riding. If your payoff is higher in scenario D than C, you loose from free-riding. In our framework, we calculate your gains from free-riding as *F* = C – D. If this is positive, then you gain. If this is negative then you loose from free-riding. For example, in the new product development alliance, you gain from free-riding if new products are successfully developed based on the other’s contribution even without much of your own. You lose from free-riding if no new products get developed because you refuse to contribute (even if the other does).

The second measure is the *cost of* *unilateral collaboration* (written as “*U*”). Unilateral collaboration means collaborating, while the other does not. This is the exact opposite of free-riding. When only one party collaborates, that party is said to unilaterally collaborate and the other is said to free-ride. Unilateral collaboration can be costly or beneficial. It is costly if both party’s investments are necessary to generate any benefits, for example in the presence of strong synergies. Unilateral collaboration can be valuable if for example committing resources to new product development generates valuable insights that may be applied elsewhere, or if there are “crowding out” effects where gains are smaller if both collaborate.

Whether one-sided collaboration results in gains or losses is again easily determined from the previous step’s estimates. From your perspective, you unilaterally collaborate in scenario B. We use your payoffs in scenario A (in which neither party collaborates) to understand the impact of your one-sided collaboration. If your payoffs in scenario A are higher than in scenario B, one-sided collaboration is costly for you. If on the other hand your payoffs in scenario B outweigh those of scenario A, you benefit from one-sided collaboration. In our framework we express the outcome of unilateral collaboration as a cost and calculate it as *U* = B – A. A negative number implies a cost, a positive number a gain. In an alliance for new product development, for instance, unilateral collaboration is costly if your efforts are wasted if the other does not contribute. You gain from unilateral collaboration if you can successfully develop new products even without much input from the other, or when working on new products you learn something that is useful in other markets.

**Step III—Assess importance of partner’s collaboration**: This involves determining the dependence of your choice on the *partner’s probability of collaborating* (written as “*p*”). The extent of this dependence varies dramatically for different combinations of the gains of free-riding (*F*) and costs to unilateral collaboration (*U*). Based on the two measures *F* and *U*, and whether their values are positive or negative, we have four possible situations (see Figure 13.4).

|  |  |  |
| --- | --- | --- |
| **Gains from unilateral collaboration (*U*>0)** | Situation 4: Pure free-riding problem | Situation 1: Bliss |
| **Costs to unilateral collaboration (*U*<0)** | Situation 2: Prisoner’s dilemma | Situation 3: Pure coordination problem |
|  | **Gains from free-riding (*F*>0)** | **Costs to free-riding (*F*<0)** |
|  |

*Figure 13.4 Four alliance situations*

Situation 1—Costs to free-riding and gains from unilateral collaboration (*F*<0, *U*>0). In this situation you have no incentive to free-ride, as that will incur costs to you. Also in this situation you are not penalized if you unilaterally collaborate as unilateral collaboration is beneficial. From this it follows that you should always collaborate regardless of what the other does or regardless of what you think the other will do. Any belief you hold about the other is acceptable for you to collaborate. Thus, the partner’s probability of collaborating (*p*) can be between 0 and 1 inclusive. This is a (blissful) situation of robust collaboration! In the new product development alliance example, you would always contribute fully.

Situation 2—Gains from free-riding and costs to unilateral collaboration (*F*>0, *U*<0). This situation is the exact opposite of the previous one. No belief is sufficient for you to collaborate. To see why, consider your best actions when the other collaborates and when the other does not. If the other collaborates, it is optimal for you not to collaborate due to gains to free-riding. If the other does not collaborate, you prefer no collaboration because you would incur costs for unilateral collaboration. Thus, no value of *p* will inspire you to collaborate. This type of payoff structure is often referred to as a *prisoner’s dilemma*. This is a case of robust non-collaboration: you would not collaborate for any value of *p*, i.e. for any belief about the other partner’s intentions. In the alliance for new product development, you would always be reluctant to invest in the alliance.

Situation 3—Costs to free-riding and costs to unilateral collaboration (*F*<0, *U*<0). The belief you hold about the other collaborating influences whether you will collaborate. Because there are costs to free-riding, you have no incentive to free-ride if the other collaborates. Yet, if you do not know for certain that the other will collaborate, you are also worried about the costs to one-sided collaboration should the other not collaborate. Only with a sufficiently strong belief will the rewards from joint collaboration outweigh the risk of losses from unilateral collaboration. The belief about the partner’s probability of collaboration, *p* required for you to collaborate can be shown to be. This type of payoff structure is known as a “pure coordination” game. The danger in this class of games does not come from greed—the tendency to take advantage of the other for short-term gains. Rather the issue is fear—the avoidance of mutually beneficial outcomes due to uncertainty about the other’s actions. In the new product development alliance, you would contribute if you are sufficiently sure the other does too.

Situation 4—Gains from free-riding and gains from unilateral collaboration (*F*>0, *U*<0). Like the previous situation, collaboration is only optimal for some beliefs. Unlike the previous situation, not fear but greed is the main obstacle to joint collaboration. Because there are benefits to unilateral collaboration, you would collaborate if the other does not. Fear is absent. However, if the other collaborates you are tempted not to collaborate. If greedy, one will take the gains from free-riding at the expense of the other. Interestingly, you will collaborate if the other does not, and not collaborate if the other does. This is a “pure free riding” game. Therefore, you will collaborate only below some probability that the other will collaborate. The formula for the exact cutoff probability is given by. In the new product development alliance, you would only contribute if paradoxically the other does not. This would be the case if it is beneficial that new products are developed but it is best if the other does most of the work.

So how does this analysis inform partner selection? **Situation 1** (costs to free-riding and gains from unilateral collaboration) is the most attractive because you would collaborate and benefit from the alliance regardless of the motivations of the other partner. More generally, if there is a choice among multiple potential alliances, you should prioritize those that seem to belong to situation 1.

**Situation 3** (costs to free-riding and to unilateral collaboration) and **situation 4** (gains from free-riding and from unilateral collaboration) are more complicated. In these pure coordination or pure free-riding situations, the partner’s probability of collaboration influences your own willingness to collaborate. Hence, ***partner selection and communication with the partner are crucial in these situations***. A good starting point is to analyze the payoffs per scenario for each potential partner, just as you did for yourself. While the alliance may look like a situation 3 (or 4) to you, for the other side it may look like bliss (situation 1) or prisoner’s dilemma (situation 2).

Working through the alliance from the other side’s perspective should give you some indication of how likely the other is to collaborate. Consider multiple partners because for some it will be more attractive to collaborate than for others. If both of you face situation 3, joint discussions and communication may suffice to solve the problem. Furthermore, you may have good information about how a partner has behaved in similar situations in the past. If doubts about a partner’s probability to collaborate remain, you could ask for the alliance to be implemented gradually. You can start with smaller initiatives and when these are successful, progress to bigger projects. Alternatively, you could try to jointly alter the payoffs by restructuring incentives, and trying to make collaboration less dependent on the partner’s actions (and vice versa- the partner may have similar concerns about you). There are limits to doing this though, as contracts cannot be used to manage all aspects of collaborative behavior (which is why we have alliances in the first place).

**Situation 2** (gains from free-riding and costs to unilateral collaboration) is potentially the hardest situation. First, you need to analyze whether the problem appears on just your side or both sides. For example, you may be reluctant to collaborate (because of temptation for free-riding or fear of unilateral collaboration) but the other side may consider it a bliss situation and would be glad to collaborate. If the problem is really on your side (i.e., the other is likely to collaborate), then you need not worry about costs to unilateral collaboration. For the gains for free-riding you have to ask yourself whether this temptation is worth more than potential future alliance with the same partner (which would be put in jeopardy) or alliance with other partners (if your bad reputation spreads).

If the problem is on both sides, then it might be useful to flag the situation in the valuation and negotiation stage and ask for contractual assurance or bonuses / penalties, though one should be aware that ultimately such approaches are limited. Second, if the interaction between partners is likely to recur for a large number of times in the future and if non-collaboration in any iteration is likely to be easily detected, then the two partners could agree to adopt a strategy of “collaborate as long as the other does”. Unfortunately, these conditions are more likely to hold for a buyer-supplier relationship, than say a one-off technology development partnership. Finally, abandoning this alliance partner is also an option at this stage.

*Trust and partner selection*

Because a contract is insufficient, trust is important in alliances. Based on the above classification, we can predict where trust will be higher and where lower. It is crucial to distinguish trust from perceived trustworthiness. Trust is your willingness to be vulnerable to a partner’s actions based on a belief that the partner will not harm you. Perceived trustworthiness is your belief that the partner will indeed not harm you.

We distinguish the same four situations from your perspective: bliss, pure coordination, pure free-riding, and prisoner’s dilemma. Based on the above discussion, you will be most keen to engage in alliance in a bliss situation, then in a pure coordination or pure free-riding situation, and least in a prisoner’s dilemma situation. Thus, your trust will be highest in bliss, intermediate in pure coordination or pure free-riding, and lowest in prisoner’s dilemma. In fact, one could argue that trust is irrelevant in a bliss situation because there is no risk involved and vulnerability is absent. Thus, trust depends on the situation (i.e., payoffs).

Because trust also depends on the other (i.e., perceived trustworthiness), you can increase trust through careful partner selection. In pure coordination, you would like to find a partner whom you think is trustworthy. Obtaining information about past behavior (e.g. references) is useful as are steps to increase trustworthiness (e.g. transparency, reliability). For pure free-riding, it is about your trustworthiness rather than about your partner’s. Here the “danger” is that you will exploit the other’s collaboration, not that the other will exploit your collaboration. Thus, the question is whether you can keep your greed in check. The other’s trustworthiness is not relevant (because there are gains from unilateral combination). The prisoner’s dilemma is a combination of both these considerations, finding a trustworthy partner and resisting the urge to exploit the other. Finally, in “bliss” situations, the partner’s trustworthiness is irrelevant.

**Valuation & negotiation: How should we share the effort and rewards?**

Valuing the benefits of an alliance is an iterative process. In arriving at the decision to ally, a systematic approach such as we recommended in sections 5 and 6, would already have made at least some approximate estimates of the value to the company from acquiring vs. allying vs. organic growth. Once the alliance alternative has been finalized and a target has been shortlisted, we may use those estimates as a starting point and refine them.

Synergies in alliances fall into the usual 4C’s: Consolidation, Combination, Customization and Connection. A rigorous method to estimate the value of these synergies is through the Net Present Value of future cash flows of both the partners after taking into account the effects of synergies between them (as well as the costs of extracting them). The Appendix to Section 2 provides details on how to value synergies using value drivers and discounted cash flows.

Integration costs refer to the costs of making the organizational changes across the partners to integrate activities and extract synergies. In alliances, these costs are likely to be, for the most part, dependent on the kind of synergies being extracted; they may be thought of as a tax that eats into the value of the synergy. As we noted in Section 2, we can make some informed conjectures about the *differences* between the integration costs (as a percentage of synergy value) as well as the uncertainty associated with each type of synergy.

In section 5 we described how the anticipated costs of restructuring and ensuring compatibility influences the choice between acquisition and alliance. These costs are independent of the magnitude of synergies in the relationship. Unlike in M&A, there are fewer synergy *in*dependent integration costs in an alliance. Synergy independent costs of integration depend on the scale and age of the target organization. All else being equal, larger and older organizations, regardless of the nature of the synergies involved in the deal, will require greater efforts to convert their systems and processes to be compatible with the acquirer, and to separate and divest unwanted assets. These costs are largely avoided in a strategic alliance, so that valuing an alliance is largely restricted to valuing synergies and integration costs (as a fraction of the former).

When negotiating an M&A, how the value of synergies (net of integration costs) is to be split between the partners in the form of an acquisition premium is often the most important point of negotiation, as the acquirer can unilaterally decide how to organize the combined entity. In contrast, when negotiating an alliance, the parties also need to jointly decide how to organize the alliance. This is because an alliance is a *temporary*, *lateral* organization. Finally, the negotiation process also shapes expectations about the partner’s likelihood of collaboration. We examine these ideas in detail below:

*Design elements of an alliance*

Organization theorists recognize that any organization, even a temporary, lateral one, features the division of labor and the integration of effort. The division of labor in organizations refers to dissecting the organization’s goals into contributory tasks and the allocation of these tasks to individual members within the organization. The integration of effort within an organization requires mechanisms to incentivize effort to cooperate as well as to provide the necessary information to coordinate. Seen as an organization, an alliance must thus have solutions to four basic problems of organizing:

1. *Task division* (a.k.a. “What need to be done”). This refers to the goals and scope of the alliance, and what its value chain will look like. Essentially, one can think of the alliance as a new business, and specify its business model (who are the customers, what is the value proposition and how will it be delivered), value chain and underlying resources needed to operate.

1. *Task allocation* (a.k.a. “Who does what”). This is the division of the roles and responsibilities among the partners; which partner will contribute which pieces of the alliance’s value chain. While conceptually task allocation is a distinct step from task division, in practice the two will go together; indeed, the task division will reflect what the two partners can uniquely bring to the table to create synergies.
2. *Value sharing* (a.k.a. “Who gets what”). This refers to how the value created by the two partners will be shared between them. Shares can be expressed contractually in terms of profits or sales (e.g. through a royalty), in terms of the share of equity of one firm in another, or in a jointly owned new firm (e.g. as is the case in a joint venture) or as fixed fees paid by one partner to another (e.g. licensing fees take this form).
3. *Interface* (a.k.a. “Who talks to whom”). This specifies the channels of communication and structures of coordination (e.g. task forces, committees, integrator roles) between the alliance partners. It is effectively the organizational structure of the alliance.

Because alliances, like most organizations, do not solve the problems above perfectly, a fifth design element is also important:

1. *Dispute resolution* (a.k.a. “Who is the tie-breaker”?). When disputes arise, who has final say on which issues? If the partners must go to court, which jurisdiction will they be under? What if any is the possible arbitration process?

These correspond to the key design elements of an alliance agreement, and most contracts between partners will have clauses that specifically reflect these elements. The partners must negotiate on and agree on these design elements in order to extract the most value they can from alliance. The challenge lies in the fact that these negotiations simultaneously determine:

1. the “size of the pie”, i.e. how much value from synergy can be created by linking the appropriate value chain activities across partners, which is determined by choices about task division and task allocation and interface
2. the ‘share of the pie”, i.e. how much each gets, which is determined by the choices about value sharing.

What typically matters to each side ultimately is neither the size of the pie nor the share of the pie, but the “size of the bite” they can get. An important exception is the class of situations in which the perceived fairness of the “share of the pie” each gets influences future willingness to collaborate in the alliance; when collaboration is not robust in an alliance, this factor must be weighed carefully, and may require the partners to settle for “smaller bites” to preserve perceptions of equity.

Joint ventures are complicated relative to other forms of alliances because the share of equity reflects not only the distribution of profits between parents, but also the relative control they exercise on the decisions of the joint venture, because board representation is usually proportional to equity share. A critical part of the value sharing issue is an agreement on the conditions under which the partnership will be terminated, and how the assets will be shared at that point.

Another challenge that surfaces frequently in alliance negotiation is the handling of one-sided synergies. For instance, gains from Consolidation (e.g. both partners have factories, one of the factories can be shut down) also represent significant opportunity costs—each player essentially gives up that part of the value chain. In a hierarchical arrangement, like a merger or acquisition, the distribution of these gains is easier as a single decision maker buys control of both sets of resources to be consolidated.

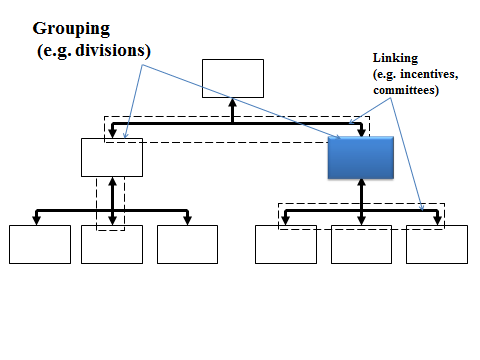
**Integration in alliances: What and how much to integrate?**

To extract the synergies in an alliance requires setting up the organization to do so. This will connect activities across the partners, in order to coordinate them. Integration is thus an elaboration and implementation of the decisions about the alliance interface reached during negotiations about the key design elements of alliance structure.

Integration planning ideally commences at the stage of valuation (as the synergies that are being valued must be the ones that are extracted) and is completed before the formal announcement of the alliance, at which point the integration plans can be implemented. A separate program management office may then be created to oversee the integration process, with a host of integration projects targeted at the extraction of particular synergies. We focus here on the planning of the integration process, the key decisions to be made and trade-offs to be considered.

Integration in alliances is typically not as complicated as it in the case of acquisitions. This is because of the (relatively) limited scope of activities involved across partners, as well as the lower incidence of consolidation synergies in alliances (partners are typically unlikely to give up an in-house activity for a temporary lateral arrangement). However, partners typically differ not only in their formal structures, but also in their organizational and possibly national cultures. These differences can impede collaboration across organizations and create conflict.

Organization structure decisions consist of two sequential choices: one about *grouping* (into organizational units) and the other about *linking* activities across groupings (i.e. the boxes and arrows in organization charts, see Figure 13.5).



*Figure 13.5 Grouping and linking*

Given the lateral, temporary nature of alliance organizations, grouping decisions are unlikely to be involved in integration of activities; rather the focus is on linking mechanisms. This also implies that the trade-off between collaboration and disruption, which is so central in M&A integration (see Section 12), does not play as important a role in alliances, and that the range of linking choices is limited in alliances relative to M&A; extremely high levels of linking are ruled out because grouping is ruled out.

*Linking choices*

The key integration choice in an alliance is about *linking* units or how a) incentives, b) information channels and c) work practices are changed across units from the two partner organizations (P1 and P2) to either keep them operating autonomously (towards the left-low scores on the scales) or collaboratively (towards the right-high scores on the scales below), see Figure 13.6.



*Figure 13.6 Linking choices in alliance integration*

To consider these linking choices in more detail, think of them as lying on this spectrum:

1. Incentives:

0: Continue to reward on individual unit’s performance, i.e. either partner 1 or partner 2 🡨🡪

3: Reward on combined (alliance) performance

1. Information channels:

0: No information flows between partner units

🡨🡪

3: Extensive information flows between units across partners

Standardization of work procedures:

0: Let each unit continue to use own processes and procedures

🡨🡪

3: Switch to common process and procedures

Where relevant and feasible, choices of *geographic/physical location* can reinforce or weaken the consequences of choices about organizational integration. If the partner unit is left in its original location, this is consistent with low scores on all dimensions. In contrast, relocating the partner unit to collocate with other partner’s unit is consistent with higher scores.

*The fundamental trade-off between collaboration and competition in alliance integration*

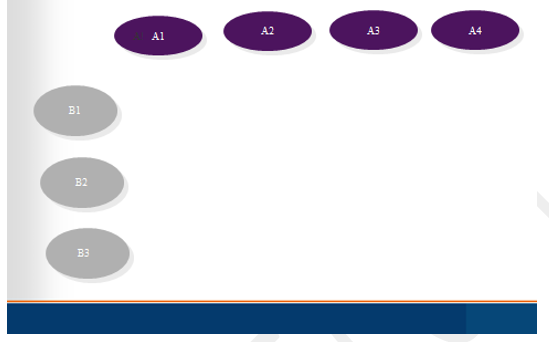
As one goes from the left of these scales to the right, two things happen. First the degree of collaboration between the individuals in the units involved across partners increases. Common incentives, free flow of information, and smooth operating procedures all enable the employees of partner firms to collaborate effectively to extract the synergies that motivated the alliance. Second, precisely for the same reasons, the exposure of each partner to the other, in terms of possible leakage of knowledge and talent also increases. In an M&A context this would not have been a problem, as the two units ultimately belong to the same firm. In an alliance this is not the case, as the partners may implicitly compete.

This competition has its roots in the temporary nature of an alliance; eventually each partner can foresee a future in which the other partner does not exist. There can thus exist situations in which each partner is essentially aiming to make the other redundant to themselves; they have an incentive to to “copy” the capabilities of the other. This is especially relevant when synergies between partners are from Customization or from Connection, as these involve dissimilar resources. Note that this hidden agenda would not be a problem in a permanent relationship like an acquisition. To the extent this hidden agenda is suspected to exist, integration decisions must balance the need for coordination between partners, while minimizing the size of the “window” through which the partners can observe, learn from and copy each other’s capabilities.

**A framework for alliance integration planning**

Armed with these principles, we can introduce the basic framework for integration planning in alliances. **The key principle behind this framework is that in every alliance, each pair of organizational units from the partner firms could have a different optimal level of integration between them, based on the synergy operators that link them.** Take the following steps:

1. Start with a clear statement of potential synergies between the partners (preferably the same one used to value the alliance). Understand exactly where and how the value chains of the two companies will join-up. Section 2 and the synergy operators provide insight into this process.
2. Identify the organizational units in the partner firms associated with the affected value chain segments.
3. Create a matrix with the organizational units of the first partner on the rows (see Figure 13.7), and the organizational units housing synergistic value chain segments of the other partner on the other (based on synergies analysis above).
4. In this Partner-Partner matrix, for each cell, note the value of the synergies to be realized as estimated in the valuation phase. In addition also put down the impact of risk of leakage of capability (and possibly any implicit learning benefits for yourself).
5. Finally, for each cell consider the linking choices. Bear in mind the collaboration-competition tradeoff when selecting the degree of integration.
6. For each unit (row), the integration level should be such as to avoid conflict with the cell for which the synergies are greatest.
7. You can choose to do the integration in **phases**. You can decide on a desired level of integration for Phase 1, achieve it, and then plan for the next level of integration in Phase 2. This is not the same as slow vs. fast implementation, in which the desired end state is known and we only vary the time taken to get there. Phase-wise integration can be very useful if you expect new information to emerge that may materially alter your plan for extracting synergies (e.g. on how trustrworthy the partner really is).



*Figure 13.7: Alliance integration matrix*

The guiding principle for these choices may be stated as follows: In general, lower levels of integration (i.e. low scores on linking choices) are sufficient for low modification and dissimilar underlying resources. Thus the synergies requiring least and most integration, in that order are likely to be Connection, [Combination, Customization], Consolidation. At the same time, you will want to avoid high integration across units in which you see significant dangers of leakage of knowledge and skills to the partner (i.e. in Connection and Customization synergies).

**Application: The Burger Behemoth**—**Mighty Monkey alliance**

In the case of the planned alliance between Burger Behemoth and Mighty Monkey, the goal is for Burger Behemoth (BB) to access the physical infrastructure, content development and service delivery capabilities needed to operate in this business via this alliance. In return, Mighty Monkey (MM) sees value in being able to access the brand and customer loyalty of BB, particularly in the segment of families with children below 12. A priori, there are benefits from collaborating.

Partner selection: While the partner has been identified, BB might benefit from considering the robustness or fragility of collaboration in this alliance. Collaboration for BB could involve making efforts at cross-selling the theme park through its restaurants, and accommodating requests from MM for co-branding, and resisting from trying to “copy” the capabilities at theme park management from MM. Collaboration for MM might mean making sure its infrastructure and services are at the best possible level to prevent any dilution of BB’s brand, and to avoid “copying” BB’s capabilities at managing customer loyalty in the families with young children segment. It is likely that in a situation such as the one we described, neither party gains from holding back on collaboration when the other collaborates (i.e., no gains from free-riding), though both parties may suffer if they unilaterally collaborate. If we assume it is unlikely that BB would want to copy MM’s capabilities with the intention of eventual entry on their own; and we also assume a symmetric reasoning process for MM, then this situation looks like a pure coordination problem. Communicating their concerns to each other and setting up a transparent system for mutual verification of collaboration efforts could be useful in this context.

If on the other hand there is some private gain for each side to try to copy the capabilities of the other, then we could be looking at a situation that looks like a prisoner’s dilemma. In this situation, it is unlikely either side would collaborate. Modifying the payoffs by explicitly agreeing non-compete conditions, increasing the scope of the relationship to gradually increase more and more theme park sites that MM has, or finding a different partner are some of the options they have to choose from.

Valuation and negotiation: In this situation, the synergies are largely from Connection, and the effects are primarily on revenues. Therefore the two sides will have to agree on some form of revenue sharing agreement, which is able to estimate the incremental revenue produced by the alliance. The design of the alliance structure is quite straightforward; task division and task allocation must recognize the relative competencies of BB and MM, and the interface can be a relatively thin one (probably located within the marketing departments of the two firms).

Alliance integration: Given the nature of the synergies, there is limited need for integration between partners, even if there were no concerns about “learning races”. If such concerns exist, maintaining a thin interface becomes even more critical. In either case, this will be a fairly easy alliance to implement.

<APPLICATION ENDS>

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| **Basic facts about alliances**   * Alliances are difficult to manage. When managers are asked to rate their alliance, about 50% of alliances get rated as unsuccessful. This is similar to reported baseline success rates for organic growth projects or M&A. In many ways though, alliances are harder to manage than acquisitions, when there are significant one sided synergies (some of which may be secret) and when partners are trying to “learn/copy” the dissimilar resources of others, even though alliances are cheaper to set-up than acquisitions. This is because in an acquisition, the control of one partner over the other is absolute but in an alliance it is not. Thus, unless the terms of the alliance are such as to induce effective collaboration, it is likely that in an alliance, the relationship reverts to the letter rather than the spirit of the contract. * Alliances are not forever. While the duration varies by type of alliance and by context, many alliances terminate within 10 years of formation. This holds also for joint-ventures, where typically one partner eventually buys out the other partner. Note that a terminated alliance is not the same as a failed alliance. Many alliances are set up precisely for a limited period, and sometimes as a reaction to regulatory requirements, which when changed may lead to termination. * Alliance negotiations must take into account concerns about fairness if ongoing collaboration between partners is critical to the success of the alliance. Some common contentions issues in alliance negotiations include diverging views of the goal, jockeying for relative control, profit sharing, cannibalization of businesses not involved in alliance, distribution of one-sided synergies, learning races and exit conditions. |

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| **Common mistakes to avoid**   * Mistaking equality for equity: Equity involves each partner getting a share that is proportional to its contribution; sometimes this may be very different from equality. Negotiations between prospective alliance partners may sometimes become mired in issues around perceived inequality. But because partners typically will make different sized contributions and have different bargaining power, expecting equal shares is unrealistic. There is an important exception to this: if the differences in contribution and bargaining power across partners is small, and ongoing collaboration between partners are critical to the future of the alliance, then ignoring equity and sharing equally may be sensible. * Mistaking value creation for value captured: Remember, your goal in an alliance is to maximize total profits to yourself. The size of the bite is what matters, not the total size of the pie or the equality of the shares of the pie. To reiterate the important exception here: if ongoing collaboration between partners will be critical to the future of the alliance, then negotiating hard to win the last dollar of expected value may vitiate the relationship to the extent that the other partner does not collaborate as needed. * Ignoring the possibilities of learning races: An alliance does not guarantee a permanent meeting of interests. You must therefore consider the possibility of learning races and how your bargaining power relative to the partner may evolve over time. * Ignoring exit conditions: Alliances are temporary organizations. Therefore it is important to agree as part of the alliance design, the conditions under which the alliance can be terminated, and the distribution of assets between the parties at that point. This may seem like striking a discordant note in the negotiation and design phase where the rhetoric is all about partnership; nonetheless it is necessary. |

**Frequently asked questions**

*Q1. My company wants to become better at managing alliances. What should we do?*

Experience is a useful mentor, but only if lessons across alliances are actively integrated. Two hurdles need to be overcome. First, just doing multiple alliance will not necessarily lead to insight unless effort is made to distil lessons. Second, alliances occur across the corporation so that lessons learnt in one business are not automatically available to other businesses. A solution for both hurdles is to set up a dedicated alliance team, for example at the corporate level. Give this group the responsibility for documenting lessons learned from ongoing alliances and disseminating this information across the corporation. They should also be given a formal role in the initiating of new alliances and evaluation of ongoing alliances.

*Q2. I have heard that in alliances one has to avoid the challenge of the “prisoner’s dilemma” where each side ends up not collaborating even though there are synergies from collaboration. How can I avoid this problem?*

In a prisoner’s dilemma, there are no incentives to collaborate for each partner regardless of what the other partner does. The only options are to try to re-structure the payoffs, try to make the game a repeated one, or to find another partner for whom the alliance is not a prisoner’s dilemma. Actually the prisoner’s dilemma is only one of four possible situations that you can find your alliance in (see Figure 13.4); this particular structure has disproportionate mindshare among both students and managers. The more general issue is to understand to what extent the incentives to collaborate for one partner depend on the expected actions of the other. That’s what the framework to assess the robustness or fragility of collaboration does. *Q3: How do international alliances differ from alliances between companies within a country?* Many of the same issues are still relevant in international alliances as in domestic alliances. However, new complications are introduced by the cross-border nature of these alliances. For instance regulatory requirements sometimes force companies to enter a market through a joint venture (rather than a wholly owned subsidiary), so that in these cases the alliance structure is not the first best choice for the company. This has often been mandated in emerging markets. Second, differences in intellectual property regimes across countries can accentuate the learning race problems of alliances. Finally, cultural differences are likely to be more pronounced in cross-border contexts, but the effect of cultural differences are most pronounced when the synergies between partners require close collaboration (i.e. in Consolidation or Customization synergies).

*Q4. How are joint ventures different from other kinds of alliances?*

Joint ventures are a particular form of equity alliance. Their uniqueness arises from the fact that a new legal entity, the joint venture company, is created, in which the parents own shares (see Figure 13.8). A common division is 50-50% ownership but other division are possible.



*Figure 13.8 Non-equity and equity alliances*

Joint ventures are preferred over acquisitions when the partners have diversified interests which have few points of overlap. There is relatively low exposure to risk, and limited motivational consequences. JV’s are preferred over alliances when a high degree of coordination and incentive alignment for *relevant personnel* from the parent companies is important. However, JV’s also opens up each side to greater risk of knowledge leakage than other forms of alliance. JV’s are harder to negotiate than traditional alliances because relative control and profit sharing are often tied together in the equity shares of the parents. In addition many of the traditional challenges of alliances remain relevant- such as cannibalization, learning races, and one sided synergies.

*Q5. I have multiple alliances. Does that matter? Would I do anything differently than if I had just a few?*

Yes. There could be both benefits and cots. The benefits include an ability to broker between otherwise unconnected partners. For example, a new technology that you learn in one alliance might be fruitfully applied in one of your other alliances. Furthermore, by having multiple alliances within an industry, you might be better able to compete with others who are not in your network. On the cost side, your existing alliance could restrict the number of new alliances that you can enter. For example, others might be reluctant to share technology with you if there is a risk it could end up with their competitors. Possible solutions include taking an equity stake or structuring the alliance such that knowledge flows are limited.

**Academic background**

On the importance of partnering to compete, see:

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For more on exiting from alliances, see:

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For more on networks of alliances, see:

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Lavie, D. (2007). Alliance Portfolios and Firm Performance: A Study of Value Creation and Appropriation in the U.S. Software Industry. *Strategic Management Journal*, *28*(12), 1187-1212.

1. This section is a simplified presentation of the arguments in “Note on analyzing fragility in collaborative relationships”, by Puranam, Kretschmer, and Vanneste. [↑](#footnote-ref-1)