THE ALLIANCE ANALYST

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Alliances for the year 2000

Mr Ernst's third go-round

Alliance insight seems to be one of the earth's most perishable goods. If, in the 1980s, you had asked an American manager about alliances, the discussion would have almost certainly turned to international collaboration and the subtleties of partnering with such misunderstoods as the Japanese and the French. In the early 1990s, David Ernst and Joel Bleeke of McKinsey & Co produced a book mirroring this trend, devoted almost exclusively to foreign partnering.

But then the world changed. Alliances spread from the near-exclusive domain of international executives into the hands of virtually any and all line managers. These warriors and their bosses began forging strategic relationships everywhere—from suppliers and scientists to competitors and governments—and most were in their home markets. Confusion, miscommunication and missed opportunity enveloped the corporate landscape. Value escaped and executive tempers frayed. In the mid-1990s, David Ernst of McKinsey & Co and James Bamford of *The Alliance Analyst* produced a framework to assist companies in effectively coordinating portfolios of alliances. Their work helped modern organizations move to a new stage of evolution, one suited to the early demands of alliance capitalism.

But the world changed again. Alliances have become even more central to corporate success. As the stakes have risen, so has the understanding and sophistication of alliance management. Alliance deal types are becoming increasingly delineated, with a set of best-practices developing around each cluster. Collaborative strategies are being chiseled into a new art form. In the late 1990s, David Ernst has struck again. Not this time in the form of a guidebook or seminal article, but rather, on a soapbox at the 1998 Strategic Alliances Conference in London. Ernst, weary and bereft of handouts, cleared his throat and cast forth pure, unadulterated genius. Below are excerpts from his presentation.

Share of mind

All you read about in financial papers these days are big M&A deals. But as studies have shown, alliances also affect market value in a major way. When you look at many of the world's largest companies it turns out that more than 20 percent of their assets are tied up in alliances. So alliances are not capturing their rightful share of mind. What I'd like to do today is to right that wrong, primarily by focusing on three topics:

Alliances as a means of creating value. There are six alliance levers companies can pull to create value. I would encourage you to think about how many of those your company is using to date, and whether there might be a missed opportunity.

Seven alliance sins. These have a lot of overlap with others touted by various alliance pundits.

Lessons from successful companies. I will share with you the lessons from our research efforts on what distinguishes successful companies in managing individual alliances and alliance portfolios.

First, my definition of an alliance. A strategic alliance involves joint contributions where there is shared control and ownership, and where the two companies are both sharing the risk, the reward or the cost. There is usually some degree of exclusivity and they are often, but not always, temporary vehicles. So anything between a merger, an acquisition or a web strategy based on informal contract vehicles is an alliance. It would include joint ventures, nonequity alliances and minority equity stakes accompanied by an operating relationship. If you think back five or ten years you can see that we've moved from a space where most alliances were equity joint ventures in emerging markets, or R&D collaborations, to one where we have all kinds of joint ventures and many flavors of nonequity alliances. Some of the most common nonequity alliances include cobranding, comarketing, strategic outsourcing, cooperative bidding, joint purchasing, and so forth. And the number of deal structures is continuing to expand. On top of that, each industry has its own tailored deal structures.

Alliances to capture value

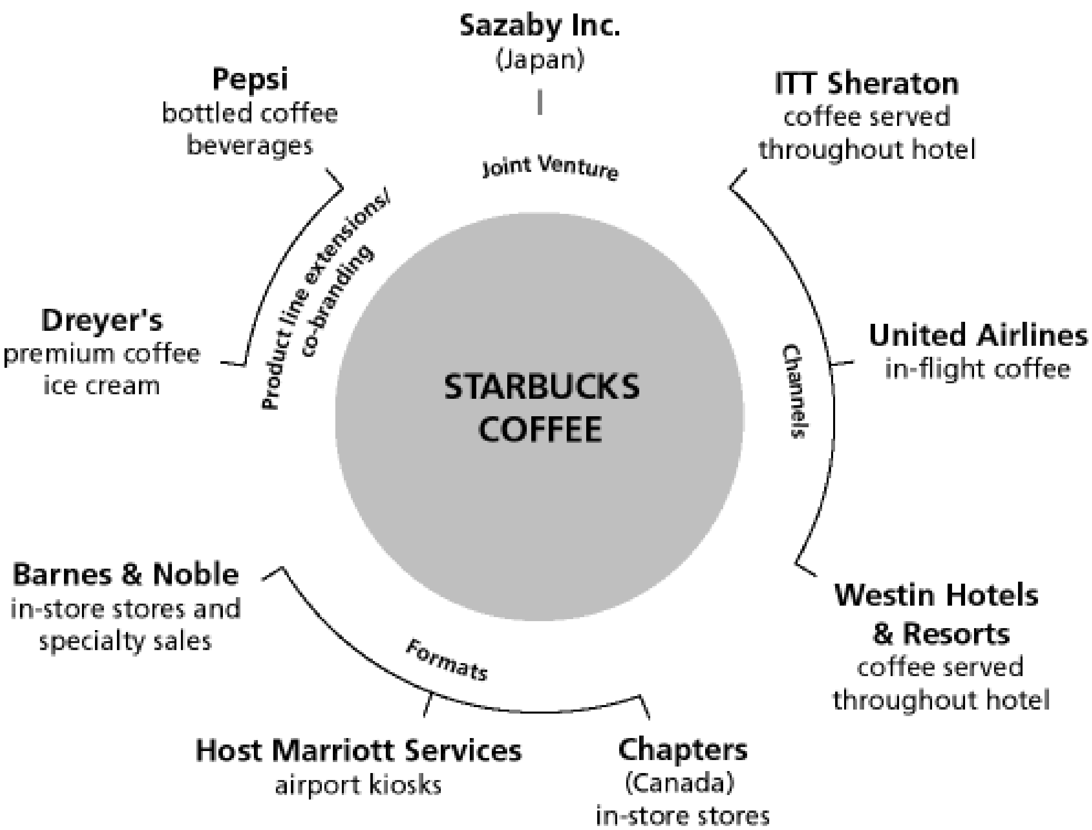
There are six main ways that alliances can be used to successfully capture value.

Alliances to build new businesses. Many companies have used joint ventures to build new businesses. Consider, for example, the successful joint ventures between Siemens and Corning in fiber optic cable, Microsoft and NBC in internet news, or First Data with its bank partners in creditcard processing. Nonequity alliances can also be used to build new businesses. Philips and Sony had a small nonequity alliance which they used to pool their patents in order to develop the compact disk. They then licensed the product as an open standard with Sony pushing it in Asia, and Philips pushing it in Europe and the US. In so doing, the two partners have garnered over a billion dollars in estimated licensing revenues. Pretty successful for a nonequity deal.

Alliances to enter new markets. We're all familiar with emerging market alliances. But what we are seeing now is the use of alliances to achieve a "global sliver effect." Under this approach, a specialized player pursues a product or value chain sliver on a worldwide basis. Think about Starbucks, which has leveraged a brand and a concept through a whole set of alliances (Exhibit 1). Some of Starbucks's alliances are geographic (Japan, Korea, Singapore), some are with customers like United Airlines and Westin Hotels, some are with retail formats such as Marriott, and some are with complementary producers such as Pepsi. Starbucks has grown from a small company 5 years ago, to one with a market cap of over $3 billion. Quite a success story.

Exhibit 1

Starbucks: brand-building partnerships



Alliances to access skills. Twenty years ago no one had heard of Samsung. Today it is a leading player in TV monitors, VCRs and a wide range of electronics and semiconductors. They accessed the skills and required technology platforms through multiple joint ventures and licensing agreements. Of a hundred or more new businesses they've started, at least twenty-five have gotten their start through joint ventures. Even when joint ventures haven't been the vehicles, the licensing arrangements have allowed them to access critical skills and technology.

Alliances to gain scale. So far I've mentioned the classic alliance strategies, putting together complementary capabilities for learning. We believe you can also use alliances in a very different way, much more like M&A. Think about BP and Mobil in Europe. They became the number one player in both gasoline marketing and refining by combining their Europe businesses in a region-wide joint venture. The companies have announced they expect to earn hundreds of millions of dollars annually in additional net income because of the alliance. The arrangement looks a lot like M&A as it allows partners to consolidate overlapping businesses. There are several reasons why companies might choose an alliance over an acquisition to gain scale: acquisition premiums are often high, most joint ventures are tax free, alliances do not come with a goodwill hit attached, and companies don't have to give up control of the business.

Alliances to improve supplier effectiveness. Mercedes is marketing the M-class sports utility vehicle very successfully in the US. What has Mercedes done that is different? They have shifted a lot of the risk, capital investment and effort to long-term suppliers. They have cut down the number of suppliers and they've signed long-term contracts with the remaining suppliers. In return they've insisted that suppliers speed up development time and invest their own money in developing some modules of the car. Mercedes is not alone. Companies from a range of industries are taking part of their value chain and shifting it out to their suppliers to improve overall effectiveness.

Alliances to create advantaged networks. Duke Energy is one of the world's leading utilities, with a price-earnings-ratio that has consistently been higher than that of many of its competitors. Stable short-term earnings have helped, but more important is its growth story—one that has been supported by alliances. For example, Duke brings expertise in operating power plants into joint ventures with Fluor Daniel where they build, own and operate power plants worldwide. Duke also has an agreement with Puget Sound Energy to broker electricity and natural gas in the northwestern United States (Exhibit 2). So getting beyond individual alliances to assembling a portfolio of alliances that stretches core competencies can create a growth story that has a real effect on market value.

Exhibit 2

A sampling of Duke Energy's alliances

Carolina Power Light and BellSouth	Joint Venture to develop wireless technology for voice, video and data
Fluor Daniel	Joint venture for turnkey E&C and O&M of coal-fired plants
Exxon	Joint venture to build coal-fired plants in China
Puget Sound Energy	Joint venture to broker electricity and natural gas in the Northwest
B&W Nuclear Service	Alliance for nuclear outage steam generator replacement
Peregrine Energy	Jointly pursue industrial energy projects in US
North Carolina State University	Alliance to develop and promote electro-technologies in textile industry
Mitsubishi	Joint venture to own and operate plants in Indonesia

Source: Alliance Analyst

Seven pitfalls to avoid

To avoid being categorized as an alliances purist, let me point out that many alliances don't succeed. Various studies, including ours, point to success rates anywhere between 30 to 60 percent. The question is how do you get into the successful group? The first thing is to avoid some of the common pitfalls. Here is my list of seven:

• unclear objectives

• lack of a detailed business plan

• decision gridlock

• aligning with a weak or competitive partner

• unmanaged cultural clash

• failure to learn or protect core capabilities

• failing to plan for alliance evolution

Everyone has more or less the same list. How do you avoid these pitfalls?

What distinguishes the winners?

If you look at successful companies operating effective alliances you can see a definite approach to how they develop alliance strategies, select partners, structure the deal and plan for evolution. There are four keys to success:

Have a clear alliance strategy. The next time you are forming an alliance write down on one piece of paper, and only one piece of paper, your definition of success for the alliance in three years time. What would be the financial measures and what would be the strategic measures? And what would those be for the partner? I would say that 80 percent of the time I've asked this question it has resulted in a couple of weeks of intensive soul-searching and work. Crispness of objectives is key.

Second, ask yourself the question, "Do we really need an alliance?" Alliances are terrible vehicles. You don't have control, you don't know how long it is going to last, you don't know whether your partners will change their objectives, and you may not know the whole partner organization. Only use alliances when you need to: when going-it-alone will take too long or cost too much, when you need more control and alignment than is possible with an arms-length contract, or when seeking very specific capabilities. Sometimes you may want to use a joint venture if it is the only way to buy or sell a business.

Choose your partners carefully. Choose financially strong partners. Alliances between two strong partners have a success rate that is twice that of alliances in which even one of the partners is weak. If executives have to spend attention on fixing a weak core business they will not have the time to focus on the alliance. Second, for alliances that are not aimed at consolidation, find partners that have very different strengths than you. Kentucky Fried Chicken and Mitsubishi may sound like strange bedfellows, but their alliance makes a lot of sense. KFC wanted to sell fried chicken in Japan and needed to know where to buy or lease real estate. Mitsubishi happened to have that capability. Because the two companies are very different there was no threat of competition, conflict or a buy-out in that alliance.

Third, culture. Culture can be divided into a number of components. Executives need to consider the following questions: What are their partner's values? Are their objects to maximize revenue, to maximize shareprice, to maximize profits, or are they really focusing on cashflow? What does the organization look like? If it is an oil company, are they organized by assets, region or by function? If it is a pharmaceutical company, are they organized by function or therapeutic area group? Is it a highly centralized or decentralized company? Is it hierarchical? What is the share of base-pay versus performance or bonus? What kinds of schools are employees hired from and what is the turnover rate? There are about 20 indicators of culture that give a very good sense of what the important differences are between companies.

Fourth, in terms of partner choice, it is important to think about how bargaining power evolves. This is just as important in nonequity deals as in joint ventures. Consider an alliance in the automotive products business. The emerging market distribution partner had a license to the product. The producer was a global company whose brand was on the product and whose technology was used. It became clear to the distribution company that they had a $300 million business that was completely dependent on the license of their partner. They were thinking about a pan-regional strategy in the Americas, but the license expired in two years. They needed to renegotiate the alliance immediately when their partner's switching cost was high, for in two years it was going to be quite low. So thinking about bargaining power is absolutely crucial.

Choose the right structure and govern accordingly. Executives need to think about structuring alliances in a way that is very different from M&A. It is not about price and value. It is about scope and strategy, and it is about governance. Legal and financial arrangements follow rather than lead. There is often a trade-off between how much value you get out of a structure and the complexity and commitment of that deal structure. For example, two companies were considering a joint venture. Joint ventures can be very complicated, so we looked at the alternatives and found that if the company did a contractual joint purchasing and cross-selling alliance they would capture about $150 million in value. They could have captured slightly more value with an alternate structure, but they felt the added complexity outweighed the benefits.

Setting up an effective governance structure is crucial, and we estimate that about half of alliance failures result from governance issues. For example, a Japanese and a US company had a joint venture in the US where the R&D and manufacturing personnel reported to the Japanese parents, while sales and marketing was handled by the US parent. A customer asked for a change in the product, and promised a very large order on completion of that change. What happened? The sales people talked to the R&D staff, who "negotiated" the product change through a series of discussions with the parent and the potential customer. But by the time a decision was reached the customer had decided to go with a competitor who could make decisions more rapidly. Joint venture success required a decision-making structure that was more cohesive.

There is no "best practice" or "one size fits all" answer for setting up alliance governance. If you are setting up a JV, there are three basic governance models to choose from. The preferred model, all else equal, is to set up the JV as a largely autonomous unit, like the Siemens Corning venture. These are autonomous strong organizations that make more of the major decisions: hire, fire, pricing, most capex decisions, etc. A second model is BP Mobil, which is what I'd call dependent. BP takes the lead on the refining and marketing part of the alliance. Mobil takes the lead on the lubricants business. Many oilfield joint ventures follow this model; with one of the partners acting as the operator.

But increasingly, joint ventures and other forms of alliances follow a third model: interdependence. These are alliances where you cannot escape having multiple levels of interaction by the parents. For example, Toshiba and Motorola established a joint venture where they relied on Toshiba for DRAM technology, and on Motorola for microprocessor technology.

Plan for evolution. The lessons for joint venture evolution are pretty well known (Joel Bleeke and David Ernst, "Is your strategic alliance really a sale?," *Harvard Business Review*, 1995), but here are some thoughts about nonequity deals. If you are committing exclusive rights you should think about exit. Case in point: a US consumer goods company signs an exclusive ten-year license with a leading player in a significant Latin American country. At the time it was a great deal. However a number of problems arose: the local partner did not perform, competitors started attacking the market, and there was no exit clause. The US company had committed all of its sales potential in a major geographic region for 10 years with no way out. Thinking about an exit is quite important anytime you have locked up your intangible assets or customers in an alliance.

Prepare for scope expansion and restructuring. This is necessary for all forms of alliances, from licensing deals to joint ventures. The most successful alliances tend to evolve and grow. Executives need to be ready. How will the alliance grow? What kinds of conflicts will that create? What is the natural lifecycle of the technology or product? Will the alliance need to be escalated from a licensing deal to a joint venture? Will additional partners need to be added? There is a whole mindset about alliances that has to do with evolution that is absolutely crucial to future success. Alliances are not necessarily a success if they last a long time. Yet if executives don't think about alliance evolution, the chance of success is slim.

Alliances are powerful creators of wealth. The success rates are quite mixed, though. What is most important is crisply defining success for each and every alliance. Other key factors include choosing strong and complementary partners, having a balance of bargaining power, tailoring the scope, structure and governance of the deal and effectively managing alliance evolution.