The Role of Alliances in Corporate Strategy
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Alliances have become an increasingly important—and complex—part of corporate strategy. The last two decades of the twentieth century witnessed explosive growth in corporate partnering. According to one estimate, approximately 35 percent of global corporate revenues in 2002 were a direct result of alliances—up from only 2 percent in 1980.1 Clearly, alliances have become an integral part of the corporate-finance and corporate-development tool kit.

The economic downturn following the bursting of the Internet bubble of the late 1990s caused the number of new alliances created worldwide each year to decline precipitously. Nevertheless, alliances remain central to competitive advantage in key sectors of the global economy, such as telecommunications and pharmaceuticals. As more and more companies shift their attention to growth after a period of consolidation and restructuring, it’s likely that the upward swing in alliances will resume again. This is a trend that has already begun in some regions of the world.

In order to create successful alliances, however, a company must know when an alliance is appropriate and when it is not. One of the main reasons to engage in alliances—as opposed to mergers and acquisitions (M&A)—is to share risk and limit the resources a company must commit to the venture in question. Alliances can be extremely useful in situations of high uncertainty and in markets with growth opportunities that a company either cannot or does not want to pursue on its own.

But the very characteristics that make alliances attractive also put strict limits on their usefulness. Alliances are more appropriate for some business goals (for example, participating in incremental revenue enhancement) than for others (for instance, achieving economic synergies through cost cutting). And the advantages of shared risk are often offset by unclear governance and a lack of genuine commitment. It’s important for a company to understand when alliances make strategic sense—and how to recognize and react when they begin to deliver diminishing returns.

Alliances are also notoriously difficult to manage. In many respects, implementing an alliance is similar to conducting a merger or an acquisition. A company needs to put a structured process in place in order to define the explicit role of alliances in its strategy, identify appropriate partners, structure the right kind of relationship, and manage the relationship over time. But alliances also differ significantly from M&A. In many cases, a company needs to establish clear criteria for exit—before entering into a partnership. And it must be prepared to monitor the relationship continuously and interact effectively with its partners in order to achieve its goals.

The Role of Alliances in Corporate Strategy distills lessons about alliance strategy and management drawn from recent client work and research by the Corporate Finance and Strategy practice of The Boston Consulting Group. The report

• describes the situations in which companies should pursue an alliance strategy instead of a strategy based on M&A
• presents research on recent trends in alliance formation and performance
• defines a structured six-step process for managing alliances
• analyzes the role of alliances in three key industries: telecommunications, airlines, and pharmaceuticals
• introduces BCG’s ten-point CEO alliance checklist

The Strategic Logic of Alliances

To understand the growing importance of alliances and the management challenges they present, consider the following three examples:

In February 1999, the Japanese mobile-telephone carrier NTT DoCoMo launched its *i-mode* service for mobile access to the Internet. Within a brief three-year period, the company was able to establish *i-mode* as the dominant industry standard in Japan, attracting 30 million subscribers and penetrating 45 percent of the Japanese market for cellular phones. What accounted for *i-mode*’s rapid growth? A key factor was that instead of developing its own content, DoCoMo formed alliances with a wide range of content providers. These partnerships allowed the company to quickly assemble a critical mass of rich content and services that made *i-mode* immediately attractive to Japanese consumers.

In the 1990s, the airline industry witnessed the development of a handful of global multicarrier alliances. These alliances provided airlines with a highly effective means of skirting legal and regulatory barriers to consolidation and capturing incremental revenue. By 2004, the three major airline alliances accounted for roughly half of the global passenger market and more than half of global revenue. However, the alliance structure has proved to be considerably less effective when it comes to eliminating overcapacity and realizing synergies through aggressive cost cutting. For this reason, the next phase in the industry’s evolution is likely to happen through M&A rather than through alliance formation.

With patent expirations increasing and the existing stock of blockbuster drugs leveling off, the global pharmaceutical industry needs to find new ways to fill its diminishing pipelines. One important way companies are addressing this challenge is by licensing new compounds developed by small biotech companies. Alliance deals involving big pharmaceutical and small biotech companies are growing in value by more than 20 percent per year and penetrating into earlier and earlier stages of drug development. (For in-depth examinations of these three examples, see the case studies on pages 10, 18, and 24.)

Clearly, alliances have become an integral part of the corporate-finance and corporate-development tool kit. Although the number of new alliances created each year has recently declined, alliances remain central to competitive advantage in key sectors of the global economy, such as telecommunications and pharmaceuticals. As more and more companies shift their attention to growth after a period of consolidation and restructuring, it’s likely that the upward swing in alliances will resume again. This trend has already begun in the Americas.

In order to create successful alliances, however, a company must understand how alliances differ from other forms of corporate control and recognize when they make strategic sense—and when they do not.

### Defining Alliances

Alliances represent a distinctive type of corporate control. Although in many respects they pose managerial challenges that are similar to those of other forms of corporate control, alliances also present distinctive characteristics that need to be considered.

Business relationships between companies can run the spectrum from a simple, short-term transactional relationship (for example, between a corporate customer and its supplier) to a full-fledged acquisition in which one company takes full ownership of another. (See Exhibit 1, page 8.) A transactional relationship allows one company to influence and, to some degree, direct the actions of another company. But it is a relatively light form of control, restricted to terms stipulated in a contract and gen-
erally limited in scope and duration. At the same time, the allocation of business risk between buyer and seller tends to be highly asymmetric, depending on which party has the preponderant market power. In an acquisition, by contrast, the acquirer expends resources to gain complete control through ownership of the assets and capabilities of the acquired company. But the acquirer also assumes full responsibility for any risks those assets incur.

Alliances fall in the middle of this spectrum. They are interfirm collaborations in which two or more companies jointly invest in an activity over a number of years, sharing in the risks and potential returns but remaining independent economic agents. In the case of one form of alliance—the joint venture—an alliance involves the creation of a new legal entity, and the time frame is generally long term.2

But most alliances are simply contractual relationships of greater complexity than traditional customer-supplier relationships. (For example, some involve an exchange of equity.) Although alliances tend to last longer than a typical buyer-supplier contract, they also usually have a clear endpoint, whether it be a specific point in time or a threshold defined in terms of invested costs or expected returns.


**When Alliances Make Strategic Sense**

Alliances can be an extremely effective way to embrace new strategic opportunities, pursue new sources of growth, and contribute to the upside of the business. They are particularly useful in situations of high uncertainty and in markets with growth opportunities that a company either cannot or does not want to pursue on its own. One of the main reasons to engage in an alliance (as opposed to M&A) is to share risk and limit the resources a company must commit to the venture in question.

Risk can take many different forms. One is the financial risk associated with the high costs of the investment that is required to pursue a particular opportunity. An alliance can be a way to spread—and sometimes even lower—those costs. The multi-carrier alliances in the airline industry, for example, allow companies to take advantage of the network effects made possible by a global system of hubs that any single company would find financially prohibitive to build on its own. Similarly, in the automotive industry, companies have engaged in joint research in certain base technologies in order to take advantage of economies of scale unavailable to any single partner.

Companies also commonly use alliances to manage the risks associated with emerging geographic markets. This trend has been exacerbated by legal and regulatory provisions in some countries that require global companies to create joint ventures as
a condition for direct foreign investment. Take the example of China. Although the Chinese economy is increasingly open to foreign investment, there are still many situations in which multinational companies are obliged to take on a Chinese partner (and, in some cases, a majority partner) before they may invest in the country.3

Finally, companies in industries going through a major technological or business discontinuity are increasingly turning to alliances to manage the risks associated with uncertainty. In situations in which the future evolution of an industry is highly uncertain, alliances can be a way to combine capabilities and explore new market opportunities—without committing too many resources before the future shape of the industry becomes clear. The telecommunications industry, for example, is currently going through a profound transformation brought about by the convergence of telecommunications, information technology, and consumer electronics, and by the parallel deconstruction of the value chain of traditional telecommunications. As companies in the industry try to cope with the implications of these changes, a number have turned to strategic alliances to test new business models and market opportunities.

An alliance can also be an effective way for two (or more) companies to combine complementary assets and attack a business opportunity together. For example, big pharmaceutical companies are increasingly entering into licensing partnerships with small biotech firms. Through these alliances, the pharmaceutical companies are able to stock their new-drug pipelines relatively cheaply, and the small biotech companies get access to the large firms’ formidable global marketing and sales capabilities.

However, alliances are less effective when the partners’ assets overlap considerably and when there is economic value to be gained through consolidation and cost cutting. Because the partners in an alliance remain independent, no one partner is able to control the others completely—and, therefore, to decide who will suffer the pain of tough decisions about reducing costs or consolidating operations. In the airline industry, for example, multycarrier alliances have been effective at generating new sources of revenue through such mechanisms as code sharing. But they have been less successful at consolidating alliance members’ IT operations. In this respect, M&A is a much better mechanism for cutting costs than alliances are. (See Exhibit 2 for a summary of the differences between alliances and M&A.)

3. For further information on requirements for multinational investments in China, see http://www.fdi.gov.cn/main/indexen.htm.

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### Exhibit 2

M&A AND ALLIANCES DIFFER ON SEVERAL DIMENSIONS

<table>
<thead>
<tr>
<th></th>
<th>M&amp;A</th>
<th>Alliances</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Synergies</strong></td>
<td><strong>Reciprocal</strong></td>
<td><strong>Modular or sequential</strong></td>
</tr>
<tr>
<td>Control</td>
<td>High</td>
<td>Low</td>
</tr>
<tr>
<td></td>
<td>Full ownership</td>
<td>Flexibility and quick implementation</td>
</tr>
<tr>
<td></td>
<td>Unambiguous corporate governance</td>
<td>One or multiple partners</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Benefits from network effects</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Cultural fit important</td>
</tr>
<tr>
<td>Resources</td>
<td>“Hard” and therefore easy to value</td>
<td>“Soft” and therefore difficult to</td>
</tr>
<tr>
<td></td>
<td>High redundancy</td>
<td>value</td>
</tr>
<tr>
<td></td>
<td>High potential for economies of</td>
<td>Low redundancy</td>
</tr>
<tr>
<td></td>
<td>scale</td>
<td>Low potential for cost cutting</td>
</tr>
<tr>
<td>Risk and</td>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td>uncertainty</td>
<td></td>
<td>Requires a portfolio approach</td>
</tr>
<tr>
<td>Regulations</td>
<td>No barriers to consolidation</td>
<td>Desirable in situations where</td>
</tr>
<tr>
<td></td>
<td></td>
<td>M&amp;A is impossible for</td>
</tr>
<tr>
<td></td>
<td></td>
<td>legal or regulatory reasons</td>
</tr>
</tbody>
</table>

Source: BCG analysis.
CASE STUDY: USING ALLIANCES AS A TOOL FOR GROWTH IN THE TELECOMMUNICATIONS INDUSTRY

For an example of a telecommunications company that has effectively used alliances as a means of growth under conditions of high uncertainty, consider how the Japanese mobile-phone carrier NTT DoCoMo established its i-mode mobile Internet service as the dominant standard in Japan.

Since the launch of i-mode in February 1999, DoCoMo has attracted more than 44 million customers to the service, representing nearly 60 percent of the Japanese mobile Internet market. In establishing i-mode as the dominant standard for mobile data communications in Japan, DoCoMo pursued a classic orchestrator strategy, in which alliances were at the center of its plans for growth.

Rapid Launch. Well before launching i-mode, DoCoMo created a series of partnerships with content providers. Through these alliances, the company was able to assemble a critical mass of rich content and services that made i-mode immediately attractive to consumers. Only three years after launching i-mode, DoCoMo had 30 million subscribers and had penetrated 45 percent of the Japanese market for cellular phones.

Participation in i-mode has distinctive benefits for alliance partners. DoCoMo’s content partners occupy pride of place on the standard menu on all i-mode handsets. They also benefit from i-mode’s innovative microbilling system, which allows DoCoMo to charge users small fees for each site they visit and transfer a portion of those fees to the relevant content providers after collecting a 9 percent commission. Finally, i-mode partners benefit from DoCoMo’s extensive research into how subscribers use the system, which in turn has informed how the partners design their Web sites for easy viewing and use on mobile devices.

Global Expansion. DoCoMo has also used alliances to fuel its global expansion outside Japan—a critical component of its strategy that takes advantage of economies of scale in the production of mobile phones built to the i-mode standard. The company has agreed to license the i-mode service to 13 operators outside Japan. For example, it has established partnerships with local telecom operators in nine European countries (including Telefónica in Spain, Wind in Italy, and KPN in the Netherlands) in order to create a Europewide i-mode network. With approximately 4 million subscribers outside Japan, i-mode is not as dominant globally as it is in its home country. Nevertheless, i-mode remains competitive with other Europewide networks such as Vodafone live! and Orange World.

Adjacent Businesses. In recent years, there has been a slowdown in sales growth in the mobile telecom business, forcing DoCoMo to move into adjacent businesses in order to sustain its growth. Alliances have played a central role in this development. In early 2004, DoCoMo created a joint venture with Sony to incorporate that company’s FeliCa “contactless” smart-card technology as a standard in all i-mode handsets. The technology makes it possible to store existing credit-card and bank-card data and functionality on an individual’s cell phone—in effect, creating a mobile wallet for electronic cash payments. Currently, the i-mode FeliCa service can be used at 20,000 outlets such as convenience stores and movie theaters and in more than 1,000 vending machines in Japan. DoCoMo estimates that the technology will be available on approximately 10 million phones by 2006.

In order to leverage i-mode’s new possibilities as a financial portal, DoCoMo recently announced that it is entering the credit card business through a joint venture with Sumitomo Mitsui Card, the second-largest credit-card company in Japan. By joining with Sumitomo, DoCoMo will get a bigger share of the transaction fees—not to mention the profits from any interest payments customers make. What’s more, by amortizing the costs of customer acquisition across i-mode’s already enormous customer base, the company hopes to use i-mode as a powerful platform for the delivery of a wide range of financial services.

However, as DoCoMo moves farther away from its core business in telecommunications, it is unclear whether the alliance strategy that served the company so well in the creation of i-mode will continue to be appropriate. Can DoCoMo establish a profitable business model through close cooperation with Sumitomo? Or will it need to establish a greater degree of control?
How Alliances Form and Perform

As part of our examination of the role of alliances in corporate strategy, BCG recently analyzed trends in the establishment of business alliances worldwide between 1988 and 2004. To understand the relative importance of alliances as a preferred form of institutional collaboration, we also compared these trends with those for M&A. And we disaggregated our global sample to look at trends by region and by industry.

Finally, in order to understand what kind of alliances are most successful, we studied the impact of alliance announcements on the stock price of 233 alliance partners that participated in 103 alliances in the United States and Europe.

Recent Trends in Alliance Formation

After rising substantially from 1988 to 1995, the number of alliances created each year declined in the late 1990s and dropped significantly after 2000. This decrease reflects the shift of many companies from focusing primarily on growth to focusing more on consolidation and restructuring.

And although the number of mergers and acquisitions created each year has also declined substantially from its peak in 2000, the number has begun to rebound in the last few years. The number of alliances, by contrast, has not. (See Exhibit 3, page 12.)

From the late 1980s to the mid-1990s, the share of alliances, including joint ventures, created each year as a percentage of total interfirm collaborations, including M&A, also grew—from 12 percent in 1988 to 34 percent in 1994. However, since 1994, that percentage has decreased more than fourfold: by 2004, alliances represented only 8 percent of new interfirm collaborations. (See Exhibit 4, page 12.)

The decreasing percentage of alliances has been driven by an especially sharp falloff in joint ventures. Although new joint ventures as a percentage of all alliances grew from 42 percent in 1988 to 62 percent in 1995, they dropped to a mere 10 percent in 2004. (See Exhibit 5, page 13.)

This trend may reflect the organizational costs of joint ventures (for example, the costs of the more stringent legal requirements associated with joint ventures and the risks associated with sharing proprietary knowledge) and their relatively high failure rate. In effect, companies may be deciding that joint ventures represent the “worst of both worlds”—providing neither the complete control of full-fledged M&A nor the flexibility of contract-based alliances.

So does the declining percentage of alliances mean that alliances are becoming less important? Not necessarily. A look at the regional breakdown of alliance formation helps explain why. Exhibit 6, on page 13, shows the trends in alliance formation for three major regions of the world: the Americas, Europe, and Asia-Pacific.

Two trends are immediately apparent. The first is that the Americas region, where the vast majority of alliances are located, has experienced a considerable rebound in alliance formation from the most recent low in 2001. Although the overall trend line is not yet clear, it seems that alliances in the Americas have resumed their growth path.

The second trend is that the Asia-Pacific region, which missed out on the alliance boom of the early...
EXHIBIT 3

ALTHOUGH THE NUMBER OF MERGERS AND ACQUISITIONS HAS REBOUNDED IN RECENT YEARS, THE NUMBER OF ALLIANCES CONTINUES TO DROP

Sources: Thomson Financial; BCG analysis.

EXHIBIT 4

BY 2004, ALLIANCES REPRESENTED ONLY 8 PERCENT OF NEW INTERFIRM COLLABORATIONS

Sources: Thomson Financial; BCG analysis.
The Role of Alliances in Corporate Strategy

EXHIBIT 5
A SHARP DECLINE IN JOINT VENTURES HAS CONTRIBUTED TO THE DROP IN ALLIANCES

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<thead>
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<th>Year</th>
<th>Joint ventures</th>
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<td>42</td>
<td>58</td>
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<td>1990</td>
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<td>67</td>
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<tr>
<td>2002</td>
<td>48</td>
<td>71</td>
</tr>
<tr>
<td>2004</td>
<td>33</td>
<td>74</td>
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EXHIBIT 6
AN EXAMINATION OF ALLIANCE FORMATION BY REGION SHOWS THAT ALLIANCES ARE STILL IMPORTANT

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</tr>
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</table>

SOURCES: Thomson Financial; BCG analysis.

EXHIBIT 5
Relative formation of joint ventures and strategic alliances, 1988–2004

SOURCES: Thomson Financial; BCG analysis.

EXHIBIT 6
An examination of alliance formation by region shows that alliances are still important

SOURCES: Thomson Financial; BCG analysis.

NOTE: Excludes all alliances located in Africa and the Middle East and those that involve companies from multiple regions.
In addition to variations across regions, there are considerable differences in alliance formation by industry. This finding makes sense given that alliances are most likely to be found in industrial sectors that are either growing rapidly or facing considerable uncertainty (and, therefore, increased risk). Exhibit 7 shows alliance formation by indus-

try sector—by the number of alliances and by the percentage of total alliances created each year.

Three trends stand out. First, the degree to which a single sector, technology and communications, dominates alliance formation is striking. In 2000, alliances in this sector represented 51 percent of all the alliances created that year. And even though there has been a significant decline in alliances in the sector since then, they still represented 33 percent of all alliances created in 2004. Most likely, this finding reflects the high levels of uncertainty in the fast-changing technology-and-communications sector.

Second, there has been a long-term decline (both relative and absolute) in alliances in more traditional industrial sectors, such as industrial goods and consumer goods. Alliances in these two sectors accounted for 40 percent of all alliances created in 1988 but only 19 percent in 2004.

Third, recent years have seen a rapid increase in alliances in the business services sector. Such alliances represented an almost negligible 1 percent of total alliances in 1988 but a full 27 percent in 2004. It is likely that this increase represents the proliferation of outsourcing agreements in recent years.

Analyzing Alliance Performance

To understand what kind of alliances are most successful, we analyzed 103 alliances in the United States and Europe involving some 233 partners. These alliances were announced between July 1999 and January 2001—the most recent period of major alliance activity.

We divided this sample into groups on the basis of whether the participants were competitors or noncompetitors and on the relative breadth and depth of the alliance itself. (See Exhibit 8 for an illustrative matrix.) This categorization yielded four broad alliance types:

- **Expertise alliances** bring together noncompetitors in order to share specific expertise and capabilities. Examples include outsourcing agreements for information technology and the licensing of new drug compounds in the biopharmaceutical industry.

- **New-business alliances** are partnerships in which companies that traditionally have not been competitors join together to enter a new business or market. Examples include Microsoft and Ericsson’s alliance to create Web-enabled mobile telephones and NTT DoCoMo’s recent alliance with the Japanese credit-card company Sumitomo Mitsui Card.

- **Cooperative alliances** group competitors in a joint effort to attain critical mass in an activity in order to take advantage of economies of scale or network effects. Examples include purchasing alliances in the mobile communications sector and joint R&D on selected base technologies in the automotive industry.

- **M&A-like alliances** are partnerships in which competitors may desire total integration but are prevented from pursuing it—either by regulatory obstacles or by unfavorable conditions in the stock market. Examples include the airline industry’s multica rrier alliances.

To measure the impact of these four types of alliances on value creation, we analyzed their announcement effect—the impact of the announcement of the alliance on the share prices of the participating companies. Calculating announcement effects is a common analytical tool in evaluating the success of M&A. Typically, researchers measure the movement in share price of the acquiring
company from a few days (or weeks) before to a few days (or weeks) after the announcement of the deal. Although a growing body of recent finance research suggests that a deal’s announcement effect is not a strong predictor of long-term value creation, it remains a useful technique to assess the differences in the potential for value creation among different types of deals. Therefore, we have used it to compare the performance of our four types of alliances.

Exhibit 9 shows the outcome of our analysis. The x axis portrays the percentage of sample companies that participated in each of our four alliance categories (the wider the column, the higher the percentage). The y axis divides our sample into three roughly equal groups. Those companies with announcement effects greater than 4 percent are winners. Those with effects between 4 and –1 percent are neutral. Those with announcement effects less than –1 percent are losers.

As the exhibit demonstrates, the majority of companies in our sample—53 percent—participated in new-business alliances. This finding makes sense because alliances are most useful for seeking growth, and the period in question (July 1999 to January 2001) was the height of the Internet boom. Relatively few companies—only 8 percent—formed M&A-like alliances, reflecting the fact that such alliances are pursued only in situations in which regulatory or other obstacles make alliances an inferior alternative to genuine M&A.

Although new-business alliances were the most common, they did not receive the most favorable market reaction. Thirty-four percent of the companies that entered into such alliances were in the loser category, and another 38 percent were in the neutral category. By contrast, 67 percent of the companies that formed expertise alliances were in the winner category.

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8. To calculate the announcement effect of an alliance, we measured the change in share price of all participating companies from three days before to two days after the announcement and compared that figure with the industry average.
M&A-like alliances were the most likely to be losers: a full 42 percent fell into this category. Again, this finding makes sense because most of these alliances are created in response to unavoidable regulatory or other restraints. But this is not to say that M&A-like alliances are not appropriate in certain circumstances.

Companies engaging in expertise alliances were not only the most likely to be winners. The size of the median announcement effect for this group was also significantly larger than those of companies pursuing other types of alliances. Expertise alliances had a median announcement effect of 7.7 percent—nearly six times that of the next-best category (new-business alliances). And cooperative alliances on average had a negligible announcement effect. (See Exhibit 10.)
In the 1990s, the airline industry saw the development of a handful of global multicarrier alliances. By 2004, the three largest—Star Alliance, Oneworld, and SkyTeam—accounted for roughly 49 percent of the global passenger market and about 58 percent of global revenue.

These alliances were formed in response to certain characteristics of the global airline industry: the high degree of fragmentation, coupled with severe regulatory and cultural barriers that have made it difficult to consolidate the industry through M&A. In such an environment, alliances have allowed the industry to take some useful steps on the road to consolidation. But there are many signs that these alliances are now producing diminishing returns. It’s likely that the future of consolidation in the airline industry will take place through M&A rather than alliances.

The Economics of Airline Alliances. Multicarrier airline alliances were a response to the financial crisis in the airline industry.1 Like many other capital-intensive industries, the airline industry struggles to earn a return on its cost of capital. As a result, the industry has historically underperformed the market. The total shareholder return of most companies is consistently in the bottom quartile of the stock market as a whole.

A major factor in this poor economic performance is the high fragmentation of the industry and the resulting excess capacity. For example, 21 European carriers divide approximately 45 percent of the transatlantic passenger traffic between Western Europe and the United States—whereas only 6 U.S. carriers provide 51 percent (and carriers from other regions of the world provide the rest). It’s likely that as few as 3 long-haul carriers (or closely integrated groups of carriers) will survive in each of the three major regions of the globe.

From a purely economic point of view, there are major benefits to consolidation in the industry. Operational synergies can provide opportunities for cost rationalization. Network synergies can both reduce costs and improve asset utilization. And consolidation can improve carriers’ competitive positions by providing a platform for growth. Despite the powerful economic logic of consolidation, however, there have been strong regulatory and cultural barriers to M&A. The commitment of individual countries to subsidize their national carriers, strict international air rights that cause an acquired company to lose highly coveted landing rights at foreign airports, and strong labor unions with powerful seniority privileges have all made it extremely difficult to consolidate the industry through M&A. So airlines have pursued global alliances as an alternative.

The Advantages—and Limits—of Airline Alliances. Multicarrier alliances provide direct benefits to consumers in the form of increased frequency of flights, better connectivity among destinations, and consolidated frequent-flyer programs. As a result, the alliances have been extremely effective at enhancing revenue. Consider one example: approximately two-thirds of Lufthansa’s transatlantic passenger traffic originates from feeder flights of the airline’s Star Alliance partner, United. According to one estimate, Lufthansa’s participation in Star Alliance was responsible for an estimated $250 million in incremental annual profits between 1999 and 2001.

But most of the extra revenue that resulted from improved connectivity has been harvested. Most major airlines have already joined one of the three major alliances, and many consumers have already been locked into one of the alliances through well-designed frequent-flyer programs. The next phase of consolidation will require long-overdue cost cutting. The airline alliances have tried to tackle these tougher cost synergies, but the alliance structure has proved singularly ineffective. Take the example of the rationalization and consolidation of IT networks. The current IT landscape in the airline industry is extremely fragmented and anachronistic, and there are powerful advantages to economies of scale. Every individual airline would benefit from an

1. For a more detailed analysis of the economic condition of the global airline industry, see Unfriendly Skies: The Outlook for the Global Airline Industry, BCG Focus, January 2002.
alliancewide (or even industrywide) solution. And yet, IT consolidation has made relatively little progress over the past decade, despite the undisputed potential. The same is true for joint procurement, whether of expensive items such as aircraft and spare parts or of daily expendables such as food and fuel.

There are at least four major reasons why the airline alliances have failed to further consolidate the industry:

- **Asymmetric Benefits.** Revenue synergies owing to increased connectivity are an incremental addition to an existing asset base. By contrast, achieving cost synergies such as consolidated IT platforms requires up-front investments. But the benefits of these investments are asymmetric and unpredictable. There is no guarantee that the airline that invests the most will receive the greatest benefits. This uncertainty causes companies to hesitate to invest.

- **Irreversible Commitments.** Because cost synergies require big investments, they also make a company’s commitment to the alliance irreversible. Once a company has invested millions of dollars in a new alliancewide IT system, it is highly unlikely to leave the alliance and walk away from that investment. But this irreversibility undermines a significant part of the logic of a strategic alliance—its flexibility—and is another reason why companies shy away from making the necessary investment.

- **Eroding Option Value.** The more engaged an airline is in an alliance, the less freedom of choice executives have to determine the destiny of the company. Put another way, the potential operational value of alliances in terms of lower costs is outweighed by the enormous option value—especially for smaller carriers—of remaining independent. In the long term, these players are unlikely to survive the ongoing consolidation of the industry. And yet, seen from the perspective of shareholder value, it is better for these players to retain their independence today in order to position themselves for acquisition in the future than to cede their independence to an alliance without giving stockholders the benefit of an actual sale. Too much reliance on alliances can dilute this strategic option value. As a result, participants withhold further commitment and investment, and the alliance enters a phase of paralysis.

- **Cumbersome Decision Making.** The effectiveness of multicarrier airline alliances has been limited by overly complex organization and decision making. In many respects, an airline alliance is like a mini United Nations in which every airline has an equal vote, irrespective of size or degree of importance to the alliance. It is striking that, to the degree that the alliances have made steps in consolidating their operations, the agreements have usually been bilateral—involving only two members—rather than agreements that involve all members of the alliance.

For all these reasons, although the major airline alliances have been an important step in the evolution of the industry, they will play a diminishing role in the future. Competitive dynamics in the industry are rapidly moving toward the endgame. Many leading airlines are scaling back their commitments to alliances. The ongoing consolidation of the industry is more likely to happen through mergers—despite the barriers to M&A. Signs of this trend include the recent mergers of KLM Royal Dutch Airlines and Air France, Lufthansa and Swiss International Air Lines, and US Airways and America West Airlines. Ultimately, the multicarrier airline alliances may end up being a temporary—and inferior—substitute for full-fledged M&A.
A Structured Process for Managing Alliances

Alliances are notoriously difficult to manage. In many respects, implementing an alliance is similar to conducting a merger or an acquisition. A company needs to put a structured process in place in order to define the explicit role of alliances in its strategy, identify appropriate partners, structure the right kind of relationship, and manage that relationship over time. But alliances also differ significantly from M&A—and need to be managed differently. There are six key steps. (See Exhibit 11.)

**Align the Alliance Strategy with the Growth Strategy**

Alliances are primarily a way to grow. Therefore, a company’s alliance strategy must be grounded in its long-term corporate strategy for growth. Among the questions senior executives need to ask are the following:

- What are the prospects for organic growth in the core business?
- Are there more attractive growth paths outside the core business?
- How risky are these options?
- Where do alliances make more sense than full-fledged M&A?
- What companies are potential partners, and what is the appropriate time frame for the alliance?

**EXHIBIT 11**

**A STRUCTURED ALLIANCE PROCESS HAS SIX KEY STEPS**

1. **Align the alliance strategy**
   - Assess needs
   - Define the alliance strategy
   - Determine the optimal deal structure

2. **Conduct a partner search**
   - Screen on the basis of financial and strategic fit
   - Select on the basis of alliance experience and cultural fit

3. **Negotiate the deal**
   - Enter with a strategic plan in place
   - Define governance and the exit strategy
   - Close the deal or stop negotiating

4. **Manage the alliance**
   - Design the alliance organization
   - Monitor on the basis of business criteria

5. **Evaluate performance**
   - Identify gaps between goals and results
   - Continue, relaunch, or exit
   - Learn from experience

6. **Adopt a portfolio approach**
   - Establish an alliance office
   - Define alliance segments
   - Continuously reshape the portfolio

**Source:** BCG analysis.
It’s also important to be clear about exactly what type of alliance makes sense, given the company’s growth strategy, because different types of alliances have different success rates.

**Conduct a Rigorous Partner Search**

When a company has a clear sense of how alliances fit into its growth strategy, it is in a position to identify potential partners and structure the right kind of alliance. In M&A, successful acquisitive companies conduct rigorous searches for the right partner, comprehensive due diligence, and what we call *high-definition valuation.*9 Alliances require an equally rigorous process. But that process must also address the distinctive features of alliances.

For example, many alliances, especially in R&D or in emerging technologies and markets, are based on tacit knowledge. Participants sense that by combining the capabilities of their companies, they will be able to take advantage of an opportunity. However, it is often very difficult to define just how large that opportunity is. In order to take advantage of the opportunity, partners need to define clearly how they intend to appropriate the value of the alliance—for example, by applying for patents or investing in new joint R&D.10 Among the questions executives need to ask are the following:

- Have we identified the full range of potential alliance partners?
- What is the strategic and financial fit with each candidate?
- Can the cultures of the two companies work together?
- Have we quantified the value we want to get from the alliance?

**Negotiate the Deal**

Once a potential alliance partner is identified, the companies must make sure that they address key aspects of the alliance during the negotiation process. One area to focus on is governance. In an acquisition, it’s clear who governs the new company: the acquirer. In an alliance, by contrast, governance often remains ambiguous. There are always questions about the relative weight of the investment of each of the partners and, therefore, the best way for revenues from the alliance to be shared. If a company isn’t careful, this ambiguity can lead to a vicious cycle in which the ambiguity about contribution and revenue sharing causes partners to become hesitant about investing and making a genuine commitment to the alliance.

It’s imperative when entering into an alliance to address this classic “free rider” problem by defining governance mechanisms as explicitly as possible. Issues such as access to financial information, criteria and metrics for evaluating performance, and the process for resolving disagreements among the partners should all be made explicit in the alliance contract.

In the past, some alliance experts argued that focusing too much on control can undermine the development of trust, and it is trust on which effective cooperation in alliances depends. But recent research suggests that as long as control mechanisms focus on business criteria that define the actual costs and benefits of the alliance, rather than on social norms of behavior, such mechanisms actually increase rather than diminish trust among alliance partners.11

The negotiation period is also the time to establish clear requirements for exit—for example, through the formulation of an explicit stop-loss agreement.

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A merger is like a marriage—ideally, it lasts forever. Not so with an alliance. Although some alliances (in particular, joint ventures) do last for a number of years, one of the great advantages of alliances is that they are temporary. Companies have the flexibility to readjust or end an alliance when competitive circumstances shift.

Before entering into an alliance, however, it’s extremely important for a company to have a clear exit strategy already in place. This strategy should specify explicit criteria and trigger points for exit, as well as explicit agreements with partners about when and how to end the alliance. Executives should be asking questions such as

- What are our triggers for exit?
- What are the responsibilities of the two parties should either decide to end the alliance?
- Are there any continuing obligations after exit—for example, access to brands or ongoing sourcing agreements?
- How should assets, personnel, and brands be valued and priced?

**Manage the Alliance**

Once a company agrees to an alliance, it must make sure to manage it carefully. In M&A, postmerger integration (PMI) is critical to realizing the value of a deal. PMI can make or break a merger and often differentiates experienced, successful acquirers from those that are less successful. But whereas PMI is a highly focused activity with a clear beginning and end, alliances need to be managed continuously throughout the life of the partnership. Among the questions executives need to ask are the following:

- Are management processes aligned with the company’s alliance strategy?
- Are managerial accountabilities for the performance of the alliance clearly defined?
- How will alliance performance be monitored over time?

**Evaluate Alliance Performance**

Once an acquisition is fully integrated, the option of divestiture is no longer on the table. In an alliance, by contrast, the possibility of liquidation is always on the table and should never be forgotten. A company needs to evaluate alliance performance regularly to determine whether or not the alliance is meeting its strategic objectives. For example, executives need to ask the following questions:

- Is the alliance meeting its strategic and financial goals?
- Has anything happened in the competitive environment to challenge the strategic logic of the alliance?
- Should the alliance continue full speed ahead or is it time to exit?

**Adopt a Portfolio Approach to Alliances**

Of course, at any single moment in time, most companies will be conducting not one or two alliances but many. According to one estimate, most large companies have at least 30 and some have more than 100. Therefore, a company must also put a process in place for actively managing its entire portfolio of alliances, weeding out the value destroyers, and nurturing the successful partnerships over time. By taking a portfolio approach to alliances, a company further protects itself from the failure of any single initiative and positions itself to take advantage of those high-risk initiatives that successfully deliver above-average returns.

One effective approach to managing the alliance portfolio is to create a dedicated alliance office. Consider, for example, the approach taken by Royal Philips Electronics. The company uses a simple matrix to divide its alliances into four groups on the basis of the amount of synergy between the partners and the potential long-term value of the alliance to Philips. (See Exhibit 12.) Business alliances are largely operational or tactical, usually focusing on logistics or purchasing. Strategic alliances usually focus on creating a new product, service, or business. Relationship alliances are partnerships that are

13. The authors would like to thank John Bell, head of the corporate alliance office at Royal Philips Electronics, for his assistance with this section.
long lasting or span multiple divisions. Finally, every year the company identifies ten alliances that are particularly important to its strategic goals. Each of these formally designated corporate alliances is sponsored by a member of the Philips board. The list of corporate alliances is revised yearly.

Business and strategic alliances are managed by the Philips business units that formed the partnerships in the first place. For these alliances, the alliance office typically functions as a competence center. For example, it makes sure that each product division adopts an appropriate alliance strategy; supports the alliance process; identifies best practices in alliance management and communicates them to the product divisions; and, in some cases, conducts postmortems after the alliance has been concluded. Once a partnership is elevated to the status of a relationship or corporate alliance, it is managed directly by the alliance office itself. In particular, each corporate alliance has a dedicated alliance manager who is responsible for overseeing all of the dealings between the partner and Philips.

This approach has the advantage of focusing senior management’s attention on the most critical of the company’s alliances at any given moment. And the existence of a dedicated alliance office has helped Philips establish throughout the organization the distinctive managerial competencies necessary to manage alliances.
The global biopharmaceutical industry has, for some time, faced a significant R&D productivity challenge. In the 1990s, industry revenues grew on the back of a surge in the stock of blockbuster drugs. But with patent expirations increasing, the stock of blockbusters is set to level off in the current decade. To avoid a sharp decline in revenue growth, big pharmaceutical companies will need to find new ways to boost their diminishing pipelines.

One important way companies have been addressing this productivity challenge is by licensing new compounds developed by small biotech companies. Small biotechs (defined as all biotech companies except for the ten largest) currently account for less than 10 percent of the industry’s cash, market capitalization, and R&D spending. And yet, these firms are responsible for two-thirds of the worldwide clinical pipeline of biopharmaceuticals.

Given the powerful economic logic for collaboration between big pharmaceutical companies, which provide resources and know-how, and small biotech companies, which furnish clinical candidates, it should be no surprise that deal making in the industry is growing in value at more than 20 percent per year and penetrating into earlier and earlier stages of drug development.

But as licensing has become critical to R&D productivity, it has also become immensely competitive. The worldwide clinical pipeline of biopharmaceuticals currently boasts more than 2,500 compounds. But nearly 1,000 of these compounds are already licensed. And the rate of deal making is growing rapidly at approximately 10 percent per year, while the total pipeline is increasing slowly at around just 2 percent per year. What’s more, only about 30 percent of the remaining unlicensed compounds would pass even a cursory licensing triage, the rest being unsuitable, not novel, or of low value. As a result, the stock of licensing candidates is rapidly draining away.

Effective licensing is very much a partnership game. Although, obviously, the amount of money a company has available for licensing deals is important, paying the most is neither the only way nor necessarily the best way to win a deal. A company’s ability to identify and attract the best partners and effectively manage its alliances will be critical to future competitive success. Five steps are key.

**Establish clear licensing objectives.** The first step is to determine precisely how much of the company’s clinical pipeline needs to come from external sources. What is the likely size of the earnings gap that licensing must fill? What are the odds that existing opportunities (given realistic assumptions about the types of projects to target and typical hit rates) can fill those gaps? Is it feasible to expand the range of compounds to target? Or is it more appropriate to revise earnings guidance? When defining its licensing objectives, a company should make sure to do more than merely set dollar value targets. Last year’s licensing may turn into this year’s deep partnership or acquisition. It’s important for the senior management team to be aligned on how to approach deals that could evolve further into broader partnerships or outright acquisitions.

**Define a strategy for where to focus.** Once the financial boundaries of the licensing partnership challenge have been set, it’s also important to develop a clear strategic focus for the kind of deals to pursue. Most companies will choose to emphasize those therapeutic areas and modalities in which they already have internal expertise. This approach ensures that the company has the requisite capabilities both for evaluating potential projects and for taking them forward once they are licensed. The choice of where to focus in drug development, however, is more complicated. It depends partly on the company’s appetite for risk and also on its attitude toward different types of deal structures. Earlier-stage deals, for example, are better suited to projects that involve deeper collaboration or shared control. One final criterion is financial: any strategy should include an agreed minimum for expected peak sales.

1. For a more comprehensive account of how biopharmaceutical companies can address the R&D productivity challenge, see *Rising to the Productivity Challenge: A Strategic Framework for Biopharma*, BCG Focus, July 2004.
**Manage the partnership message.** Once a company knows what kind of deals it is looking for, the next step is to communicate a clear and consistent message to potential partners about the advantages of allying with one particular company as opposed to another. There is a lot that a licensor can do to shape the perceptions of potential partners. And yet, unclear messages are all too common, either because the company’s general licensing strategy is itself unclear or because the company undervalues or mishandles the art of communication.

It’s largely a matter of balance: send too vague or faint-hearted a message, and potential partners will suspect a lack of commitment; come across too strong, and they will be on their guard. An effective message needs to both resonate with potential target partners and be consistent with a company’s overall image and intent. By viewing licensing efforts as being in part a branding exercise, a company can better grasp the requirements for success—namely, defining clearly and simply a promise of value that meets the needs of potential partners and then reliably and consistently following through on that promise. Such follow-through requires efforts from more than just the licensing or business development functions because perceptions are shaped by interactions with the entire company.

**Develop internal processes.** To deliver on its strategy and image promises, a pharmaceutical company also needs to put a set of processes in place for licensing—from candidate identification and screening, through negotiation, to execution and management. Take a simple example: emphasizing a company’s “responsiveness” to potential partners doesn’t mean much if there is no process in place for ensuring that inquiries are handled promptly. Establishing and managing effective processes for licensing are challenges because so many functions are involved and need to be consulted. Experts from R&D, commercial, and manufacturing all need to assess a potential project for validity and attractiveness. To reduce the burden on these functions, those within licensing must have the requisite knowledge to triage opportunities appropriately.

**Anticipate organizational tradeoffs.** There is no single best-practice organization design for managing licensing. As with most organization-design choices, different models necessarily entail different tradeoffs. It is important to be aware of the tradeoffs inherent in the model chosen and to put mechanisms in place to address the issues that arise. For example, should licensing and even M&A activities report to a single head? Or should each distinct activity report to its own group head? Split reporting—with technology licensing reporting to discovery, clinical licensing reporting to development, and M&A reporting to corporate—allows for better coordination of each group with its key stakeholders. But single reporting facilitates coordination among these groups. Depending on a company’s specific situation, one model may be demonstrably better than another. A company that seldom contemplates technology licensing, for instance, shouldn’t have a separate technology-licensing group. But even when the structural choice is clear, it’s important to think through the resulting tradeoffs and develop mechanisms to offset them.
In conclusion, we offer a ten-point CEO alliance checklist that captures the key arguments and recommendations of this report in a concise, easy-to-use format. These principles represent a useful starting point for any company’s alliance strategy.

1. Don’t get left behind. Despite the recent decline in alliance formation, alliances are here to stay. They are a permanent part of the corporate-finance and corporate-development tool kit, and they are particularly important in industries that are facing uncertainty, discontinuity, or rapid growth.

2. Understand the differences between alliances and M&A. Alliances represent a distinctive form of corporate control. Understand when they make sense strategically and when they do not. Avoid using alliances as a substitute for M&A.

3. Align your alliance strategy with your corporate strategy. In particular, know the role of alliances in your growth strategy.

4. Pay attention to option value. Alliances are a way to keep options open in order to participate in growth opportunities that otherwise wouldn’t be possible. Think of them as “options” on the future.

5. Don’t be afraid to fail. By spreading the risks of failure among multiple partners, alliances allow a company to limit its downside exposure. What’s more, because no one company takes on the full investment in any individual alliance, each partner is able to invest a fixed amount of resources in a broad array of high-risk ventures.

6. Take a portfolio approach. Actively manage your alliance portfolio. Over time, weed out the value destroyers and nurture the successful partnerships.

7. Develop a structured alliance process. Be as systematic in partner selection and negotiation as you would be in the pursuit of a merger or an acquisition. And continuously monitor alliance performance on the basis of explicit criteria for performance.

8. Pay attention to governance. Ambiguous governance undermines commitment. Make sure that governance mechanisms are clear. Address the free-rider problem and manage it carefully during the lifetime of the alliance.

9. Have a clear exit strategy. Most alliances don’t last forever. Make exit criteria explicit in advance and know when to take your losses.

10. Develop a dedicated alliance function. Once a company has an active portfolio of alliances, it’s important to establish a strong capability in alliance management. The alliance office model is an effective way to embed this capability throughout your organization.
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