Alliances and risk:
securing a place in the victory parade

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Summary

Large companies once embraced joint ventures to share the risk of large projects, but their motives today are more diverse. ***Benjamin Gomes-Casseres*** *suggests that alliances can help companies hedge between competing technology standards and reduce the costs of major strategic change by bringing new skills to a participating company. An alliance might be regarded as an option on future developments - a company either takes it up or discards it according to changing conditions. Some alliances indeed enable business risks to be managed directly. Despite these attractions, relationships between companies in a joint venture are often risky in and of themselves. The author closes with some advice for ensuring that the company's allies do not become its enemies.*

Thirty years ago, if you asked the chief financial officers of large companies why they used joint ventures, they would likely say: "To share risk". In fact, the modern joint venture format was all but invented by oil companies to do just that. Exploring for oil was a risky endeavour and a series of dry holes could be costly - better to share these costs with a partner, even if this also meant sharing the rewards of a successful strike.

Today the CFO of a new-economy enterprise is likely to offer a more complex answer to the same question. Risk-sharing will feature among the motivations for alliances, but it may not be as important as gaining access to complementary resources, influencing industry standards or beating rivals in the rush to market. What they may not realise is that in these strategies too, alliances are a way of managing risk.

Today's alliances not only help companies share the costs of risky projects, they also help them hedge risks, mitigate the costs of responding to unpredictable trends and, most importantly, buy and shape options to exploit future opportunities.

However, both our old- and new-economy CFOs face an unpleasant paradox. To manage the business risks they face, they are choosing an organisational strategy that is itself notoriously risky - many joint ventures and other alliances end in nasty divorce or mutual disappointment. In a sense, alliance strategies enable companies to buy protection from business risk only by taking on additional "relationship" risks. The tragedy for many companies is that they have no comprehensive framework with which to evaluate this trade-off. The risks of managing alliances are fairly well known, but the roles of alliances in managing business risk are not. Here we will focus on the latter and briefly summarise the former.

Uncertainty and alliances

The strategic risks that companies face stem from uncertainty in their technological, market and competitive environments. This means that they cannot be confident of the pay-off of a given strategic move, such as investment in a new plant or development of a new product. What can they do? One approach is to minimise the damage of a negative outcome. Another approach is to avoid committing to a definite strategy until the future is clearer. Yet a third policy is to try to influence the uncertainty itself. Sometimes a combination of policies can be used.

Alliances can help in all these approaches to strategic risk. To see why, we must begin by defining "alliance". An alliance is a unique organisational structure to enable co-operation between companies. It comes in many forms, from simple joint ventures to complex consortia and ever-changing co-development agreements. Regardless of the form, the alliance governs an ongoing, open-ended relationship between companies that themselves remain separately owned. One-off, arm's-length deals with clear terms and conditions are not alliances; neither are complete mergers or acquisitions. The beauty - as well as the challenge - of an alliance lies precisely in its flexibility and the partial commitments of its members.

As a rule, alliances enable companies to make incremental commitments to an unfolding strategy, a useful feature when environmental uncertainties preclude decisions that are more definite. In addition, the partial commitments involved in alliances leave the company with resources to invest in more than one such arrangement, thus spreading and diversifying the risk. At the same time, however, the open-ended nature of an alliance means that if not managed carefully, it can unravel and nullify all the potential benefits. If the partial commitments of members are not enough to compel them to act co-operatively, the alliance can be a recipe for strategic gridlock. The two sides of this coin are reviewed separately.

Managing strategic risks

Lower exposure to risk

Involving many partners in a risky venture reduces the exposure that each has to the possibility of failure. This technique is as old as capitalism - the English East India Company used it in the 17th century to finance risky voyages. In the 20th century oil exploration companies often teamed up. In today's high-tech economy the explorers are not sailing to distant continents or drilling the earth - they are colonising the sky or probing the depths of DNA and atomic structures.

A prime example is Iridium - the consortium of electronics, aerospace and telecommunications companies that launched 66 satellites into space and initiated the first round-the-world telephone service in late 1998. The enterprise cost more than $5bn and filed for voluntary bankruptcy within a year.

Why? Many answers have been offered. Prime among them is that the project was overtaken by technological and market trends that were not foreseen when the initiative was launched. Being at the leading edge of technology and aiming to serve a market that did not yet exist brought huge risks for Iridium. Motorola, the US mobile telecommunications manufacturer, and its partners did well to lower their exposure to the possibility of failure. They are not alone. All the remaining satellite-communication projects underway are led by consortia of players seeking to share risk. Even Microsoft's Bill Gates has teamed up with the mobile phone pioneer Craig McCaw and Motorola to share in the next-generation Teledesic project.

This case shows why alliances can be valuable in lowering a company's risk exposure. Aside from the presence of uncertainty, the project itself is large and "lumpy" - a company cannot decide just to launch one satellite in an effort to lower its exposure. Similar conditions exist in bio-engineering research and in the push to create ever smaller structures on semiconductor chips, an area where alliances abound.

Hedge your bets

Another useful feature of alliances in bio-engineering and semiconductors is that they allow companies to hedge their bets among two or more competing technologies. This is also a chief reason why alliances in the dotcom world have proliferated so rapidly. In this strategy, not only is the company's exposure to failure in any one project reduced, but, more importantly, its chances of succeeding somewhere are increased.

Bill Gates uses this strategy too. Microsoft has been investing in a slew of companies offering competing solutions to address the coming convergence between the TV and the PC. No one knows exactly how this will occur. So, Microsoft has invested in AT&T to spur the rollout of high-speed internet access over telephone lines, in Nextel Communications to develop wireless internet access and in Comcast to promote access over cable-systems. It is likely that one or more of these options will pan out and that others will not. Either way Microsoft is likely have at least one winning bet. It may then use this to raise the ante on competitors.

Alliances are most useful in hedging your bets when there is uncertainty among competing future outcomes. This kind of uncertainty is common to the dotcom world in which there are likely to be one or only a few winners. In these "winner-takes-all" markets, it pays suppliers, customers and providers of complimentary technologies to ally with several parties to secure a place in the triumphal parade.

Reduce your transition costs

In both hedging and risk-sharing strategies, the company takes a passive role after forming its alliances. As events unfold, the company is protected from excessive loss because of its portfolio of alliances. However, alliances are also used in the more active management of risk, as the next three sections reveal.

One common use of alliances is to change the capabilities and strategic position of a company. Xerox, the US printer and copier manufacturer, and Corning, a leading US glass and systems manufacturer are among enterprises that are well known for having used joint ventures to enter new markets abroad and gain access to new technologies.

Other companies have used mergers and acquisitions for the same purpose - Daimler-Benz did so in acquiring Chrysler, becoming a German-US automotive group. When should a company, under pressure to change business capabilities or market position, use an alliance and when an acquisition? Differences in cost apart, these alternative strategies manage risk differently.

Two risks are inherent in any effort at transforming a company's business: the risk of setting off in the wrong direction and the risk of stumbling badly, even when headed in the right direction. Using alliances rather than acquisitions can mean lower "transition costs" in both situations. An alliance lets a company test out the new direction and then retreat gracefully if it proves to be the wrong move. This is generally less costly than acquiring a company and then divesting it. An alliance also helps transfer knowledge and skills gradually while a partner maintains an interest in the business; an acquisition can well kill the spirit that promised to renew the acquiring company.

A case in point involves AT&T, the US telecoms carrier. For decades, computer and telecommunications companies had thought that someday their technologies would merge. However, in a scenario akin to the TV-PC convergence described above, no one knew when or precisely how this would happen. Even faced by this big uncertainty, AT&T charged ahead to acquire computer company NCR for $7.5bn in 1991. As it turned out, there was little synergy between the two and AT&T spun off its acquisition in 1996, after the latter racked up more than $3bn in losses. An initial alliance to test the idea might have saved money, time and effort. Taking smaller steps can help managers gauge the terrain better and assist them in avoiding premature fatigue.

Buy options on the future

An alliance at an early stage of industry transformation can also be seen as a way of "buying" an option on future developments. The company first invests in an alliance and then has the option either to exit or get more deeply involved after it sees how the business develops. The cost of entering a relationship is relatively small in this case, as is the cost of exit; but the value of the option to grow the relationship may be high. Let us take a brief detour into financial options.

An option, in the financial world, is the right to buy or sell a security within a given period at a pre-arranged price. It is not a definite commitment do anything. If the option is not exercised within the period, it expires. The chief value of the option comes from the flexibility it offers to act in the future as new events unfold. Consequently, the higher the uncertainty in the environment about future events, the higher the value of this flexibility.

Corning Glass used alliances as options to explore and ultimately take leadership in optical fibres. When it started research on this technology in the 1970s, the idea of transmitting information in the form of light pulses through a glass fibre had not been tested outside the laboratory. Corning used a series of early alliances with telecommunications companies and research outfits to reduce technical uncertainties and develop a commercial solution. After it gathered new information, Corning launched a second wave of alliances, this time with early users and manufacturers. Its most important manufacturing ally was Siemens, which became a 50 per cent partner in Siecor, the optical cable company that soon rose to a dominant position in the industry. By 1999, Corning's interest in optical fibres had grown such that it preferred to "exercise" its option fully to own and manage the business and it bought out Siemens's share.

Manage business risk directly

In our fifth strategy, alliances can actually reduce business risks directly by improving a project's chances of success. This strategy is often complementary to the others; a company may do what it can to make a project succeed, while also hedging its bets in case of failure.

The pharmaceutical industry has many examples of this type. Sometimes major pharmaceutical companies make multiple investments in bio-technology start-ups and in university laboratories primarily to share risks and hedge their bets. At other times, however, they get deeply involved in shaping the agenda of a start-up or coaching it in marketing, the regulatory process and other matters that can make or break a new drug. Often, this direct management of risk is reflected in complex sequences of decisions and milestone payments, designed to guide the start-up while also creating an option-like flexibility for the larger partner.

The deal between Abbott Laboratories, the US drug and medical products maker, and Japan's Takeda Chemical Industries is a good example. In 1977 they formed TAP Pharmaceuticals, a US-based joint venture that initially would have access to all of Takeda's R&D for use in the US market. This was a classic use of the options approach to alliances, as it was uncertain which compounds would turn out to be commercially viable in the US. Abbott did not just sit by and watch the uncertainties resolve themselves. Instead, it helped TAP develop a marketing strategy and sales force and manage the long and complex drug approval process at the Federal Drug Administration. With Takeda's compound and Abbott's contributions to management, TAP Pharmaceuticals eventually developed Prevacid ®, a block-buster drug that accounted for approximately $2bn in sales in 1999.

Here too alliances were useful in dealing with risks that are inherent in the project. Another important way in which today's alliances reduce business risk directly, particularly in hotly-contested internet technologies, is by helping rivals agree on common standards. However, the risk protection offered by alliances is never free. Aside from the out-of-pocket costs of forming and managing alliances, the organisational strategy itself implies taking on additional risks.

Relationship risks in alliances

Management lore on alliances is full of anecdotes of messy relationships and of allies that turned into rivals. We need not emphasise that a poor structure or partner choice can doom an alliance from the start, nor that insufficient attention to post-deal alliance management can ruin a promising relationship. Still, it may be useful to recap how companies can manage the relationship risk in their alliances:

- Avoid "co-opetition": the risk of conflict is high in alliances between rivals.

- Define the scope carefully: Even among companies that are not direct rivals, good fences make good neighbours, to borrow a phrase from the poet Robert Frost.

- Do not ignore governance: careful structuring of the alliance in advance of the deal and continual adjustment thereafter is key to building a constructive relationship.

- Build multiple bridges: enable relationships among partners to grow at many levels of their organisations.

- Do not trust trust: personal chemistry is good and needed, but it is no substitute for monitoring mechanisms, co-operation incentives and organisational alignment.

- Success begins at home: without a support system within your own organisation, your external alliances are doomed to fail.

- Do not stare at the downside, watch for the upside: Failed alliances do not achieve what they set out to do, but successful alliances achieve much more than their original goals planned for.

Alliance strategy

These guidelines for alliance success have one thing in common: they treat the alliance as an evolving organisation embedded in a dynamic strategy. An alliance, in this view, is much more than "the deal" that is typically announced with much fanfare in the business press.

A simple play on words summarises this point: Companies should build "alliance strategies" not "strategic alliances". The difference is not semantic. Every manager has seen how excessive focus on the deal can lead to neglect of *the strategy behind the deal*. Why are we participating in an alliance? How will we manage it? How does this alliance fit our overall "constellation" of allies? How will we support it internally? These key questions go well beyond the closing of a deal. Effective use of alliances to manage risk requires such a dynamic perspective.

Further reading

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Spekman, Robert E., Lynn A. Isabella, and Thomas C. MacAvoy. *Alliance Competence: Maximizing the Value of your Partnerships* (New York, NY: John Wiley, 2000).

Articles and links at www.alliancestrategy.com.

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