Strategy Before Structure

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"Jest 'op up that ladder, Jim, and see if she's safe."

The following article is an outgrowth of a conversation with **Benjamin Gomes-Casseres**, professor at Brandeis University and author of *The Alliance Revolution: The New Shape of Business Rivalry.*

Q: Executives are beginning to talk about the need to link alliances to strategy. What do they mean by that?
A: I'm encouraged that you are hearing such talk. Most of the executives I speak with are good at tying internal growth to strategy, which the board demands, moderately successful at roping mergers and acquisitions to strategy which the market demands, and are awful at linking alliances to strategy, which nobody demands. This shallow strategic foundation has resulted in some rickety alliance structures. And these structures can be dangerous, both to executive careers and company value.

Let me give you two examples. In 1988, Mitsubishi and Daimler-Benz launched a joint venture to market automobiles in Japan. Global competition drove the companies into each other's arms and their capabilities seemed well-matched. But the strategic intent of the alliance was never clear. No major projects were forthcoming -- the alliance was stillborn. Then there is the case of IBM and Apple forming a much-touted alliance in 1990. Together they planned to take on Intel and Microsoft, but beyond this their goals were unclear. Despite the vague strategy, IBM and Apple signed a multi-part agreement outlining areas of collaboration, including investments in joint ventures and the formation of joint labs. The alliance was a failure and eight years later it has faded away.

Analysts and managers will argue eternally over what caused each link-up to fail. Some will blame egos and clashing cultures; others will cite business conflicts and ruthless competition. Yet such cases of unfulfilled promise often share one syndrome: amidst the hoopla, the creation of alliances comes to be seen as an end in itself, rather than as means to a broader strategic end. The failure of these deals teaches one clear lesson: it is the strategy behind the deal that matters, not the structure of the deal.

Companies that have heeded this lesson are generally more successful in alliances than those who have ignored it. Sun Microsystems, for example, has leveraged its core capabilities impressively through many alliances. Some of those alliances have been long-lived, others have been short. Some were narrowly focused, a few were broad. Sun's partners are large and powerful, and include Fujitsu, Toshiba, Oracle and IBM. But none of these partners or alliances, by themselves, account for Sun's success. Rather, it is Sun's overarching alliance strategy that deserves the credit.

Q: How should executives go about developing and implementing an alliance strategy? And how should they link the strategy to alliance structure?
A: All strategy should grow out of an assessment of the firm's external competitive environment, its internal capabilities and its desired goals. Only once these are meshed should executives develop tactics and policies. Going outside the firm to gain access to

capabilities should be part of the initial strategy. Unfortunately, alliance activity is often an afterthought. Alliance anecdotes filter down from golf outings and executive retreats. Alliance opportunities are pitched by myriad companies to multiple parts of the firm. Often it is well into negotiations before someone cobbles together a strategy to justify the alliance. Such an approach is nonsense; strategy must come first.

Once the strategy is in place, a partner needs to be chosen. This is the second most important step, and here again, companies tend to lack discipline. Partner choice is usually strictly ad hoc. More about this later.

You asked me to tie strategy to structure. It's good to see you've been reading Alfred Chandler. Strategy and structure are both important to alliance success. Strategy I've talked about, structure everyone talks about. Witness the mounds of books and legions of consultants selling plans to alliance success. Most have a top-ten list of critical factors--I have one too--and most are focused on the structural elements (Exhibit 1).

Exhibit 1

Alliance success factors

An alliance strategy creates the context for the success of individual partnerships, as explained in this article. In addition, ten factors pertaining to the deal itself are critical.

1. ***Have a clear strategic purpose.***
   Alliances are never an end in themselves—they ought to be tools in service of a business strategy.
2. ***Find a fitting partner.***
   This means a partner with compatible goals and complementary capabilities.
3. ***Specialize.***
   Allocate tasks and responsibilities in the alliances in a way that enables each party to do what it does best.
4. ***Create incentives for cooperation.***
   Working together never happens automatically, particularly not when partners were former rivals.
5. ***Minimize conflicts between partners.***
   The scope of the alliance and of partners' roles should avoid pitting one against the other in the market.
6. ***Share information.***
   Continual communication develops trust and also keeps joint projects on target.
7. ***Exchange personnel.***
   Regardless of the form of the alliance, personal contact and site visits are essential for maintaining communication and trust.
8. ***Operate with long-term horizons.***
   Mutual forbearance in solving short-run conflicts is enhanced by the expectation of future gains.
9. ***Develop multiple joint projects.***
   Successful cooperation on one project can help partners weather the storm in less successful joint projects.
10. ***Be flexible.***
    Alliances are open-ended, dynamic relationships that need to evolve in pace with their environment and in pursuit of new opportunities.

Don't get me wrong; these lists do have their place. But executives need more than a prefab plan. They need to tailor alliance architecture to alliance strategy. There is no one-size-fits-all answer. The best practices for a supply alliance are likely to be quite different than those for a learning alliance. A supply alliance is usually driven by a desire to reduce costs, improve quality and focus core competencies. Such an alliance, by its very nature, needs to be run differently than a learning alliance formed for knowledge absorption purposes.

Q: You claim that executives need to pay more attention to strategy, be more rigorous in partner choice, and show more finesse with structural issues. Are these all equally important?
A: I've come to look at those three elements not as equals but as subsidiary to each other. That is, the strategy determines the partner choice, and the partner choice determines the structure. Fundamental strategies rarely change, and partners generally stay for the life of the alliance. Structure is the most fluid and in many ways the least important of the three.

Q: Tell me about partner choice.
A: Partner selection generally happens in one of three ways: A company responds to an unsolicited approach, executives call industry contacts or executives simply go with the market leader. More analytical rigor is required.

For example, partnering with a market leader does not make sense in all situations. Imagine you work for a small software company that has developed a new program relevant to certain industries. Indeed, the program has the potential to revamp the way business is conducted in those industries. In this case, partnering with a market leader may not make sense. Market leaders have much to lose and little to gain by introducing the product. A better approach would be to partner with an aggressive, up-and-coming player.

Another partner choice issue is second-order or third-order connections. A partner may look good on its own, but may be tied up by corporate enemies. Executives need to take a fuller view of emerging partner-clusters within an industry.

Then there are the usual partner choice concerns: can we get along with a particular company, what is their management like, do our cultures fit, have we had a successful relationship with them in the past, etc. (Exhibit 2) These issues are still important, and you would be surprised how little time is spent on them.

Exhibit 2

Partner choice

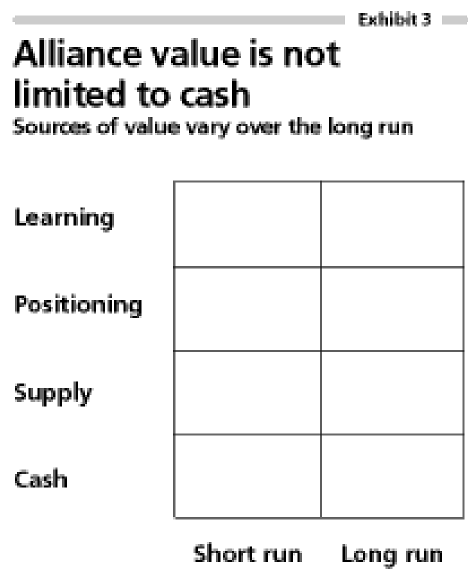
	Company A	Company B
Complementary capabilities		
• product and market • technology and capital • global network & local customers		
Conflicts of interest		
• overlapping geographic markets • competing sources of production • transfer pricing across companies		
Compatible goals		
• market access...product access • local knowledge...technology • time savings...cash generation		
Targets and missions		
• common rivals • new market, new technology • time horizons • value		

Getting partner choice right goes a long way toward ensuring effective alignment of interest. There is no structure in the world that is going to make a workable alliance between certain companies. The built-in friction, strategic and otherwise, is too great. Having said that, structure does play an important role as it aligns incentive structures, establishes governance mechanisms and allows for evolution over time.

Q: Take us through the three structural elements you mentioned: incentive alignment, governance mechanisms and alliance evolution.
A: Let me start with incentives. Cooperation is not a natural act for companies. Everything in their competitive environment, and in their corporate histories, drives them toward win-lose competition and a reliance on internal resources. This is beginning to change. An increasing number of companies are built around an alliance strategy. Charles Schwab, America Online and MasterCard come to mind. But even those companies tend to have a bias toward selling their own product over a partner's product, all else being equal. To overcome this natural barrier to cooperation, firms must create compelling incentives.

Most executives intuitively understand this, but many still fail to fully explore their options. They focus on division of equity, licensing terms, milestone payments and transfer pricing. These are all important but ignore the non-financial aspects often critical to corporate motivation. It sounds heretical, but short-term financial returns are not the be-all and end-all.

I'm not saying that alliance-based companies shouldn't thump the value drum as loudly as anyone else. It’s just that there is more than one beat. Value from an alliance can vary from cash, to product supply, to competitive positioning in the market, to learning (Exhibit 3).



Often what financial people are interested in, and good at measuring, is short-term cash. That is, the bottom left-hand corner of the diagram. They also understand the value of products that the alliance is supplying to the company. But it is rare that companies have developed ways of measuring long-term value associated with market positioning or learning. That is a problem because alliances are often based on vague desires to improve learning or positioning. Without appropriate measures and monitors alliance progress can't be tracked, managerial adjustments can't be made, and stakeholders--whether they be shareholders, customers or employees--can't be motivated.

The news is not all bleak. I've seen a handful of companies whose alliances are subject to the regular business planning process. I've even seen executives track progress against key performance metrics. While these practices are still the exception, I expect them to become the norm.

Q: Tell me more. What performance measures should I be establishing for a non-equity research alliance, and how should they differ from, say, a marketing joint venture?
A: You've asked the question in a way that many people tend to ask it. That is to say, backwards. You're starting with the structure or deal, and then asking how to measure it. Structural considerations such as equity versus non-equity are of secondary concern. The non-backwards way is to think about strategic intent. What is the alliance trying to achieve?

In the case of your learning alliance, performance metrics may focus on access to new technologies, rights of discovery, improvement in R&D cycle times, effectiveness of knowledge capture, minimization of knowledge leakage and so on. The performance metrics must be tied to the alliance's strategic intent, be measurable and be well-communicated. A marketing alliance could have performance metrics ranging from market share, customer access, insight to customer needs and product design. It all depends on the goals.

Once again, I think there is a tendency to focus on structure and ignore strategy. It is sort of a legalistic tendency. Many managers will say, "For an equity alliance what are the rules?" Or they will say, "For a non-equity alliance, what are the milestones?" These are valid concerns. There ought to be milestones, and obviously if there is equity there has to be some return. But if we don't go back to what the original purpose of the arrangement is, we are unlikely to come up with a good set of measures.

Q: What can you tell me about alliance governance?
A: It is not possible to think coherently about governance without clearly defining the term "alliance." My definition is one that Analyst subscribers will be familiar with: an alliance is a way of managing an open-ended agreement between two companies. What I mean by open-ended is that things are going to change or evolve as the alliance progresses. An alliance is a way of sharing control over future decisions and governing future negotiations between the firms--it is a recognition that the initial agreement is in some sense incomplete (Exhibit 4).

Exhibit 4

Alliance agreements are open-ended and incomplete

- Changes in technology and markets
- Uncertainty in what resources joint work will require
- Difficulty in measuring inputs or outputs
- Integration among concurrent projects
- Difficulty in protecting intellectual assets

If all the terms of an exchange between two firms can be completely specified and agreed upon at the outset, they need not form an alliance; a simple purchase order or legal contract will do. If executives can make the agreement sealed and complete I would encourage them to do so. But for many reasons, such finality is not possible. Hence we are stuck making these incomplete contracts work.

The key to making them work is effective governance of the "open-end." It is the role of alliance governance to help determine information flows, establish decision-making processes, delineate executive responsibilities, integrate partner operations, products and so on. If executives get this correct at the outset, they will have to spend less time in the alliance management swamp later on.

Q: Could you share an example of where good governance principles have been well-applied?
A: One high-profile information technology company has been working with a constellation of partners for some time. The company makes a core product and relies on partners for logistics and after-sales service. The company started out with a very large number of partners but has since scaled back. It found that the network was too large, too loose and uncommitted. The company decided to shrink the group and tighten the governance structure. It created subcommittees around key issues and promoted an all-inclusive alliance council forum.

There were a couple of things the constellation did to avoid death-by-committee. The lead company had the goal of maximizing joint value and distributing it fairly. It instituted a simple, effective incentive program that encouraged the partners to work together to minimize costs of delivery. For example, if suppliers were able to deliver a service below current cost, the company shared the gain with them. Once the financial incentives were in place and had been shown to work, it was fairly easy to build a set of common processes and practices around other goals.

Q: You talk about alliances being open-ended contracts and governance structures needing to adapt to evolution. How do companies ensure that they maintain their standing as the alliance evolves?
A: To avoid losing influence companies must do three things: they must keep an eye on their own strategy, they must monitor the source of value they contribute to the alliance and they must continue to invest in themselves. For example, if the goal of the alliance is to learn, then executives should realize the key to increased influence is the ability to absorb and implement knowledge.

The GM-Toyota NUMMI joint venture is a great example. Equity was split 50-50. Toyota brought a manufacturing process and a design, and GM brought market knowledge, labor knowledge and a plant. It sounded like an even match. But when you look at the companies' commitment and intent you find a different story. Toyota managed the plant itself and was exposed to daily learning-by-doing. GM, on the other hand, sent a rotating group of visitors to look at the plant one or two days per week. Toyota was seeking to break into the American market and was desperate to understand what it would take to compete. GM wanted to prod and poke Japanese efficiency but had little desire or ability to overhaul its Detroit plants.

Not surprisingly, Toyota learned more than GM. Over the life of the alliance, the balance of power continued to shift toward Toyota. No amount of governance restructuring by GM lawyers could right the imbalance.

Q: Evolution often means exit. How should executives prepare?
A: Managers complain about high “divorce rates” in alliances, and consultants run statistical studies on alliance instability. This focus on termination rates misses the central point: alliances are a means to an end, not an end in themselves. Alliance longevity is irrelevant--strategic success is what counts.

Sometimes the strategy will call for using alliances as transitory mechanisms on the way to a full acquisition or full divestiture. At other times, particularly in the case of technological uncertainty, alliances may be used as positioning markers or R&D bets. Such a strategy is no different from an internal investment program where companies hedge their bets or pursue parallel projects. The flexibility and thus instability of alliances is often a strength, not a weakness.

Executives should talk about exit mechanisms during initial alliance negotiations. At the very least, such discussions are a useful way of understanding the potential partner's key issues. But they shouldn't over do it. Too much talk of post-alliance options, and suspicion settles in for good.

Q: Your book, *The Alliance Revolution*, talks about a new form of business rivalry: constellation-based competition. What key strategic issues arise in this context?
A: In traditional competitive strategy the notion of barriers to entry is central. By raising

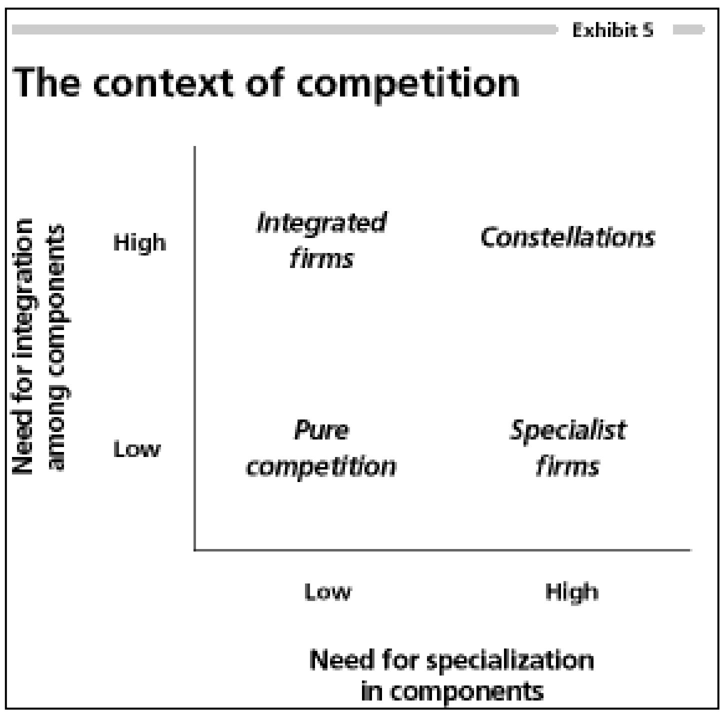
these barriers incumbent firms can keep potential competitors at bay and exploit market power. When rivals can gain advantage through collaboration, however, another type of barrier can be used: barriers to collaboration. Anything that makes it costly to form and manage an alliance successfully constitutes a barrier to collaboration.

Military strategists have known for ages how important barriers to collaboration can be. For Sun Tzu, the famous Chinese military strategist, one of the first moves in war was: "Disrupt his alliances." His commentator Tu Yu added: "Do not allow your enemies to get together." And, with a slightly different twist, Wang Hsi elaborated: "Look into the matter of his alliances and cause them to be severed and dissolved." This age-old wisdom suggests three offensive strategies that firms can use to raise the costs or reduce effectiveness of a rival's alliance.

The first strategy is, as Sun Tzu said, disrupting a rival's existing alliances. For example, a firm might form a new alliance with a member of a rival group or even with common third parties. Competition along one leg of the triad tends to disrupt collaboration in other legs. As a possible defense against this strategy, the rival may seek ways to improve control--for example, by a merging or restructuring the alliance.

The second strategy involves preempting a rival's potential alliances. "Do not allow them to get together," to paraphrase Tu Yu. Knowing that a rival will need access to a given capability, a constellation may try to corner the market for that capability by forming alliances with the most attractive partners. Firms can do the same through acquisitions or alliances.

The third way to reduce the effectiveness of a rival alliance is by shifting the context of competition so as to place strain on that alliance. "Cause them to be severed," in Wang Hsi's words. A constellation competing with a single firm may have an advantage when competition revolves around complex, loosely integrated products and services. Single firms--which have the advantage of unified control--may try to redefine the industry context to make narrow business focus and tight integration more important (Exhibit 5).



Q: What are the key structural issues for constellations?
A: In order to be effective, a constellation must maximize the benefits of collaboration and minimize the conflicts among members. Sun Tzu's words are again relevant: "He whose ranks are united in purpose will be victorious." My research revealed at least four lessons that can help managers improve their chances of success in collective competition.

The first lesson is that the balance between competition and collaboration is delicate and needs to be managed constantly. Allies can turn into serious rivals, particularly when partners develop joint products and share sensitive information. The evidence suggests that market competition can seriously threaten the success of technological collaboration; pre-competitive alliances are thus not likely to succeed. Conversely, constellations with a promise of benefits for all, such as standard setting consortia, have a better chance of success.

Our second lesson is that alliance instability need not be feared, but embraced. Indeed, managers should be wary of alliances that are too stable, a condition that may indicate stagnation or, worse, mounting pressure for change. Effective constellations adapt to changes in the environment and in the partners' capabilities and goals. In particular, a rival's use of alliances creates pressures for new alliances or for modifications to one's constellation. As with bilateral alliances, it is important to remember that dissolution does not necessarily mean failure.

The third lesson is that constellations should be structured to minimize the coordination costs of multiple alliances. Large group sizes and internal conflicts tend to increase managerial complexity and costs. A large number of partners often make it more difficult to integrate operations and to unify the group behind a strategic goal.

In using multiple partners, firms must heed a fourth lesson: They must position themselves strategically among constellations, as well as within each constellation. Two sets of factors affect the value a firm can receive from a constellation. One set influences the group's collective benefits, and the other influences the firm's power to claim a share of those benefits. Managers must be concerned with both their own firm's profits and those of their allies.

Q: Any big-picture thoughts to leave us with?
A: More than two decades ago, as the controversy surrounding the power of multinationals was heating up, a seminal study by Raymond Vernon began as follows: "Suddenly, it seems, the sovereign states are feeling naked. Concepts such as national sovereignty and national economic strength appear curiously drained of meaning." In reality, the author showed, multinationals were not the single-minded powerhouses feared by sovereign states. Still, they represented a new source of economic efficiency and power.

Today, single firms are feeling naked, as the locus of economic power shifts toward constellations. The reality of alliances is complex, but their impact on every facet of economic competition is profound. No firm can afford to ignore the use of alliances in competitive strategy. And all firms--whether they use alliances or not--will face a new competitive environment in which the players take on more varied shapes and in which the pattern of rivalry is transformed.