The Strategic Logic of Alliances

Alliances have become an increasingly important—and complex—part of corporate strategy. According to one estimate, approximately 30 percent of global corporate revenues in 2005 were a direct result of alliances—up from only 2 percent in 1980. And despite a sharp falloff in recent years due to the economic downturn that followed the Internet boom, corporate alliances are poised for a comeback. In 2005 the total number of new deals surpassed that in 2004 by about 15 percent. 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 continue.

To create successful alliances, however, a company must understand when alliances make strategic sense—and how to manage them for business results. Alliances can be extremely useful in situations of great uncertainty and in markets with growth opportunities that a company either cannot or does not want to pursue on its own. But the advantages of shared risk are often offset by unclear governance and lack of genuine commitment; for that reason, alliances must be managed carefully.

When Alliances Make Sense

Alliances are collaborations in which two or more companies jointly invest in an activity, sharing in the risks and potential returns but remaining independent economic agents. Some alliances—for example, joint ventures—involve the creation of a new legal entity. But most are simply contractual relationships of longer duration and greater complexity than traditional customer–supplier relationships.

One of the main reasons to engage in an alliance, as opposed to a conventional merger or acquisition, is to share risk and limit the resources a company must commit to the venture in question. Risk can take many forms.

One is the financial risk associated with the high costs of the investment required to pursue a particular opportunity. An alliance can be a way to spread—and sometimes even lower—those costs. The multicity 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 prohibitive to build on its own. Similarly, companies in the automotive industry have engaged in joint research in certain basic 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 reinforced 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 ally with a Chinese partner before they may invest in the country.1

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 com-

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bine capabilities and explore new market opportunities—without committing too many resources before the 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 industry’s traditional value chain. 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.

As this last example suggests, alliances are a way to maximize flexibility. Through an alliance, two (or more) companies can quickly 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 biotech companies can gain access to the large firms’ formidable global-marketing and sales capabilities.2

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 can control the others completely—and, therefore, decide who will suffer the consequences of tough decisions about reducing costs or consolidating operations. In the airline industry, for example, multirairline 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, mergers and acquisitions (M&A) are a much better mechanism for cutting costs than alliances are.

Managing Alliances Systematically

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 to define the explicit role of alliances in its strategy, identify appropriate partners, build the right kind of relationship, and manage that relationship over time. But because alliances differ significantly from M&A, they also need to be managed differently. (See the exhibit “A Structured Alliance Process Has Six Key Steps.”)

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 those options?
• When do alliances make more sense than full-fledged M&A?
• What types of companies would make the best partners, and what is the appropriate time frame for the alliance?

Conduct a rigorous partner search. Once 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. As with M&A, alliances require a rigorous search process, including in-depth due

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diligence and what we call high-definition valuation. 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 believe that by combining the capabilities of their companies, they will be able to take advantage of an opportunity. But it is often very difficult to determine just how large that opportunity is. To take advantage of it, 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 research and development.

Executives need to ask the following questions:

- Have we identified the full range of potential alliance partners?
- What is our 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 partner is identified, the companies must make sure to address key aspects of the alliance during the negotiation process. One area is governance. Unlike in M&A, governance in alliances often
remains ambiguous. There are questions about the relative weight of each partner’s investment and about the best way for revenues to be shared.

If a company isn’t careful, this ambiguity about contribution and revenue sharing can lead to a vicious cycle that 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.

The negotiation period is also the time to establish clear requirements for exit—for example, through the formulation of an explicit stop-loss agreement. 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 defined exit strategy in place: explicit criteria and trigger points for exit, as well as agreements with partners about when and how to end the alliance. The key questions are

- What are our triggers for exit?
- What are the responsibilities of the partners should one of them 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 manage it carefully. Unlike M&A, in which integration is a highly focused activity with a clear beginning and end, alliances need to be managed throughout the life of the partnership. Executives should ask the following questions:

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

**Evaluate performance.** In an alliance, the possibility of liquidation is always on the table and should never be forgotten. A company needs to evaluate the alliance’s performance regularly to determine whether it is achieving its objectives. For example,

- 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.** Of course, at any single moment, most companies will be involved in not one or two alliances but many. Therefore, a company must also put a process in place for actively managing its full complement of alliances—weeding out the value destroyers and nurturing the successful partnerships over time. By taking a portfolio approach, a company fur-
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ther protects itself from the failure of any single initiative and positions itself to take advantage of high-risk initiatives that deliver above-average returns.

One effective approach to managing the alliance portfolio is to establish a dedicated alliance office. Royal Philips Electronics, for example, uses a simple matrix to divide its alliances into four groups on the basis of the amount of synergy among the partners and the potential long-term value of the alliance to Philips.4 Business alliances are largely operational or tactical, usually focusing on logistics or purchasing. Strategic alliances usually focus on developing a new product, service, or business. Relationship alliances are partnerships that are 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.

Philips manages the different types of alliances differently. For business and strategic alliances, the alliance office typically functions as a competence center. Once a partnership becomes a relationship or corporate alliance, it is managed directly by the alliance office.

The Philips approach has the advantage of focusing senior management’s attention on the company’s most critical alliances at any given moment. And the dedicated alliance office helps spread throughout the organization the distinctive competencies necessary to manage alliances. As alliances take on a more central role in corporate strategy, it’s likely that more and more companies will adopt a similar approach.

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