The three laws of business combinations: how to create value by remixing assets

Benjamin Gomes-Casseres

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Benjamin Gomes-Casseres has adapted this article from his latest book, *Remix Strategy: The Three Laws of Business Combinations* (Harvard Business Review Press, 2015).[1] A professor at Brandeis University's International Business School (bgc@brandeis.edu), where he directs the Asper Center for Global Entrepreneurship and teaches courses in strategy, alliances, and acquisitions, he has researched and taught the topic of business combinations for 30 years and consulted with major corporations in the US and abroad.

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Business is being turned outside-in. Acquisitions, mergers, joint ventures, alliances, partnerships and other business combinations are bringing in resources from outside the firm. And they are no longer exceptions in most businesses – they have become central to gaining competitive advantage.

This is not surprising. At the most basic level, new value often comes from combining ideas and effort from disparate sources–labor and capital, technology and brand, hardware and software, global and local. In today's world of fleeting advantage, combining assets, capabilities, markets and talent pools is even more important than ever.

This combining of resources to create new value is the business "remix." Remix strategy is thus the mixing of resources, assets, and capabilities of one organization with those of another to create value.

The first to see focus on the role of business combinations in competition was Joseph Schumpeter, the great political economist of the early twentieth century. In his pioneering work on entrepreneurship, he described how the normal routine of a business could be upended by new combinations of the elements of the business. Entrepreneurs, he argued, are the ones who made these new combinations – combinations of existing and new manufacturing processes, of markets and new sources of supply, of new products and technologies, and even of new corporate structures and strategies. These new combinations were at the heart of his theory of innovation.

Although the remixing of businesses is not a new phenomenon, we have not previously recognized fully how to use it to advance strategy. The real issue is not whether you should be looking outside your walls for resources. The question is how these ventures will enhance your competitive position. How will they create value? And how are you going to capture that value? Whether you are at the top of the company driving the remix, in the middle managing an acquisition or a partnership, or among the operating ranks keeping the pieces humming, you need to know the answers to such questions. The remix strategy framework gives practitioners a simple but powerful guide to see clearly what the key decisions are and then to navigate those decisions successfully.

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The three laws

Successful business combinations – those that turn out to be a profitable use of resources – all follow three laws. These laws are not formulated as commandments or orders, but are necessary conditions for success. All business combinations must have the

potential to create joint value, must be governed to realize this value, and must share value in a way that provides a reward to each party's investment (see Figure 1-1).

First law: identify potential joint value

The combination must have the potential to create more value than the parties can alone. The first law asks these practical questions: How much more value can we create in the market together? What specific resources must we combine to create this value?

The potential for joint value creation drives any business combination. Out of this value, each party might earn a return on its efforts. But in fact, the benefits of a combination may come in various forms – from added cash profits or lowered costs to added learning or sustainability of an advantage. And the steps from strategic benefits to market valuation are, in themselves, usually rough estimates at best. Furthermore, each partner may perceive the benefits from any given combination differently and they make the initial evaluation of joint value murky.

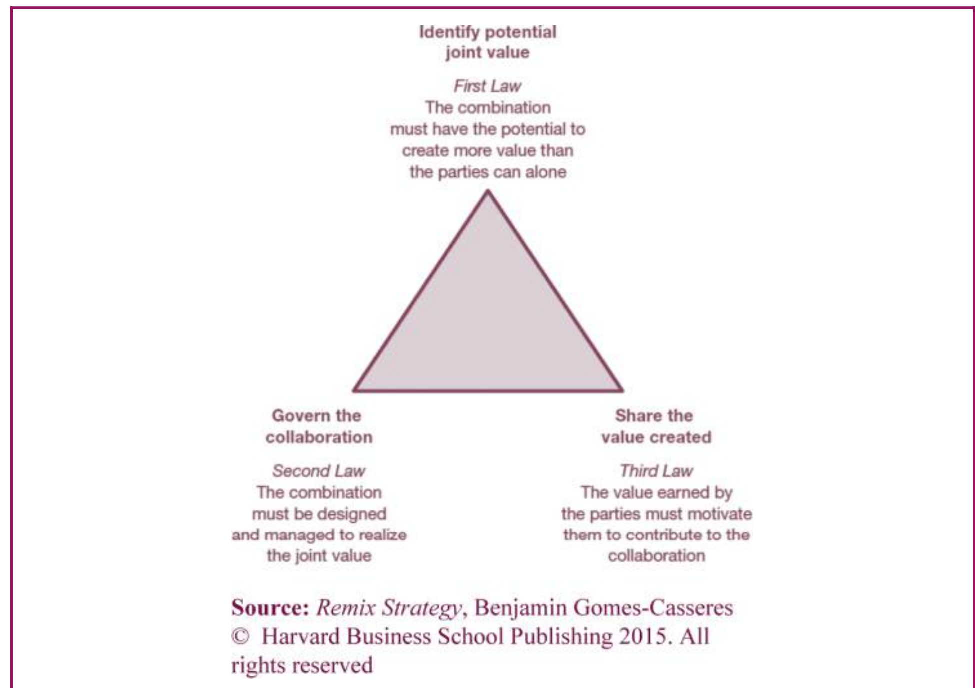
To address these kinds of ambiguities, we need to focus concretely on the economic and competitive mechanisms that will drive the creation of joint value. This calls for fundamental strategic analysis. Why would combining resources yield an added benefit? What new competitive advantages are generated by the combination? Does how the resources are combined matter? Which key levers affect the amount of value created by the combination?

Second law: govern the combination

The combination must be designed and managed to realize the joint value. Key questions here are: Which partners and structures fit this goal best? How do we manage the risk and uncertainty inherent in such combinations?

The second law of business combinations is that they must be implemented in a way that creates joint value in reality, not just on paper. Joint value does not appear automatically when assets are combined; value creation and distribution also depend on how the combination is shaped and managed after the initial deal is concluded. And

Figure 1-1 The three laws of business combinations



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the combination itself can take many forms – from a merger to a loss alliance; selecting the right form for the task is the first step in effective governance of collaboration.

The elements that are critical to creating joint value must be managed effectively in a coordinated fashion. If the main source of joint value is economies of scale in production, for example, then the combination – whatever its form – must successfully integrate investment and management of the production facilities. If the joint value comes from sales, then that aspect of the deal, similarly, needs coordinated management.

Third law: share the value created

The value earned by the parties must motivate them to contribute to the combination. Questions to consider: How to divide the joint value created? How will value be shared over time?

Even when joint value is created by a well-governed combination, a company might not receive a good part of the value. That's why the last law is certainly not the least: ultimately, the joint gains need to be divided in a way that leaves each party better off than it would have been without the combination. The share of profits is the reward, or incentive, that encourages each party to contribute its resources to the combination.

Determining this split of profits is often just as hard as estimating the joint value itself. Just as the joint value depends on future trends in the competitive environment, so too does the division of profits. The balance of power between the parties in the combination usually evolves, and with it, so do the profit shares. This third law of business combinations is intimately tied to the other two laws. Because of these links, companies often look at the other two laws through the lens of what they will gain or lose in this final equation. In other words, they evaluate the potential for joint value with a keen eye toward what share of value each party will capture, and they consider governance in the same way.

Rethinking strategy

These three laws apply to every combination and should shape your whole approach to competition. As the use of combinations increases, competition is becoming a battle of groups of firms against other groups. These "constellations," composed of firms and their allies, have boundaries and structures that shift continually. Because of this, remix strategy has implications for all of the big questions in strategy. This new perspective helps us rethink strategic decisions in five key areas: (1) the unit of competition in strategy; (2) the source of competitive advantage; (3) the scope of governance; (4) how to manage change and innovation; and (5) the determinants of your return on investment.

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Combinations of resources compete, not firms

In the traditional approach to strategy, the unit of analysis is either the business or the corporation as a whole. The scope and content of strategy will be different for business units and entire corporations. In remix strategy, the fundamental unit of analysis is the combination of resources that yields value. That combination competes with other combinations. Some combinations will gain advantage over others because they encompass just the right resources; others will gain advantage because they manage their collective resources better than others do.

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The organization that governs the asset combination may well be a firm. But there are many alternatives to this governance form, including constellations of various shapes and sizes that

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are composed of allied firms and that may be structured in many ways. In traditional strategy, we think of the firm as a bundle of resources. But in fact, the bundle of resources that is critical for success need not always be shaped as a firm.

The right combination yields competitive advantage

Traditional strategic thinking argues that advantage comes from your resources and activities. Remix strategy adds a twist – it posits that you can derive advantage from the way you combine resources, including resources that you don't own.

But if external resources are so important in your strategy, might your dependence on them not neutralize your potential advantage over another firm? After all, both you and your competitors may have access to the same external resources. The answer is no, you can still create a unique advantage – but you must create it through the smart use of your combinations. How well resources are matched determines the joint value that they can generate. In addition, the way the combination is governed determines whether the potential joint value is reached or falls short. These two factors leave much room for firms to differ in terms of the advantages that they might derive from a combination, even if they have the same external resources available to them.

Govern what matters – even if you don't own it

Governance traditionally refers to the way decisions are made about the use of the corporation's assets. In remix strategy the term refers to how you best manage a combination of assets to create value. Many of those assets may not fall under the usual scope of governance, because they are not owned by the firm. You can expand the strategic options available to your firm by keeping an open mind about precisely how resources should be recombined.

Governance of combinations is an organizational strategy – akin to the way firms need to organize internally to implement strategic goals. Organizational choices inside firms affect the success of various strategies. For example, depending on your firm's strategy and situation, you may prefer to manage internal resources in a centralized or decentralized way.

Remix strategy extends this idea to assets beyond your firm's boundaries, but not without adding complexity. Designing and managing groups of allied firms is challenging because of the multiple interests involved. In internal organization, even disparate units have common interests in that they are owned by a single firm. Internal management relies on bureaucratic power, incentives and controls, routines and processes, among other factors. Cross-firm management uses all these tools, plus contracts, partial ownership, and more ambiguous factors like organizational trust and reputation.

Remix to innovate and reposition

Recent strategic thinking shows that competitive advantage is often fleeting and that success depends on speed and agility. With a constellation of allies, you can quickly expand your range of competitive moves.

Remix strategy can drive change and innovation, as envisioned by Joseph Schumpeter a century ago. Product or business model innovation often relies on external resources.

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Business remix also creates its own new form of competition – whole new industries can come into being through combinations.

Making business combinations is also a speedy way to reposition your company. Switching partners, adding partners and just growing a constellation of allies can be important strategic moves in a world in which combinations of resources compete against each other. In fact, the easy-in, easy-out nature of alliance constellations often leads to competition for partners.

As a corollary to these switches, new combinations can also block rivals. In principle, every new alliance creates a new, friendly relationship. But it may also generate several new enemies – the firms that weren't selected or those that were closed out of future partnerships. For this reason, every new alliance can create barriers to collaboration for future suitors. No alliance is a watertight defense against a determined foe, but the maneuver is a relatively low-cost ways to block a rival.

Value is earned at two levels – the combination and its members

The ultimate goal of your strategy, of course, is to achieve superior performance. So, you naturally want to evaluate strategic options by their promised contribution to that performance. Here again, in the new world of group versus group – or combination versus combination – sticking to traditional metrics can lead to misguided decisions.

In this world, performance needs to be measured at different levels in a combination. Should you evaluate the performance of the resource combination as a whole or of its constituent parts? An analogy: What matters more in baseball – the success of a team or a player's individual statistics, or perhaps the contribution that a player makes to the performance of others? It all depends on your point of view. Team owners will think differently than players will.

In a constellation of related, but independent firms, each party will likely measure success on its own terms – that is, the firm will aim for a return on its own resources. But paradoxically, this return will depend on the performance of the group as a whole. Whenever firms get together to compete as a group, they need to focus on two elements of remix strategy: (1) the competitive advantage of the group over other external rivals and (2) their own bargaining position among members inside the group. The interaction of these two elements determines what each firm will earn on its resources. The game of strategy may have changed – with complex constellations now battling against firms – but we still keep score the old way.

Combining assets in new ways is a powerful route to creating value and is more common and more effective than many people think. Following Joseph Schumpeter's vision, I equate this method of creating value with entrepreneurship writ large – not just the launch of new firms, but also the turn around and restructuring of mature businesses. You can mix and match assets to make a strong, new business and to remodel an old business into something better. Doing so successfully requires a change in perspective. Instead of seeing competition as a battle of firm vs. firm, you need to think hard about how bundles

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of resources compete, regardless of whether they are organized as firms. To do this you will need the new tools of remix strategy and the three laws of business combinations.

Acknowledgments

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Note

1. www.remixstrategy.com

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