Chapter **9**

Corporate Strategy: Strategic Alliances and Mergers and Acquisitions

Chapter Outline

Learning Objectives

LO 9-1 Apply the build-borrow-or-buy framework to guide corporate strategy.

LO 9-2 Define strategic alliances, and explain why they are important to implement corporate strategy and why firms enter into them.

LO 9-3 Describe three alliance governance mechanisms and evaluate their pros and cons.

LO 9-4 Describe the three phases of alliance management and explain how an alliance management capability can lead to a competitive advantage.

LO 9-5 Differentiate between mergers and acquisitions, and explain why firms would use either to execute corporate strategy.

LO 9-6 Define horizontal integration and evaluate the advantages and disadvantages of this option to execute corporate-level strategy.

LO 9-7 Explain why firms engage in acquisitions.

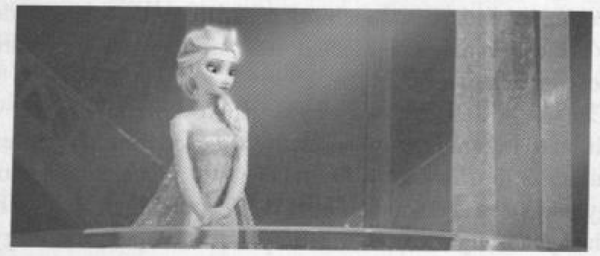
LO 9-8 Evaluate whether mergers and acquisitions lead to competitive advantage.

CHAPTER**CASE 9** /

Disney: Building Billion-Dollar Franchises

WITH OVER $50 BILLION in annual revenues, Disney is the world's largest media company. In recent years, Disney has grown through a number of high-profile acquisitions, including Pixar (2006), Marvel (2009), and Lucasfilm (2012), the creator of *Star Wars.* All this was done with the goal to build billion-dollar franchises based on movie sequels, park rides, and merchandise. Let's take a closer look at how an alliance with Pixar turned into an acquisition.

Pixar started as a computer hardware company producing high-end graphic display systems. One of its customers was Disney. To demonstrate the graphic display systems' capabilities, Pixar produced short, computer-animated movies. Despite being sophisticated, Pixar's computer hardware was not selling well, and the new venture was hemorrhaging money. To the rescue rode not Buzz Lightyear, but Steve Jobs. Shortly after being ousted from Apple in 1986, Jobs bought the struggling hardware company for $5 million and founded Pixar Animation Studios, investing another $5 million into the company. The Pixar team led by Edwin Catmull and John Lasseter then transformed the company into a computer animation film studio.



Elsa from the animated Disney blockbuster hit *Frozen.*
© Moviestore collection Ltd / Alamy

To finance and distribute its newly created computer-animated movies, Pixar entered a strategic alliance with Disney. Disney's distribution network and its stellar reputation in animated movies were critical complementary assets that Pixar needed to commercialize its new type of films. In turn, Disney was able to rejuvenate its floundering product lineup, retaining the rights to the newly created Pixar characters and to any sequels.

Pixar became successful beyond imagination as it rolled out one blockbuster after another: *Toy Story (1, 2,* and *3), A Bug's Life, Monsters, Inc., Finding Nemo, The Incredibles,* and *Cars,* grossing several billion dollars. Given Pixar's huge success and Disney's abysmal performance with its own releases during this time, the bargaining power in the alliance shifted dramatically. Renegotiations of the Pixar–Disney alliance broke down in 2004, reportedly because of personality conflicts between Steve Jobs and then-Disney Chairman and CEO Michael Eisner.

After Robert Iger was appointed CEO, Disney acquired Pixar for $7.4 billion in 2006. The success of the alliance demonstrated that the two entities' complementary assets matched, and gave Disney an inside perspective on the value of Pixar's core competencies in the creation of computer-animated features. In 2009, Disney turned to acquisitions again. The acquisition of Marvel Entertainment for $4 billion added Spiderman, Iron Man, The Incredible Hulk, and Captain America to its lineup of characters. Marvel's superheroes grossed a cumulative $15 billion at the box office, with *The Avengers* bringing in some $2 billion. In 2012, Mickey's extended family was joined by Darth Vader, Obi-Wan Kenobi, Princess Leia, and Luke Skywalker when Disney acquired Lucasfilm for more than $4 billion.

After taking the reins, Iger transformed a lackluster Disney after a decade or so of inferior performance by refocusing it around what he calls "franchises," which generally begin with a big movie hit and are followed up with derivative TV shows, theme park rides, video games, toys, clothing such as T-shirts and PJs, among many other spin-offs. Rather than churning out some 30 movies per year as it did prior to Iger, Disney now produces about 10 movies per year, focusing on box office hits. Disney's annual movie lineup is now dominated by such franchises as *Stars Wars* and Marvel superhero movies and also live-action versions of animated classics such as *Cinderella* and *Beauty and the Beast.* The biggest Disney franchises that started with a movie hit are *Pirates of Caribbean* (grossing almost $4 billion, with its fifth installment due in 2017), *Toy Story* (some $2 billion with a fourth movie also due in 2017), *Monsters, Inc.* (some $1.5 billion), *Cars* (over $1 billion, with a third sequel rumored to be in the making), and, of course, *Frozen*.

To further build its *Frozen* franchise, Disney is already working on a sequel of its animated movie hit as well as offering *Frozen Ever After*, a new dreamlike ride through the fictional world of Arendelle at Disney World's Epcot Center, which had grown stale. The animated movie *Frozen* (made by Walt Disney Animation Studios run by Pixar execs Catmull and Lasseter) has grossed some $1.5 billion since its release in 2013, making it the most successful animated movie ever![1]

You will learn more about Disney from reading this chapter; related questions appear on page 316.

DISNEY ENTERED STRATEGIC alliances and acquired other media businesses to create theme-based franchises. CEO Iger's corporate strategy around building billion-dollar franchises is certainly paying off: Disney's revenues are up almost 10 percent and it earned some $8 billion in profits in 2015. Its stock has risen by over 230 percent between 2010 and 2015, outperforming its rivals such as Time Warner, Sony's Columbia Pictures, or 21st Century Fox.

As a diversified media company, Disney is active in a wide array of business activities, from movies to amusement parks as well as cable and broadcast television networks (ABC, ESPN, and others), cruises, and retailing. It became the world's leading media company to a large extent by pursuing a corporate strategy of *related-linked diversification* (see Chapter 8). This is because some, but not all, of Disney's business activities share common resources, capabilities, and competencies. As detailed in the ChapterCase, Disney's executives implemented its corporate strategy through the use of strategic alliances and acquisitions.

In Chapter 8, we discussed *why* firms grow. In this chapter we discuss *how* firms grow. In addition to internal organic growth (achieved through reinvesting profits, see discussion of Exhibit 4.3 in Chapter 4), firms have two critical strategic options to execute corporate strategy: alliances and acquisitions. We devote this chapter to the study of these fundamental pathways through which firms implement corporate strategy.

We begin this chapter by introducing the *build-borrow-buy framework* to guide corporate strategy in deciding whether and when to grow *internally (build)*, use *alliances (borrow)*, or *make acquisitions (buy)*. We then take a closer look at strategic alliances before studying mergers and acquisitions. We discuss alliances before acquisitions because alliances are smaller strategic commitments and thus are much more frequent. Moreover, in some cases, alliances may lead to acquisitions later; offering a "try before you buy" approach as in the Disney–Pixar example. We conclude with "Implications for the Strategist," in which we discuss practical applications.

9.1 How Firms Achieve Growth

After discussing in Chapter 8 why firms need to grow, the next question that arises is: *How do firms achieve growth?* Corporate executives have three options at their disposal to drive firm growth: organic growth through internal development, external growth through alliances, or external growth through acquisitions. Laurence Capron and Will Mitchell developed an insightful step-by-step decision model to guide managers in selecting the most appropriate corporate strategy vehicle.[2] Selecting the most appropriate vehicle for corporate strategy in response to a specific strategic challenge also makes successful implementation more likely.

THE BUILD-BORROW-BUY FRAMEWORK

LO 9-1

Apply the build-borrow-or-buy framework to guide corporate strategy.

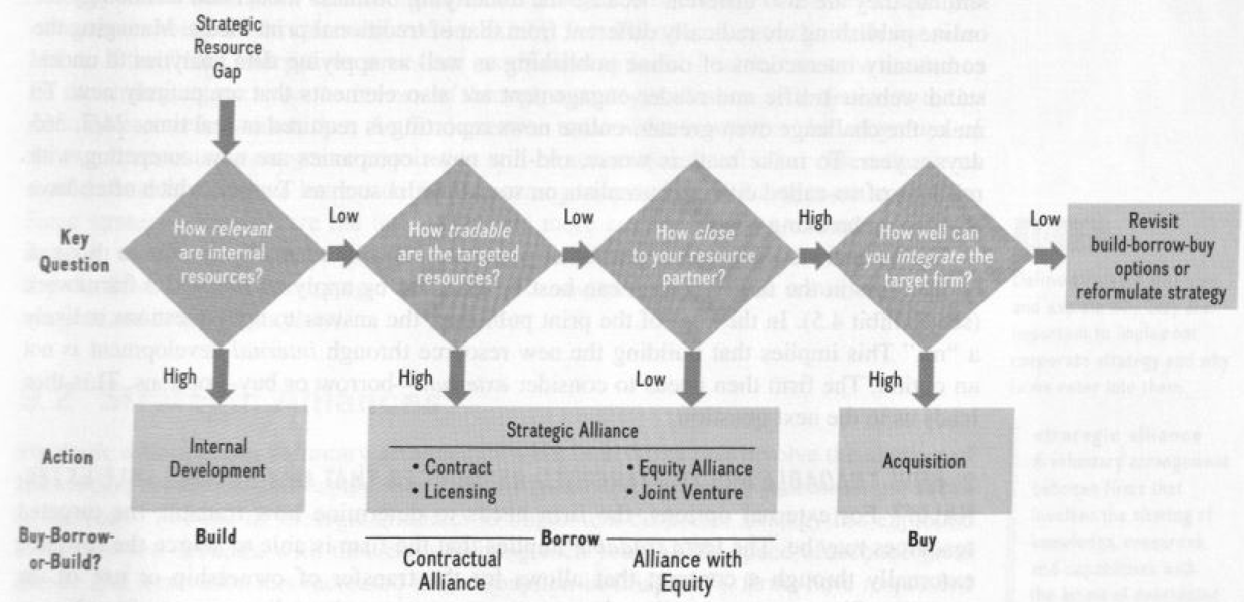
build-borrow-or-buy framework Conceptual model that aids firms in deciding whether to pursue internal development *(build)*, enter a contractual arrangement or strategic alliance *(borrow)*, or acquire new resources, capabilities, and competencies *(buy)*.

The **build-borrow-or-buy framework** provides a conceptual model that aids firms in deciding whether to pursue internal development (*build*), enter a contractual arrangement or strategic alliance (*borrow*), or acquire new resources, capabilities, and competencies (*buy*). Firms that are able to learn how to select the right pathways to obtain new resources are more likely to gain and sustain a competitive advantage. Note that in the build-borrow-or-buy model, the term *resources* is defined broadly to include capabilities and competencies (as in the *VRIO model* discussed in Chapter 4). Exhibit 9.1 shows the *build-borrow-or-buy* decision framework.

The starting point is the firm's identification of a strategic resource gap that will impede future growth. The resource gap is *strategic* because closing this gap is likely to lead to a competitive advantage. As discussed in Chapter 4, resources with the potential to lead to competitive advantage cannot be simply bought on the open market. Indeed, if any firm could readily buy this type of resource, its availability would negate its potential for competitive advantage. It would no longer be *rare*, a key condition for a resource to form the basis of competitive advantage. Moreover, resources that are *valuable, rare,* and *difficult to imitate* are often embedded deep within a firm, frequently making up a resource bundle that is hard to unplug whole or in part. The options to close the strategic resource gap are, therefore, to build, borrow, or buy. *Build* in the build-borrow-buy framework refers to internal development; *borrow* refers to the use of strategic alliances; and *buy* refers to acquiring a firm. When acquiring a firm, you buy an entire "resource bundle," not just a specific resource. This resource bundle, if obeying VRIO principles and successfully integrated, can then form the basis of competitive advantage.

Exhibit 9.1 provides a schematic of the build-borrow-or-buy framework. In this approach executives must determine the degree to which certain conditions apply, either

EXHIBIT 9.1 / Guiding Corporate Strategy: The Build-Borrow-or-Buy Framework



Source: Adapted from L. Capron and W. Mitchell (2012), *Build, Borrow, or Buy: Solving the Growth Dilemma* (Boston, MA: Harvard Business Review Press).

high or low, by responding to up to four questions sequentially before finding the best course. The questions cover issues of *relevancy, tradability, closeness,* and *integration:*

1. **Relevancy.** How *relevant* are the firm's existing internal resources to solving the resource gap?
2. **Tradability.** How *tradable* are the targeted resources that may be available externally?
3. **Closeness.** How *close* do you need to be to your external resource partner?
4. **Integration.** How well can you *integrate* the targeted firm, should you determine you need to acquire the resource partner?

As shown in Exhibit 9.1, the answers to these questions lead to a recommended action or the next question. We'll review each in more depth.

1. HOW *RELEVANT* ARE THE FIRM'S EXISTING INTERNAL RESOURCES TO SOLVING THE RESOURCE GAP? The firm starts by asking whether the firm's internal resources are high or low in relevance. If the firm's internal resources are highly relevant to closing the identified gap, the firm should itself build the new resources needed through internal development.

But how does a manager know whether the firm's resources are relevant in addressing a new challenge or opportunity? Firms evaluate the relevance of internal resources in two ways: they test whether resources are (1) *similar* to those the firm needs to develop and (2) *superior* to those of competitors in the targeted area.[3] If *both* conditions are met, then the firm's internal resources are relevant and the firm should pursue internal development.

Let's look at both conditions. Managers are often misled by the first test because things that might appear similar at the surface are actually quite different deep down.[4] Moreover, managers tend to focus on the (known) similarities rather than on (unknown) differences. They often don't know how the resources needed for the existing and new business opportunity differ. An executive at a newspaper publisher such as *The New York Times* may conclude that the researching, reporting, writing, and editing activities done for a printed newspaper are similar to those done for an online one. Although the activities may be similar, they are also different because the underlying business model and technology for online publishing are radically different from that of traditional print media. Managing the community interactions of online publishing as well as applying data analytics to understand website traffic and reader engagement are also elements that are entirely new. To make the challenge even greater, online news reporting is required in real time, 24/7, 365 days a year. To make matters worse, old-line news companies are now competing with millions of so-called citizen journalists on social media such as Twitter, which often have an edge on breaking news.[5]

The second test, determining whether your internal resources are *superior* to those of competitors in the targeted area, can best be assessed by applying the VRIO framework (see Exhibit 4.5). In the case of the print publisher, the answer to both questions is likely a "no." This implies that building the new resource through *internal* development is not an option. The firm then needs to consider *external*—borrow or buy—options. This then leads us to the next question.

2. HOW *TRADABLE* ARE THE TARGETED RESOURCES THAT MAY BE AVAILABLE EXTERNALLY? For external options, the firm needs to determine how tradable the targeted resources may be. The term *tradable* implies that the firm is able to source the resource externally through a contract that allows for the transfer of ownership or use of the resource. Short-term as well as long-term contracts, such as licensing or franchising, are a way to *borrow* resources from another company (see discussion in Chapter 8).

In the biotech-pharma industry, some producers use licensing agreements to transfer knowledge and technology from the licensor's R&D to the licensee's manufacturing. Eli Lilly, for example, has commercialized several breakthrough biotech drugs using licensing agreements with new ventures. The implication is that if a resource is highly tradable, then the resource should be *borrowed* via a licensing agreement or other contractual agreement. If the resource in question is not easily tradable, then the firm needs to consider either a deeper strategic alliance through an equity alliance or a joint venture, or an outright acquisition.

3. HOW *CLOSE* DO YOU NEED TO BE TO YOUR EXTERNAL RESOURCE PARTNER? Many times, firms are able to obtain the required resources to fill the strategic gap through more integrated strategic alliances such as equity alliances or joint ventures (see Exhibit 8.4) rather than through outright acquisition. Mergers and acquisitions are the most costly, complex, and difficult to reverse strategic option. This implies that only if extreme closeness to the resource partner is necessary in order to understand and obtain its underlying knowledge should M&A be considered the *buy* option. Regardless, the firm should always first consider *borrowing* the necessary resources through integrated strategic alliances before looking at M&A.

4. HOW WELL CAN YOU *INTEGRATE* THE TARGETED FIRM, SHOULD YOU DETERMINE YOU NEED TO ACQUIRE THE RESOURCE PARTNER? The final decision question using the build-borrow-buy lens is: *Can you integrate the target firm?* The list of post-integration failure, often due to cultural differences, is long. Multibillion-dollar failures include the Daimler-Chrysler integration, AOL and Time Warner, HP and Autonomy, and Bank of America and Merrill Lynch. More than cultural differences were involved in Microsoft's 2015 decision to write down $7.6 billion in losses on its $9.4 billion acquisition of Nokia (or more than 80 percent) some 15 months earlier. It's now up to Microsoft CEO Satya Nadella to decide how to compete in the mobile device arena after former CEO Steve Ballmer made a desperate gamble on acquiring the Finnish cell phone maker.[6]

Only if the three prior conditions *(low relevancy, low tradability,* and *high need for closeness)* shown in the decision tree in Exhibit 9.1 are met, should the firm consider M&A: If the firm's internal resources are insufficient to *build, and* the resource needed to fill the strategic gap cannot be *borrowed* through a strategic alliance, *and* closeness to the resource partner is needed, then the final question to consider is whether the integration of the two firms using a merger or acquisition will be successful. In all other cases, the firms should consider finding a less costly *borrow* arrangement when *building* is not an option. Since strategic alliances are the less costly and more common tool to execute corporate strategy, we discuss alliances first before mergers and acquisitions. Per the build-borrow-buy decision framework, strategic alliances *(borrow)* also need to be considered before mergers and acquisitions *(buy)*.

9.2 Strategic Alliances

LO 9-2

Define strategic alliances, and explain why they are important to implement corporate strategy and why firms enter into them.

Strategic alliances are voluntary arrangements between firms that involve the sharing of knowledge, resources, and capabilities with the intent of developing processes, products, or services.[7] The use of strategic alliances to implement corporate strategy has exploded in the past few decades, with thousands forming each year. As the speed of technological change and innovation has increased (see discussion in Chapter 7), firms have responded by entering more alliances. Globalization has also contributed to an increase in cross-border strategic alliances (see discussion in Chapter 10).

strategic alliance
A voluntary arrangement between firms that involves the sharing of knowledge, resources, and capabilities with the intent of developing processes, products, or services.

Strategic alliances may join complementary parts of a firm's value chain, such as R&D and marketing, or they may focus on joining the same value chain activities. Strategic alliances are attractive because they enable firms to achieve goals faster and at lower costs than going it alone. In contrast to M&A, strategic alliances also allow firms to circumvent potential legal repercussions including potential lawsuits filed by U.S. federal agencies or the European Union.

Firms enter many types of alliances, from small contracts that have no bearing on a firm's competitiveness to multibillion-dollar joint ventures that can make or break the company. An alliance, therefore, qualifies as *strategic* only if it has the potential to affect a firm's competitive advantage. A strategic alliance has the potential to help a firm gain and sustain a competitive advantage when it joins together resources and knowledge in a combination that obeys the VRIO principles (introduced in Chapter 4).[8] The locus of competitive advantage is often not found within the individual firm but within a strategic partnership.

relational view of competitive advantage
Strategic management framework that proposes that critical resources and capabilities frequently are embedded in strategic alliances that span firm boundaries.

According to this **relational view of competitive advantage**, critical resources and capabilities frequently are embedded in strategic alliances that span firm boundaries. Applying the VRIO framework, we know that the basis for competitive advantage is formed when a strategic alliance creates resource combinations that are valuable, rare, and difficult to imitate, and the alliance is organized appropriately to allow for value capture. In support of this perspective, over 80 percent of Fortune 1000 CEOs indicated in a recent survey that more than one-quarter of their firm's revenues were derived from strategic alliances.[9]

WHY DO FIRMS ENTER STRATEGIC ALLIANCES?

To affect a firm's competitive advantage, an alliance must promise a positive effect on the firm's economic value creation through increasing value and/or lowering costs (see discussion in Chapter 5). This logic is reflected in the common reasons firms enter alliances.[10] They do so to

- Strengthen competitive position.
- Enter new markets.
- Hedge against uncertainty.
- Access critical complementary assets.
- Learn new capabilities.

STRENGTHEN COMPETITIVE POSITION. Firms can use strategic alliances to change the industry structure in their favor.[11] Firms frequently use strategic alliances when competing in so-called battles for industry standards (see discussion in Chapter 7). Strategy Highlight 9.1 shows how IBM and Apple entered a strategic alliance to strengthen their respective competitive position in mobile computing and business productivity apps. This in turn increases the competitive pressure on rivals of both companies, in particular, Microsoft.

ENTER NEW MARKETS. Firms may use strategic alliances to enter new markets, either in terms of products and services or geography.[12]

Using a strategic alliance, HP and DreamWorks Animation SKG created the Halo Collaboration Studio, which makes virtual communication possible around the globe.[13] Halo's conferencing technology gives participants the vivid sense that they are in the same room. The conference rooms of clients match, down to the last detail, giving participants the impression that they are sitting together at the same table. DreamWorks produced the

Strategy Highlight 9.1

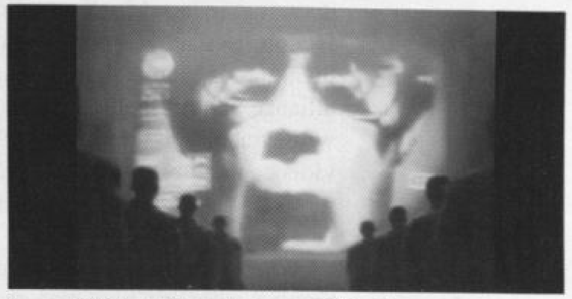
IBM and Apple: From Big Brother to Alliance Partner

An excerpt from a speech by Apple co-founder Steve Jobs introducing the iconic "1984" Macintosh ad that aired during the Super Bowl XVIII telecast provides a historic perspective about the relationship between Apple and IBM:[14]

> In 1977, Apple, a young fledgling company on the West Coast, invents the Apple II, the first personal computer as we know it today. IBM dismisses the personal computer as too small to do serious computing and unimportant. The early 1980s. Apple II has become the world's most popular computer, and Apple has grown to a $300 million company, becoming the fastest-growing corporation in American business history. IBM enters the personal computer market in 1981. Apple and IBM emerge as the industry's strongest competitors, each selling approximately $1 billion worth of personal computers in 1983. The shakeout is in full swing. The first major firm goes bankrupt, with others teetering on the brink. It is now 1984. IBM wants it all and is aiming its guns on its last obstacle to industry control: Apple. Will Big Blue dominate the entire computer industry—the entire information age? Was George Orwell right about 1984?

Steve Jobs compares IBM to George Orwell's Big Brother, the all-present dictator of a totalitarian state that has absolute power over its inhabitants, including thought control. In the ad, Apple—portrayed by an athletic heroine with a stylized line drawing of Apple's Macintosh on her tank top—is the only hope to save humanity from total oppression and ensure its freedom.

Fast-forward 30 years to 2014. Apple has become the world's most valuable company and IBM is struggling. Although Jobs had a visceral disdain for IBM, Apple CEO Tim Cook took his first job out of college with IBM, where he worked for 12 years. Nonetheless, given their adversarial past and decades as rivals, it came somewhat as a surprise when Apple and IBM announced a strategic alliance to create simple-to-use business productivity apps and to sell



Source: "1984 Apple's Macintosh Commerical," YouTube, posted by Mac History, February 1, 2012

iPhones and iPads to IBM's corporate clients. Why would the former archenemies form a partnership?

Both parties stand to benefit from this arrangement. Although hugely successful, Apple has mainly been a consumer company (B2C). Historically, Apple did not sell directly to business clients. As more and more people bring their mobile devices to work, Apple sees the enterprise business as a huge opportunity for future growth. Cook, for example, claims that he does 80 percent of the work of running the world's most valuable company on his iPad.

In contrast, IBM has long-standing and deep ties as a business-to-business (B2B) company and major seller of tech services, especially in government, banking, finance, and insurance. Yet, IBM has been slow to catch the wave of mobile computing. With this seminal partnership, IBM is hoping to capitalize on the popularity of Apple's devices as it moves more and more of its software productivity tools onto mobile platforms. IBM will be selling and servicing Apple mobile devices to its corporate clients. Together, they plan to create simple to use business apps that bring together Apple's core competency of hardware and software integration to produce a seamless user experience with IBM's core competency in business services and big data analytics. One of the first new business apps resulting from this alliance will help airline pilots determine the right amount of fuel to carry on a particular flight. This task requires significant data analytics displayed in an easily understandable way so that pilots can digest it quickly when glancing at their iPad in a cockpit before departure.[15]

computer-animated movie *Shrek 2* using this new technology for its meetings. People with different creative skills—script writers, computer animators, directors—though dispersed geographically, were able to participate as if in the same room, even seeing the work on each other's laptops. Use of the technology enabled faster decision making, enhanced productivity, reduced (or even eliminated) travel time and expense, and increased job satisfaction. Neither HP nor DreamWorks would have been able to produce this technology breakthrough alone, but moving into the videoconferencing arena together via a strategic alliance allowed both partners to pursue related diversification. Moreover, HP's alliance with DreamWorks Animation SKG enabled HP to compete head on with Cisco's high-end videoconferencing solution, TelePresence. The HP and DreamWorks Animation SKG was motivated by the desire to enter a new market, in terms or products and services offered, that neither could enter alone.[16]

When entering new geographic markets, in some instances, governments such as Saudi Arabia or China may require that foreign firms have a local joint venture partner before doing business in their countries. These cross-border strategic alliances have both benefits and risks. While the foreign firm can benefit from local expertise and contacts, it is exposed to the risk that some of its proprietary know-how may be appropriated by the foreign partner. We will address such issues in Chapter 10 when studying global strategy.

HEDGE AGAINST UNCERTAINTY. In dynamic markets, strategic alliances allow firms to limit their exposure to uncertainty in the market.[17] For instance, in the wake of the biotechnology revolution, incumbent pharmaceutical firms such as Pfizer, Novartis, and Roche entered into hundreds of strategic alliances with biotech startups.[18] These alliances allowed the big pharma firms to make small-scale investments in many of the new biotechnology ventures that were poised to disrupt existing market economics. In some sense, the pharma companies were taking *real options* in these biotechnology experiments, providing them with the right but not the obligation to make further investments when new drugs were introduced from the biotech companies.

real-options perspective
Approach to strategic decision making that breaks down a larger investment decision into a set of smaller decisions that are staged sequentially over time.

A **real-options perspective** to strategic decision making breaks down a larger investment decision (such as whether to enter biotechnology or not) into a set of smaller decisions that are staged sequentially over time. This approach allows the firm to obtain additional information at predetermined stages. At each stage, after new information is revealed, the firm evaluates whether or not to make further investments. In a sense, a real option, which is the right, but not the obligation, to continue making investments allows the firm to buy time until sufficient information for a go versus no-go decision is revealed. Once the new biotech drugs were a known quantity, the uncertainty was removed, and the incumbent firms could react accordingly.

For example, in 1990 the Swiss pharma company Roche initially invested $2.1 billion in an equity alliance to purchase a controlling interest (greater than 50 percent) in the biotech startup Genentech. In 2009, after witnessing the success of Genentech's drug discovery and development projects in subsequent years, Roche spent $47 billion to purchase the remaining minority interest in Genentech, making it a wholly owned subsidiary.[19] Taking a wait-and-see approach by entering strategic alliances allows incumbent firms to buy time and wait for the uncertainty surrounding the market and technology to fade. Many firms in fast-moving markets subscribe to this rationale. Waiting can also be expensive, however. To acquire the remaining less than 50 percent of Genentech some 20 years after its initial investment required a price that was

some 24 times higher than the initial investment, as uncertainty settled and the biotech startup turned out to be hugely successful. Besides biotechnology, the use of a *real-options perspective* in making strategic investments has also been documented in nanotechnology, semiconductors, and other dynamic markets.[20]

ACCESS CRITICAL COMPLEMENTARY ASSETS. The successful commercialization of a new product or service often requires complementary assets such as marketing, manufacturing, and after-sale service.[21] In particular, new firms are in need of complementary assets to complete the value chain from upstream innovation to downstream commercialization. This implies that a new venture that has a core competency in R&D, for example, will need to access distribution channels and marketing expertise to complete the value chain. Building downstream complementary assets such as marketing and regulatory expertise or a sales force is often prohibitively expensive and time-consuming, and thus frequently not an option for new ventures. Strategic alliances allow firms to match complementary skills and resources to complete the value chain. Moreover, licensing agreements of this sort allow the partners to benefit from a division of labor, allowing each to efficiently focus on its core competency.

LEARN NEW CAPABILITIES. Firms also enter strategic alliances because they are motivated by the desire to learn new capabilities from their partners.[22] When the collaborating firms are also competitors, *co-opetition* ensues.[23] **Co-opetition** is a portmanteau describing cooperation by competitors. They may cooperate to create a larger pie but then might compete about how the pie should be divided. Such co-opetition can lead to **learning races** in strategic alliances,[24] a situation in which both partners are motivated to form an alliance for learning, but the rate at which the firms learn may vary. The firm that learns faster and accomplishes its goal more quickly has an incentive to exit the alliance or, at a minimum, to reduce its knowledge sharing. Since the cooperating firms are also competitors, learning races can have a positive effect on the winning firm's competitive position vis-à-vis its alliance partner.

co-opetition
Cooperation by competitors to achieve a strategic objective.

learning races
Situations in which both partners in a strategic alliance are motivated to form an alliance for learning, but the rate at which the firms learn may vary.

NUMMI (New United Motor Manufacturing, Inc.) was the first joint venture in the U.S. automobile industry, formed between GM and Toyota in 1984. Recall from Chapter 8 that joint ventures are a special type of a strategic alliance in which two partner firms create a third, jointly owned entity. In the NUMMI joint venture, each partner was motivated to learn new capabilities: GM entered the equity-based strategic alliance to learn the lean manufacturing system pioneered by Toyota in order to produce high-quality, fuel-efficient cars at a profit. Toyota entered the alliance to learn how to implement its lean manufacturing program with an American work force. NUMMI was a test-run for Toyota before building fully owned *greenfield plants* (new manufacturing facilities) in Alabama, Indiana, Kentucky, Mississippi, Texas, and West Virginia. In this 25-year history, GM and Toyota built some 7 million high-quality cars at the NUMMI plant. In fact, NUMMI was transformed from worst performer (under GM ownership before the joint venture) to GM's highest-quality plant in the United States. In the end, as part of GM's bankruptcy reorganization during 2009–2010, it pulled out of the NUMMI joint venture.

The joint venture between GM and Toyota can be seen as a learning race. Who won? Strategy scholars argue that Toyota was faster in accomplishing its alliance goal—learning how to manage U.S. labor—because of its limited scope.[25] Toyota had already perfected lean manufacturing; all it needed to do was learn how to train U.S. workers in the method and transfer this knowledge to its subsidiary plants in the United States. On the other hand, GM had to learn a completely new production system. GM was successful in transferring lean manufacturing to its newly created Saturn brand (which was discontinued in 2010 as part of GM's reorganization), but it had a hard time implementing lean manufacturing in its *existing* plants. These factors suggest that Toyota won the learning race with GM, which in turn helped Toyota gain and sustain a competitive advantage over GM in the U.S. market.

Also, note that different motivations for forming alliances are not necessarily independent and can be intertwined. For example, firms that collaborate to access critical complementary assets may also want to learn from one another to subsequently pursue vertical integration. In sum, alliance formation is frequently motivated by leveraging economies of scale, scope, specialization, and learning.

LO 9-3

Describe three alliance governance mechanisms and evaluate their pros and cons.

GOVERNING STRATEGIC ALLIANCES

In Chapter 8, we showed that strategic alliances lie in the middle of the make-or-buy continuum (see Exhibit 8.4). Alliances can be governed by the following mechanisms:

- Non-equity alliances
- Equity alliances
- Joint ventures[26]

Exhibit 9.2 provides an overview of the key characteristics of the three alliance types, including their advantages and disadvantages.

non-equity alliance Partnership based on contracts between firms.

explicit knowledge Knowledge that can be codified; concerns *knowing about* a process or product.

NON-EQUITY ALLIANCES. The most common type of alliance is a **non-equity alliance**, which is based on contracts between firms. The most frequent forms of non-equity alliances are *supply agreements, distribution agreements,* and *licensing agreements.* As suggested by their names, these contractual agreements are vertical strategic alliances, connecting different parts of the industry value chain. In a non-equity alliance, firms tend to share **explicit knowledge**—knowledge that can be codified. Patents, user manuals, fact sheets, and scientific publications are all ways to capture explicit knowledge, which concerns the notion of *knowing about* a certain process or product.

Licensing agreements are contractual alliances in which the participants regularly exchange codified knowledge. The biotech firm Genentech licensed its newly developed drug Humulin (human insulin) to the pharmaceutical firm Eli Lilly for manufacturing, facilitating approval by the Food and Drug Administration (FDA), and distribution. This partnership was an example of a vertical strategic alliance: One partner (Genentech) was positioned upstream in the industry value chain focusing on R&D, while the other partner (Eli Lilly) was positioned downstream focusing on manufacturing and distribution. This type of vertical arrangement is often described as a "hand-off" from the upstream partner to the downstream partner and is possible because the underlying knowledge is largely explicit and can be easily codified. When Humulin reached the market, it was the first approved genetically engineered human therapeutic drug worldwide.[27] Subsequently, Humulin became a billion-dollar blockbuster drug.

Because of their contractual nature, non-equity alliances are flexible and easy to initiate and terminate. However, because they can be temporary in nature, they also sometimes produce weak ties between the alliance partners, which can result in a lack of trust and commitment.

EXHIBIT 9.2 / Key Characteristics of Different Alliance Types

Alliance Type	Governance Mechanism	Frequency	Type of Knowledge Exchanged	Pros	Cons	Examples
Non-equity (supply, licensing, and distribution agreements)	Contract	Most common	Explicit	• Flexible • Fast • Easy to initiate and terminate	• Weak tie • Lack of trust and commitment	• Genentech–Lilly (exclusive) licensing agreement for Humulin • Microsoft–IBM (nonexclusive) licensing agreement for MS-DOS
Equity (purchase of an equity stake or corporate venture capital, CVC investment)	Equity investment	Less common than non-equity alliances, but more common than joint ventures	Explicit; exchange of tacit knowledge possible	• Stronger tie • Trust and commitment can emerge • Window into new technology (option value)	• Less flexible • Slower • Can entail significant investments	• Renault–Nissan alliance based on cross equity holdings, with Renault owning 44.4% in Nissan; and Nissan owning 15% in Renault • Roche's equity investment in Genentech (prior to full integration)
Joint venture (JV)	Creation of new entity by two or more parent firms	Least common	Both tacit and explicit knowledge exchanged	• Strongest tie • Trust and commitment likely to emerge • May be required by institutional setting	• Can entail long negotiations and significant investments • Long-term solution • JV managers have double reporting lines (2 bosses)	• Hulu, owned by NBC, Fox, and Disney-ABC • Dow Corning, owned by Dow Chemical and Corning

equity alliance Partnership in which at least one partner takes partial ownership in the other.

tacit knowledge Knowledge that cannot be codified; concerns *knowing how* to do a certain task and can be acquired only through active participation in that task.

EQUITY ALLIANCES. In an **equity alliance**, at least one partner takes partial ownership in the other partner. Equity alliances are less common than contractual, non-equity alliances because they often require larger investments. Because they are based on partial ownership rather than contracts, equity alliances are used to signal stronger commitments. Moreover, equity alliances allow for the sharing of **tacit knowledge**—knowledge that cannot be codified.[28] Tacit knowledge concerns *knowing how* to do a certain task. It can be acquired only through actively participating in the process. In an equity alliance, therefore, the partners frequently exchange personnel to make the acquisition of tacit knowledge possible.

Toyota used an equity alliance with Tesla Motors, a designer and maker of electric cars (and featured in ChapterCase 3), to learn new knowledge and gain a window into new technology. In 2010, Toyota made a $50 million equity investment in the California startup. In the same year, Tesla Motors purchased the NUMMI plant in Fremont, California, where it now manufactures its Models S and X. Tesla CEO Elon Musk stated, "The Tesla factory effectively leverages an ideal combination of hardcore Silicon Valley engineering talent, traditional automotive engineering talent, and the proven Toyota production system."[29] Toyota in turn hopes to infuse its company with Tesla's entrepreneurial spirit. Toyota President Akio Toyoda commented, "By partnering with Tesla, my hope is that all Toyota employees will recall that 'venture business spirit' and take on the challenges of the future."[30] Toyoda hoped that a transfer of tacit knowledge would occur, in which Tesla's entrepreneurial spirit would reinvigorate Toyota.[31] This equity-based learning race ended in 2014 when Toyota sold its stake in Tesla.[32] The Japanese automaker is shifting away from electric cars, renewing its focus on hybrid vehicles and exploring fuel-cell technology.

Another governance mechanism that falls under the broad rubric of equity alliances is **corporate venture capital (CVC)** investments, which are equity investments by established firms in entrepreneurial ventures.[33] The value of CVC investments is estimated to be in the double-digit billion-dollar range each year. Larger firms frequently have dedicated CVC units, such as Dow Venture Capital, Siemens Venture Capital, Kaiser Permanente Ventures, and Johnson & Johnson Development Corporation. Rather than hoping primarily for financial gains, as venture capitalists traditionally do, CVC investments create real options in terms of gaining access to new, and potentially disruptive, technologies.[34] Strategy scholars find that CVC investments have a positive impact on value creation for the investing firm, especially in high-tech industries such as semiconductors, computing, and the medical-device sector.[35]

corporate venture capital (CVC)
Equity investments by established firms in entrepreneurial ventures; CVC falls under the broader rubric of equity alliances.

Taken together, equity alliances tend to produce stronger ties and greater trust between partners than non-equity alliances do. They also offer a window into new technology that, like a real option, can be exercised if successful or abandoned if not promising. Equity alliances are frequently stepping-stones toward full integration of the partner firms either through a merger or an acquisition. Essentially, they are often used as a "try before you buy" strategic option.[36] The downside of equity alliances is the amount of investment that can be involved, as well as a possible lack of flexibility and speed in putting together and reaping benefits from the partnership.

JOINT VENTURES. A *joint venture* (JV) is a standalone organization created and jointly owned by two or more parent companies (as discussed in Chapter 8). For example, Hulu (a video-on-demand service) is jointly owned by NBC, Disney-ABC, and Fox. Since partners contribute equity to a joint venture, they are making a long-term commitment. Exchange of both explicit and tacit knowledge through interaction of personnel is typical. Joint ventures are also frequently used to enter foreign markets where the host country requires such a partnership to gain access to the market in exchange for advanced technology and know-how. In terms of frequency, joint ventures are the least common of the three types of strategic alliances.

The advantages of joint ventures are the strong ties, trust, and commitment that can result between the partners. However, they can entail long negotiations and significant investments. If the alliance doesn't work out as expected, undoing the JV can take some time and involve considerable cost. A further risk is that knowledge shared with the new partner could be misappropriated by opportunistic behavior. Finally, any rewards from the collaboration must be shared between the partners.

ALLIANCE MANAGEMENT CAPABILITY

LO 9-4
Describe the three phases of alliance management and explain how an alliance management capability can lead to a competitive advantage.

Strategic alliances create a paradox for managers. Although alliances appear to be necessary to compete in many industries, between 30 and 70 percent of all strategic alliances do not deliver the expected benefits, and are considered failures by at least one alliance partner.[37] Given the high failure rate, effective alliance management is critical to gaining and sustaining a competitive advantage, especially in high-technology industries.[38]

Alliance management capability is a firm's ability to effectively manage three alliance-related tasks concurrently, often across a portfolio of many different alliances (see Exhibit 9.3):[39]

- Partner selection and alliance formation.
- Alliance design and governance.
- Post-formation alliance management.

alliance management capability
A firm's ability to effectively manage three alliance-related tasks concurrently: (1) partner selection and alliance formation, (2) alliance design and governance, and (3) post-formation alliance management.

PARTNER SELECTION AND ALLIANCE FORMATION. When making the business case for an alliance, the expected benefits of the alliance must exceed its costs. When one or more of the five reasons for alliance formation are present—to strengthen competitive position, enter new markets, hedge against uncertainty, access critical complementary resources, or learn new capabilities—the firm must select the best possible alliance partner. Partner compatibility and partner commitment are necessary conditions for successful alliance formation.[40] *Partner compatibility* captures aspects of cultural fit between different firms. *Partner commitment* concerns the willingness to make available necessary resources and to accept short-term sacrifices to ensure long-term rewards.

ALLIANCE DESIGN AND GOVERNANCE. Once two or more firms agree to pursue an alliance, managers must then design the alliance and choose an appropriate governance mechanism from among the three options: non-equity contractual agreement, equity alliances, or joint venture. For example, in a study of over 640 alliances, researchers found that the joining of specialized complementary assets increases the likelihood that the alliance is governed hierarchically. This effect is stronger in the presence of uncertainties concerning the alliance partner as well as the envisioned tasks.[41]

In addition to the formal governance mechanisms, *interorganizational trust* is a critical dimension of alliance success.[42] Because all contracts are necessarily incomplete, trust between the alliance partners plays an important role for effective post-formation alliance management. Effective governance, therefore, can be accomplished only by skillfully combining formal and informal mechanisms.

EXHIBIT 9.3 / Alliance Management Capability

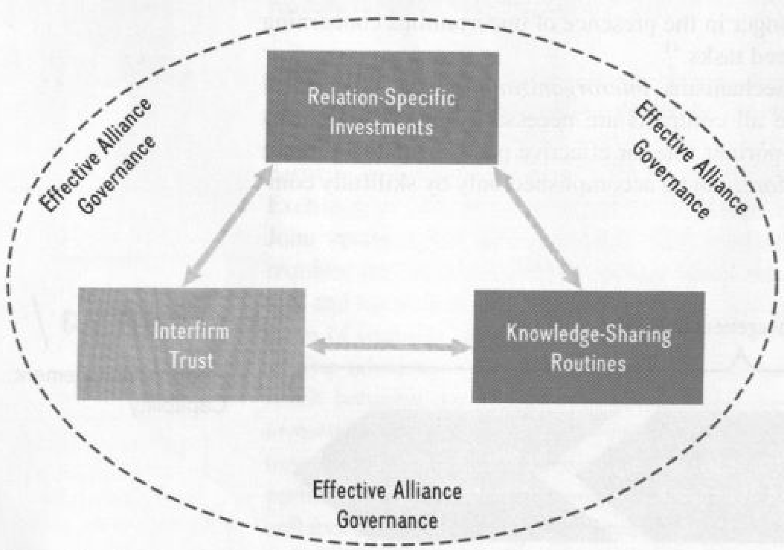
POST-FORMATION ALLIANCE MANAGEMENT. The third phase in a firm's alliance management capability concerns the ongoing management of the alliance. To be a source of competitive advantage, the partnership needs to create resource combinations that obey the VRIO criteria. As shown in Exhibit 9.4, this can be most likely accomplished if the alliance partners *make relation-specific investments, establish knowledge-sharing routines,* and *build interfirm trust.*[43]

Trust is a critical aspect of any alliance. Interfirm trust entails the expectation that each alliance partner will behave in good faith and develop norms of reciprocity and fairness.[44] Such trust helps ensure that the relationship survives and thereby increases the possibility of meeting the intended goals of the alliance. Interfirm trust is also important for fast decision making.[45] Several firms such as Eli Lilly, HP, Procter & Gamble, and IBM compete to obtain trustworthy reputations in order to become the alliance "partner of choice" for small technology ventures, universities, and individual inventors.

Indeed, the systematic differences in firms' alliance management capability can be a source of competitive advantage.[46] But how do firms build alliance management capability? The answer is to build capability through repeated experiences over time. In support of this idea, several empirical studies have shown that firms move down the learning curve and become better at managing alliances through repeated alliance exposure.[47]

The "learning-by-doing" approach has value for small ventures in which a few key people coordinate most of the firms' activities.[48] However, there are clearly limitations for larger companies. Conglomerates such as ABB, GE, Philips, or Siemens are engaged in hundreds of alliances simultaneously. In fact, if alliances are not managed from a portfolio perspective at the corporate level, serious negative repercussions can emerge.[49] Groupe Danone, a large French food conglomerate, lost its leading position in the highly lucrative and fast-growing Chinese market because its local alliance partner, Hangzhou Wahaha Group, terminated their long-standing alliance.[50] Wahaha accused different Danone business units of subsequently setting up partnerships with other Chinese firms that were a direct competitive threat to Wahaha. This example makes it clear that although alliances are important pathways by which to pursue business-level strategy, they are best managed at the corporate level.

EXHIBIT 9.4 / How to Make Alliances Work



Source: Adapted from J.H. Dyer and H. Singh (1998), "The relational view: Cooperative strategy and the sources of intraorganizational advantage," *Academy of Management Review* 23: 660–679.

To accomplish effective alliance management, strategy scholars suggest that firms create a *dedicated alliance function,*[51] led by a vice president or director of alliance management and endowed with its own resources and support staff. The dedicated alliance function should be given the tasks of coordinating all alliance-related activity in the entire organization, taking a corporate-level perspective. It should serve as a repository of prior experience and be responsible for creating processes and structures to teach and leverage that experience and related knowledge throughout the rest of the organization across all levels. Research shows that firms with a dedicated alliance function are able to create value from their alliances above and beyond what could be expected based on experience alone.[52]

Pharmaceutical company Eli Lilly is an acknowledged leader in alliance management.[53] Lilly's Office of Alliance Management, led by a director and endowed with several full-time positions, manages its far-flung alliance activity across all hierarchical levels and around the globe. Lilly's process prescribes that each alliance is managed by a three-person team: an alliance champion, alliance leader, and alliance manager.

- The *alliance champion* is a senior, corporate-level executive responsible for high-level support and oversight. This senior manager is also responsible for making sure that the alliance fits within the firm's existing alliance portfolio and corporate-level strategy.
- The *alliance leader* has the technical expertise and knowledge needed for the specific technical area and is responsible for the day-to-day management of the alliance.
- The *alliance manager,* positioned within the Office of Alliance Management, serves as an alliance process resource and business integrator between the two alliance partners and provides alliance training and development, as well as diagnostic tools.

Some companies are also able to leverage the relational capabilities obtained through managing alliance portfolios into a successful acquisition strategy.[54] As detailed earlier, Eli Lilly has an entire department at the corporate level devoted to managing its alliance portfolio. Following up on an earlier 50/50 joint venture formed with Icos, maker of the $1 billion-plus erectile-dysfunction drug Cialis, Lilly acquired Icos in 2007. Just a year later, Eli Lilly outmaneuvered Bristol-Myers Squibb to acquire biotech venture ImClone for $6.5 billion. ImClone discovered and developed the cancer-fighting drug Erbitux, also a $1 billion blockbuster in terms of annual sales. The acquisition of these two smaller biotech ventures allowed Lilly to address its problem of an empty drug pipeline.[55]

9.3 Mergers and Acquisitions

LO 9-5
Differentiate between mergers and acquisitions, and explain why firms would use either to execute corporate strategy.

A popular vehicle for executing corporate strategy is mergers and acquisitions (M&A). Hundreds of mergers and acquisitions occur each year, with a cumulative value in the trillions of dollars.[56] Although the terms are often used interchangeably, and usually in tandem, mergers and acquisitions are, by definition, distinct from each other. A **merger** describes the joining of two independent companies to form *a combined entity.* Mergers tend to be friendly; in mergers, the two firms agree to join in order to create a combined entity. In the live event-promotion business, for example, Live Nation merged with Ticketmaster.

merger
The joining of two independent companies to form a combined entity.

acquisition
The purchase or takeover of one company by another; can be friendly or unfriendly.

hostile takeover
Acquisition in which the target company does not wish to be acquired.

An **acquisition** describes the purchase or takeover of one company by another. Acquisitions can be friendly or unfriendly. As discussed in the ChapterCase, Disney's acquisition of Pixar, for example, was a friendly one, in which both management teams believed that joining the two companies was a good idea. When a target firm does not want to be acquired, the acquisition is considered a **hostile takeover**. British telecom company Vodafone's acquisition of Germany-based Mannesmann, a diversified conglomerate with holdings in telephony and Internet services, at an estimated value of $150 billion, was a hostile one.

In defining mergers and acquisitions, size can matter as well. The combining of two firms of comparable size is often described as a merger even though it might in fact be an acquisition. For example, the integration of Daimler and Chrysler was pitched as a merger, though in reality Daimler acquired Chrysler, and later sold it. After emerging from bankruptcy restructuring, Chrysler is now majority-owned by Fiat, an Italian auto manufacturer.

In contrast, when large, incumbent firms such as GE, Cisco, or Microsoft buy start-up companies, the transaction is generally described as an acquisition. Although there is a distinction between mergers and acquisitions, many observers simply use the umbrella term *mergers and acquisitions,* or M&A.

LO 9-6

Define horizontal integration and evaluate the advantages and disadvantages of this option to execute corporate-level strategy.

horizontal integration The process of merging with competitors, leading to industry consolidation.

WHY DO FIRMS MERGE WITH COMPETITORS?

In contrast to vertical integration, which concerns the number of activities a firm participates in up and down the industry value chain (as discussed in Chapter 8), **horizontal integration** is the process of merging with a competitor at the same stage of the industry value chain. Horizontal integration is a type of corporate strategy that can improve a firm's strategic position in a single industry. As a rule of thumb, firms should go ahead with horizontal integration (i.e., acquiring a competitor) *if the target firm is more valuable inside the acquiring firm than as a continued standalone company.* This implies that the net value creation of a horizontal acquisition must be positive to aid in gaining and sustaining a competitive advantage.

An industry-wide trend toward horizontal integration leads to industry consolidation. In particular, competitors in the same industry such as airlines, banking, telecommunications, pharmaceuticals, or health insurance frequently merge to respond to changes in their external environment and to change the underlying industry structure in their favor.

There are three main benefits to a horizontal integration strategy:

- Reduction in competitive intensity.
- Lower costs.
- Increased differentiation.

Exhibit 9.5 previews the sources of value creation and costs in horizontal integration, which we discuss next.

REDUCTION IN COMPETITIVE INTENSITY. Looking through the lens of Porter's five forces model with a focus on rivalry among competitors (introduced in Chapter 3), horizontal integration changes the underlying industry structure in favor of the surviving firms. Excess capacity is taken out of the market, and competition tends to decrease as a consequence of horizontal integration, assuming no new entrants. As a whole, the industry structure becomes more consolidated and potentially more profitable. If the surviving firms find themselves in an oligopolistic industry structure and maintain a focus on non-price competition (i.e., focus on R&D spending, customer service, or advertising), the industry can indeed be quite profitable, and rivalry would likely decrease among existing firms. The wave of recent horizontal integration in the U.S. airline industry, for example, provided several benefits to the surviving carriers. By reducing excess capacity, the mergers between Delta and Northwest Airlines, United Airlines and Continental, Southwest and AirTran, and American and US Airways lowered competitive intensity in the industry overall.

Horizontal integration can favorably affect several of Porter's five forces for the surviving firms: strengthening bargaining power vis-à-vis suppliers and buyers, reducing the threat of entry, and reducing rivalry among existing firms. Because of the potential to reduce competitive intensity in an industry, government authorities such as the Federal Trade Commission (FTC) in the United States and/or the European Commission usually

EXHIBIT 9.5 / Sources of Value Creation and Costs in Horizontal Integration

Corporate Strategy	Sources of Value Creation (*V*)	Sources of Costs (*C*)
Horizontal integration through M&A	• Reduction in competitive intensity • Lower costs • Increased differentiation	• Integration failure • Reduced flexibility • Increased potential for legal repercussions

must approve any large horizontal integration activity. Industry dynamics, however, are in constant flux as new competitors emerge and others fall by the wayside.

In 2005, for example, the FTC did not approve the proposed merger between Staples and Office Depot, arguing that the remaining industry would have only two competitors, with Office Max being the other. Staples and Office Depot argued that the market for office supplies needed to be defined more broadly to include large retailers such as Walmart and Target. The U.S. courts sided with the FTC, which argued that the prices for end consumers would be significantly higher if the market had only two category killers.[57] A few years later, however, the competitive landscape had shifted further as Walmart and Amazon had emerged as ferocious competitors offering rock-bottom prices for office supplies. Subsequently, in 2013, the FTC approved the merger between Staples and Office Max. Just two years later, the FTC also approved the merger between the now much larger Staples and Office Depot.[58]

LOWER COSTS. Firms use horizontal integration to lower costs through economies of scale and to enhance their economic value creation, and in turn their performance.[59] In industries that have high fixed costs, achieving economies of scale through large output is critical in lowering costs. The dominant pharmaceutical companies such as Pfizer, Roche, and Novartis, for example, maintain large sales forces ("detail people") who call on doctors and hospitals to promote their products. These specialized sales forces often number 10,000 or more and thus are a significant fixed cost to the firms, even though part of their compensation is based on commissions. Maintaining such a large and sophisticated sales force (many with MBAs) is costly if the firm has only a few drugs it can show the doctor. As a rule of thumb, if a pharma company does not possess a blockbuster drug that brings in more than $1 billion in annual revenues, it cannot maintain its own sales force.[60] When existing firms such as Pfizer and Wyeth merge, they join their drug pipelines and portfolios of existing drugs. They are likely to have one sales force for the combined portfolio, consequently reducing the size of the sales force and lowering the overall cost of distribution.

INCREASED DIFFERENTIATION. Horizontal integration through M&A can help firms strengthen their competitive positions by increasing the differentiation of their product and service offerings. In particular, horizontal integration can do this by filling gaps in a firm's product offering, allowing the combined entity to offer a complete suite of products and services.

As mentioned in the ChapterCase, Disney acquired Marvel for $4 billion. This acquisition certainly allowed Disney to further differentiate its product offering as an entire new lineup of superheroes was joining Mickey's family, besides being able to offer Marvel superhero themed-rides and merchandise such as clothing (T-shirts, PJs, etc.) and toys. The Marvel acquisition passed an important test of value creation because Marvel is seen as more valuable inside Disney than outside Disney.[61] Because of economies of scope and economies of scale, Marvel is becoming more valuable inside Disney than as a standalone enterprise. The same argument could be made for the other recent Disney acquisitions, including Pixar and Lucasfilm, both highlighted in the ChapterCase.

WHY DO FIRMS ACQUIRE OTHER FIRMS?

LO 9-7

Explain why firms engage in acquisitions.

When first defining the terminology at the beginning of the chapter, we noted that an *acquisition* describes the purchase or takeover of one company by another. Why do firms make acquisitions? Three main reasons stand out:

- To gain access to new markets and distribution channels.
- To gain access to a new capability or competency.
- To preempt rivals.

Strategy Highlight 9.2

Food Fight: Kraft's Hostile Takeover of Cadbury

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In 2010, Kraft Foods bought UK-based Cadbury PLC for close to $20 billion in a hostile takeover. Unlike the more diversified food-products company Kraft, Cadbury was focused solely on candy and gum. Hailing to 1824, Cadbury established itself in markets across the globe, in concert with the British Empire.

Kraft was attracted to Cadbury due to its strong position in countries such as India, Egypt, and Thailand and in fast-growing markets in Latin America. Cadbury held 70 percent of the market share for chocolate in India, with more than 1 billion people. Children there specifically ask for "Cadbury chocolate" instead of just plain "chocolate." It is difficult for outsiders like Kraft to break into emerging economies because earlier entrants have developed and perfected their distribution systems to meet the needs of millions of small, independent vendors. To secure a strong strategic position in these fast-growing emerging markets, therefore, Kraft felt that horizontal integration with Cadbury was critical. Kraft continues to face formidable competitors in global markets, including Nestlé and Mars, both of which are especially strong in China.

To focus its different strategic business units more effectively and to reduce costs, Kraft Foods restructured in 2012. It separated its North American grocery-food business from its global snack-food and candy business (including Oreos and Cadbury chocolate), which is now Mondelez International. In 2015, Kraft Foods merged with Heinz (owned by Warren Buffett's Berkshire Hathaway and 3G Capital, a Brazilian hedge fund) in a $37 billion merger, creating the fifth-largest food company in the world, behind Nestlé, Mondelez, PepsiCo, and Unilever.

In the U.S. market, the Cadbury acquisition allows the new Kraft Heinz greater access to convenience stores, gives it a new distribution channel, and opens a market for it that is growing fast and tends to have high profit margins. Domestically, Kraft Heinz has to compete with The Hershey Company, the largest U.S. chocolate manufacturer. This battle is intense because Hershey's main strategic focus is squarely on its home market. With the U.S. population growing slowly and becoming more health-conscious, however, Hershey decided to enter the Chinese market in 2013, the world's fastest-growing candy market. Since its founding in 1894, Hershey's entry into China is the company's first new product launch outside the United States. Hershey's sales growth in China, however, has been disappointing so far. Combined with little or no growth in the United States, Hershey announced job cuts in 2015.[62]

TO GAIN ACCESS TO NEW MARKETS AND DISTRIBUTION CHANNELS. Firms may resort to acquisitions when they need to overcome entry barriers into markets they are currently not competing in or to access new distribution channels. Strategy Highlight 9.2 discusses Kraft's acquisition of Cadbury to tap into new distribution channels in both the United States and fast-growing international markets.

TO GAIN ACCESS TO A NEW CAPABILITY OR COMPETENCY. Firms often resort to M&A to obtain new capabilities or competencies. To strengthen its capabilities in server systems and equipment and to gain access to the capability of designing mobile chips for the Internet of things (the concept that everyday objects such as cell phones, wearable devices, temperature controls, household appliances, cars, etc., have network connectivity, allowing them to send and receive data), Intel acquired Altera for $17 billion.[63]

TO PREEMPT RIVALS. Sometimes firms may acquire promising startups not only to gain access to a new capability or competency, but also to preempt rivals from doing so. Let's look at the acquisitions made by two of the leading Internet companies: Facebook and Google.[64]

To preempt rivals Facebook acquired Instagram, a photo- and video-sharing social media site, for $1 billion in 2012. Snapchat, however, spurned a $3 billion offer from Facebook in 2013. Facebook then went on to buy the text messaging service start-up WhatsApp for $22 billion in 2014, making it one of the largest tech acquisitions ever. In the same year, Facebook paid $2 billion to acquire Oculus, a new venture making virtual reality headsets.

Google has made a string of acquisitions of new ventures to preempt rivals. In 2006, Google bought YouTube, the video-sharing website, for $1.65 billion. Google engaged in a somewhat larger acquisition when it bought Motorola's cell phone unit for $12.5 billion (in 2011). This was done to gain access to Motorola's valuable patent holdings in mobile technology. Google later sold the cell phone unit to Lenovo, while retaining Motorola's patents. In 2013, Google purchased the Israeli start-up company Waze for $1 billion. Google acquired Waze to gain access to a new capability and to prevent rivals from gaining access. Waze's claim to fame is its interactive mobile map app. Google is already the leader in online maps and wanted to extend this capability to mobile devices. Perhaps even more importantly, Google's intent was to preempt its competitors Apple and Facebook from buying Waze. Apple and Facebook are each comparatively weaker than Google in the increasingly important interactive mobile map and information services segment.

M&A AND COMPETITIVE ADVANTAGE

LO 9-8

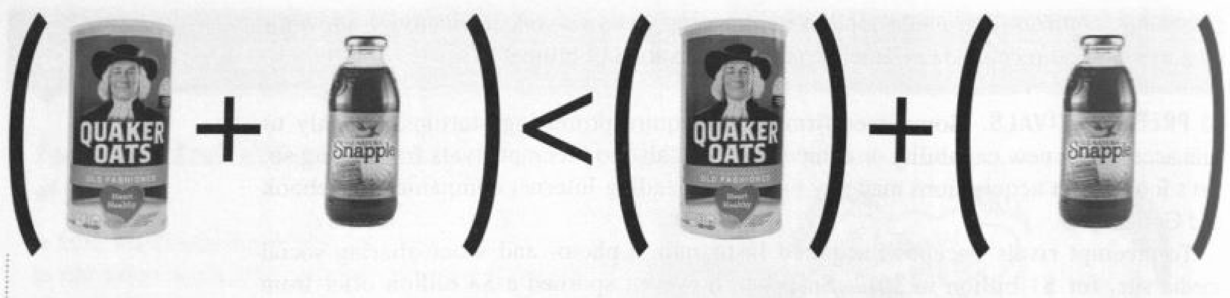
Evaluate whether mergers and acquisitions lead to competitive advantage.

Do mergers and acquisitions create competitive advantage? Despite their popularity, the answer, surprisingly, is that in most cases they do not. In fact, the M&A performance track record is rather mixed. Many mergers destroy shareholder value because the anticipated synergies never materialize.[65] If value is created, it generally accrues to the shareholders of the firm that was taken over (the acquiree), because acquirers often pay a premium when buying the target company.[66] Indeed, sometimes companies get involved in a bidding war for an acquisition; the winner may end up with the prize but may have overpaid for the acquisition—thus falling victim to the *winner's curse*.

Given that mergers and acquisitions, *on average*, destroy rather than create shareholder value, why do we see so many mergers? Reasons include:

- Principal–agent problems.
- The desire to overcome competitive disadvantage.
- Superior acquisition and integration capability.

PRINCIPAL–AGENT PROBLEMS. When discussing diversification in the previous chapter, we noted that some firms diversify through acquisitions due to principal–agent problems (see Chapter 8 discussion of managerial motives behind firm growth).[67] Managers, as agents, are supposed to act in the best interest of the principals, the shareholders. However,



Sometimes the combined value of two companies is less than the value of each company separately.
Oatmeal: © McGraw-Hill Education/ Mark Dierker, photographer; Snapple: © George W. Bailey/ Shutterstock.com RF

managers may have incentives to grow their firms through acquisitions—not for anticipated shareholder value appreciation, but to build a larger empire, which is positively correlated with prestige, power, and pay. Besides providing higher compensation and more corporate perks, a larger organization may also provide more job security, especially if the company pursues unrelated diversification.

A related problem is **managerial hubris**, a form of self-delusion in which managers convince themselves of their superior skills in the face of clear evidence to the contrary.[68] Managerial hubris comes in two forms:

managerial hubris A form of self-delusion in which managers convince themselves of their superior skills in the face of clear evidence to the contrary.

1. Managers of the acquiring company convince themselves that they are able to manage the business of the target company more effectively and, therefore, create additional shareholder value. This justification is often used for an unrelated diversification strategy.
2. Although most top-level managers are aware that the majority of acquisitions destroy rather than create shareholder value, they see themselves as the exceptions to the rule.

Managerial hubris has led to many ill-fated deals, destroying billions of dollars. For example, Quaker Oats Company acquired Snapple because its managers thought Snapple was another Gatorade, which was a successful previous acquisition.[69] The difference was that Gatorade had been a standalone company and was easily integrated, but Snapple relied on a decentralized network of independent distributors and retailers who did not want Snapple to be taken over and who made it difficult and costly for Quaker Oats Company to integrate Snapple. The acquisition failed—and Quaker Oats itself was taken over by PepsiCo. Snapple was spun out and eventually ended up being part of the Dr Pepper Snapple Group.

THE DESIRE TO OVERCOME COMPETITIVE DISADVANTAGE. In some instances, mergers are not motivated by gaining competitive advantage, but by the attempt to overcome a competitive disadvantage. For example, to compete more successfully with Nike, the worldwide leader in sports shoes and apparel, adidas (number two) acquired Reebok (number three) for $3.8 billion in 2006. This acquisition allows the now-larger adidas group to benefit from economies of scale and scope that were unachievable when adidas and Reebok operated independently. The hope was that this would help in overcoming adidas' competitive disadvantage vis-à-vis Nike. In the meantime, Under Armour has outperformed adidas in the U.S. market and has become the number two after Nike.

SUPERIOR ACQUISITION AND INTEGRATION CAPABILITY. Acquisition and integration capabilities are not equally distributed across firms. Although there is strong evidence that mergers and acquisitions, *on average*, destroy rather than create shareholder value, it does not exclude the possibility that *some* firms are consistently able to identify, acquire, and

integrate target companies to strengthen their competitive positions. Since it is valuable, rare, and difficult to imitate, a superior acquisition and integration capability, together with past experience, can lead to competitive advantage.

Disney has shown superior post-merger integration capabilities after acquiring Pixar, Marvel, and Lucasfilm. Disney managed its new subsidiaries more like alliances rather than attempting full integration, which could have destroyed the unique value of the acquisitions. In Pixar's case, Disney kept the entire creative team in place and allowed its members to continue to work in Pixar's headquarters near San Francisco with minimum interference. The hands-off approach paid huge dividends: Although Disney paid a steep $7.4 billion for Pixar, it made some $10 billion on Pixar's *Toy Story 3* franchise revenues alone. As a consequence, Disney has gained a competitive advantage over its rivals such as Sony and has also outperformed the Dow Jones Industrial Average over the past few years by a wide margin.

9.3 ◂▸ Implications for the Strategist

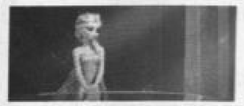
The business environment is constantly changing.[70] New opportunities come and go quickly. Firms often need to develop new resources, capabilities, or competencies to take advantage of opportunities. Examples abound. Traditional book publishers must transform themselves into digital content companies. Old-line banking institutions with expensive networks of branches must now offer seamless online banking services. They must make them work between a set of traditional and nontraditional payment services on a mobile platform. Energy providers are in the process of changing their coal-fired power plants to gas-fired ones in the wake of the shale gas boom. Pharmaceutical companies need to take advantage of advances in biotechnology to drive future growth. Food companies are now expected to offer organic, all natural, and gluten-free products.

The strategist also knows that firms need to grow to survive and prosper, especially if they are publicly traded stock companies. A firm's corporate strategy is critical in pursuing growth. To be able to grow as well as gain and sustain a competitive advantage, a firm must not only possess VRIO resources but also be able to leverage existing resources, often in conjunction with partners, and build new ones. The question of how to build new resources, capabilities, and competencies to grow your enterprise lies at the center of corporate strategy. Strategic alliances, mergers, and acquisitions are the key tools that the strategist uses in executing corporate strategy.

Ideally, the tools to execute corporate strategy—strategic alliances and acquisitions—should be centralized and managed at the corporate level, rather than at the level of the strategic business unit. This allows the company to not only assess their effect on the overall company performance, but also to harness spillovers between the different corporate development activities. That is, corporate-level managers should not only coordinate the firm's portfolio of alliances, but also leverage their relationships to successfully engage in mergers and acquisitions.[71] Rather than focusing on developing an alliance management capability in isolation, firms should develop a *relational capability* that allows for the successful management of both strategic alliances *and* mergers and acquisitions. In sum, to ensure a positive effect on competitive advantage, the management of strategic alliances and M&A needs to be placed at the corporate level.

We now have concluded our discussion of corporate strategy. Acquisitions and alliances are the key vehicles to execute corporate strategy, each with its distinct advantages and disadvantages. It is also clear from this chapter that strategic alliances, as well as mergers and acquisitions, are a global phenomenon. In the next chapter, we discuss strategy in a global world.

CHAPTERCASE 9 / Consider This . . .



THE CORPORATE STRATEGY of creating billion-dollar franchises is Disney's main focus. CEO Iger leads a group of about 20 executives whose sole responsibility is to hunt for new billion-dollar franchises. This group of senior leaders decides top-down which projects are a go and which are not. They also allocate resources to particular projects. Disney even organized its employees in the consumer products group around franchises such as *Frozen, Toy Story, Star Wars,* and other cash cows.

While things seem to be sunny right now in Southern California, there are clouds on the horizon. First, relying on a few big franchises is quite risky. What if the pipeline dries up? Many of Disney's greatest franchises such as *Star Wars* joined the family through an acquisition. (The newly released *Star Wars* sequel *The Force Awakens* is predicted to gross over $1 billion on the big screens, making it the third-bestselling movie ever after *Avatar* and *Titanic.)* An acquisition-led growth strategy, however, may not be sustainable because of the limited number of media companies such as Pixar, Marvel, or Lucasfilm that Disney can acquire. Second, some critics assert that focusing too much on billion-dollar franchises reduces originality and leaves consumers bored more quickly. Disney's recipe of success also becomes too predictable.

Third, and perhaps most important, roughly half of Disney profits come from its TV networks ESPN, ABC, and others. The media industry, however, is being disrupted: People spend much less time and money watching movies on the large screen and spend more time consuming content online via YouTube, Netflix, Hulu, and other streaming services. While ESPN is certainly very successful, the cost of rights to show the big sporting events live has escalated dramatically in recent years. In addition, more and more subscribers have cut their cable cord and get their media online. As a response, cable providers are more likely to unbundle their service offerings, which may create challenges for ESPN, an expensive part of the cable bundle (some estimate $8) with a narrow focus that doesn't appeal to everyone.

Questions

1. Do you think focusing on billion-dollar franchises is a good corporate strategy for Disney? What are pros and cons of this strategy?
2. Given the build-borrow-or-buy framework discussed in the chapter, do you think Disney should pursue alternatives to acquisitions? Why or why not?
3. Why do you think Disney was so successful with the Pixar and Marvel acquisitions, while other media interactions such as Sony's acquisition of Columbia Pictures or News Corp.'s acquisition of MySpace were much less successful?
4. Given Disney's focus on creating and milking billion-dollar franchises, some industry observers now view Disney more as a global consumer products company like Nike rather than a media company. Do you agree with this perspective? Why or why not? What strategic implications would it have if Disney is truly a global consumer products company rather than a media company?

TAKE-AWAY CONCEPTS

This chapter discussed two mechanisms of corporate-level strategy—alliances and acquisitions—as summarized by the following learning objectives and related take-away concepts.

LO 9-1 / Apply the build-borrow-or-buy framework to guide corporate strategy.

- The build-borrow-or-buy framework provides a conceptual model that aids strategists in deciding whether to pursue internal development *(build)*, enter a contract arrangement or strategic alliance *(borrow)*, or acquire new resources, capabilities, and competencies *(buy)*.
- Firms that are able to learn how to select the right pathways to obtain new resources are more likely to gain and sustain a competitive advantage.

LO 9-2 / Define strategic alliances, and explain why they are important to implement corporate strategy and why firms enter into them.

- Strategic alliances have the goal of sharing knowledge, resources, and capabilities to develop processes, products, or services.
- An alliance qualifies as strategic if it has the potential to affect a firm's competitive advantage by increasing value and/or lowering costs.
- The most common reasons firms enter alliances are to (1) strengthen competitive position, (2) enter new markets, (3) hedge against uncertainty, (4) access critical complementary resources, and (5) learn new capabilities.

LO 9-3 / Describe three alliance governance mechanisms and evaluate their pros and cons.

- Alliances can be governed by the following mechanisms: contractual agreements for non-equity alliances, equity alliances, and joint ventures.
- There are pros and cons of each alliance governance mechanism, shown in detail in Exhibit 9.2 with highlights as follows:

  Non-equity alliance's pros: flexible, fast, easy to get in and out; cons: weak ties, lack of trust/commitment.

  Equity alliance's pros: stronger ties, potential for trust/commitment, window into new technology (option value); cons: less flexible, slower, can entail significant investment.

  Joint venture pros: strongest tie, trust/commitment most likely, may be required by institutional setting; cons: potentially long negotiations and significant investments, long-term solution, managers may have two reporting lines (two bosses).

LO 9-4 / Describe the three phases of alliance management and explain how an alliance management capability can lead to a competitive advantage.

- An alliance management capability consists of a firm's ability to effectively manage alliance-related tasks through three phases: (1) partner selection and alliance formation, (2) alliance design and governance, and (3) post-formation alliance management.

- An alliance management capability can be a source of competitive advantage as better management of alliances leads to more likely superior performance.
- Firms build a superior alliance management capability through "learning by doing" and by establishing a dedicated alliance function.

LO 9-5 / Differentiate between mergers and acquisitions, and explain why firms would use either to execute corporate strategy.

- A merger describes the joining of two independent companies to form a combined entity.
- An acquisition describes the purchase or takeover of one company by another. It can be friendly or hostile.
- Although there is a distinction between mergers and acquisitions, many observers simply use the umbrella term *mergers and acquisitions,* or M&A.
- Firms can use M&A activity for competitive advantage when they possess a superior relational capability, which is often built on superior alliance management capability.

LO 9-6 / Define horizontal integration and evaluate the advantages and disadvantages of this option to execute corporate-level strategy.

- Horizontal integration is the process of merging with competitors, leading to industry consolidation.
- As a corporate strategy, firms use horizontal integration to (1) reduce competitive intensity, (2) lower costs, and (3) increase differentiation.

LO 9-7 / Explain why firms engage in acquisitions.

- Firms engage in acquisitions to (1) access new markets and distributions channels, (2) gain access to a new capability or competency, and (3) preempt rivals.

LO 9-8 / Evaluate whether mergers and acquisitions lead to competitive advantage.

- Most mergers and acquisitions destroy shareholder value because anticipated synergies never materialize.
- If there is any value creation in M&A, it generally accrues to the shareholders of the firm that is taken over (the acquiree), because acquirers