CHAPTER 7

Strategic Alliances

Learning Objectives: After reading this chapter, you should be able to . . .

1. Define a strategic alliance and three specific examples of strategic alliances.

2. Describe nine different ways that alliances can create value for firms and how these nine sources of value can be grouped into three large categories.

3. Describe how adverse selection, moral hazard, and hold-up can threaten the ability of alliances to generate value.

4. Describe the conditions under which a strategic alliance can be rare and costly to directly duplicate.

5. Describe the conditions under which "going it alone" and acquisitions are not likely to be substitutes for alliances.

6. Describe how contracts, equity investments, firm reputations, joint ventures, and trust can all reduce the threat of cheating in strategic alliances.

Opening Case: Original Programming at HBO

"Sex in the City," "The Sopranos," and "Band of Brothers"—all these programs have at least three things in common. First, they have all been among the most critically acclaimed programs on television. "Sex in the City" routinely earned the Grammy for "Best Comedy Series," "The Sopranos" was nominated for the "Best Dramatic Series" Grammy every year it was on television, and "Band of Brothers"—a ten part mini-series that documents the history of the 101st Airborne during World War II—won numerous Grammys the year it was broadcast.

Second, they have been among the most watched shows on cable television. Indeed, in its fourth year, "The Sopranos" became the most watched series ever on premium cable television and led HBO to its highest ratings ever.

Finally, all three of these shows were co-produced by HBO—a division of AOL-Time Warner—through HBO's Original Programming Division.

This has not always been the case. Originally, HBO presented only material produced by others—in particular, movies. Indeed, for many years, competition between HBO and other premium cable channels focused exclusively on which of these channels would gain the broadcast rights to which movies. The resulting competition led to substantial increases in rights fees—the fee a cable channel pays a movie’s producers for the right to broadcast that movie. This competition hurt the profitability of many premium cable channels, including HBO.
However, beginning in the mid-1990s, HBO began producing, or co-producing, its own programming. This began slowly, with a few low budget movies and sports programs (e.g., “NFL This Week” and various boxing matches). However, by the late 1990s, original programming had become an important part of HBO’s weekly schedule.

Most of this original programming was produced through partnerships between HBO Original Productions and independent production companies, including Steven Spielberg’s production company Dreamworks and Tom Hanks’ production company Play Tone. And in the summer of 2003, HBO announced that it would enter into similar partnerships to begin producing movies for theatrical release.

The entry of HBO into partnerships to produce original programming has increased its profitability. It has also shifted the basis of competition in the premium cable market from “Who can broadcast the biggest movies?”—a competition that was making movie producers wealthy but reducing the profits of premium cable channel companies—to “Who can develop the most cutting edge, provocative, and popular entertainment on television?”

This shift in strategy at HBO has also had an impact on the content of broadcast network shows. ABC, NBC, CBS, Fox, and the WB have all had to increase the quality and “cutting edge” feel of their series and other programs if these programs are to attract viewers away from the shows broadcast on HBO. Shows like “Frazier,” “Will and Grace,” “NYPD Blue,” “Law and Order,” “The West Wing,” “24”, and “Boomtown” have all incorporated comedic and dramatic elements first pioneered on television in shows co-produced by HBO.

While HBO is now committed to using partnerships to co-produce much of its entertainment programming, other premium channels have not yet made such a commitment. For example, Cinemax (a division of HBO), Starz (a 12 channel premium service), and the Sundance Channel all have very little self-produced content. Indeed, the only other premium cable channels that are following HBO’s lead are Showtime—the second largest premium cable channel—and the Independent Film Channel—which has begun investing in the production of independent films for theatrical release.

Sources:

www.AOLTW.com

www.HBO.com

End Opening Case

Text:

HBO’s decision to begin producing its own shows is an example of a backward vertical integration decision—the kind of decision discussed in Chapter 6. However, rather than fully incorporating the production process within its
boundaries, HBO uses partnerships with independent producers to create virtually all of its original content. These partnerships are an example of strategic alliances.

The use of strategic alliances to manage economic exchanges has grown substantially over the last several years. In the early 1990s, strategic alliances were relatively uncommon, except in a few industries—including the entertainment industry. However, by the late 1990s, they had become much more common in a wide variety of industries. High technology firms like IBM and Cisco were creating alliances with hundreds of partners. Over 450 alliances between large pharmaceutical firms and biotechnology firms were created in 1997 and 1998 alone. Even firms in more traditional industries—including firms in the U.S. automobile industry—began using alliances to manage their international expansion. Currently, alliances account for over 35% of the revenue of the largest 1,000 firms in the United States.¹

WHAT IS A STRATEGIC ALLIANCE?

A strategic alliance exists whenever two or more independent organizations cooperate in the development, manufacture, or sale of products or services. As shown in Figure 7.1, strategic alliances can be grouped into three broad categories: non-equity alliances, equity alliances, and joint ventures.

[Insert Figure 7.1 Here]

In a non-equity alliance, cooperating firms agree to work together to develop, manufacture, or sell products or services, but they do not take equity positions in each other or form an independent organizational unit to manage their cooperative efforts. Rather, these cooperative relations are managed through the use of various forms of contracts. Licensing agreements (where one firm allows others to use its brand name to sell products), supply agreements (where one firm agrees to supply others), and distribution agreements (where one firm agrees to distribute the products of others) are examples of non-equity strategic alliances. Most of the alliances between HBO and independent producers take the form of non-equity supply agreements.

In an equity alliance, cooperating firms supplement contracts with equity holdings in alliance partners. For example, when General Motors began importing small cars manufactured by Isuzu, not only did these partners have supply contracts in place, but GM purchased 34.2 percent of Isuzu's stock. Ford had a similar relationship with Mazda, and Daimler-Chrysler had a similar relationship with Mitsubishi.² Equity alliances are also very common in the biotechnology industry. Large pharmaceutical firms like Pfizer and Merck own equity positions in several startup biotechnology companies.
In a joint venture, cooperating firms create a legally independent firm in which they invest and from which they share any profits that are created. Some of these joint ventures can be very large. For example, Dow and Corning’s joint venture Dow-Corning is a Fortune 500 company on its own. SBC and BellSouth are co-owners of the joint venture Cingular, one of the largest wireless phone companies in the United States—especially after its recent acquisition of AT&T Wireless Service. And CFM—a joint venture between General Electric and SNECMA (a French Aerospace firm)—is one of the world’s leading manufacturers of jet engines for commercial aircraft. If you have ever flown on a Boeing 737, then you have placed your life in the hands of this joint venture because it manufactures the engines for virtually all of these aircraft.

**HOW DO STRATEGIC ALLIANCES CREATE VALUE?**

Like all the strategies discussed in this book, strategic alliances create value by exploiting opportunities and neutralizing threats facing a firm. Some of the most important opportunities that can be exploited by strategic alliances are listed in Table 7.1. Threats to strategic alliances are discussed later in this chapter.

[Table 7.1 About Here]

**TABLE 7.1**

Strategic Alliances can create economic value by . . .

... helping firms improve the performance of their current operations

1. Exploiting economies of scale
2. Learning from competitors
3. Managing risk and sharing costs

... creating a competitive environment favorable to superior performance

4. Facilitating the development of technology standards
5. Facilitating tacit collusion

... facilitating entry and exit

6. Low-cost entry into new markets
7. Low-cost entry into new industries and new industry segments
8. Low-cost exit from industries and industry segments
9. Managing uncertainty

**STRATEGIC ALLIANCE OPPORTUNITIES**

Opportunities associated with strategic alliances fall into three large categories. First, these alliances can be used by a firm to improve the performance of their current operations. Second, alliances can be used to create a
competitive environment favorable to superior firm performance. Finally, they can be used to facilitate a firm's entry into or exit from new markets or industries.

**Improving Current Operations**

One way that firms can use strategic alliances to improve their current operations is to use alliances to realize economies of scale. The concept of economies of scale was first introduced in Chapter 2. **Economies of scale** exist when the per unit cost of production falls as the volume of production increases. Thus, for example, while the per unit cost of producing one Bic pen would be very high, the per unit costs of producing 50 million Bic pens can be very low.

To realize economies of scale, firms have to have a large volume of production, or at least a volume of production large enough so that the cost advantages associated with scale can be realized. Sometimes—as was described in Chapters 2 and 4—a firm can realize these economies of scale by itself. Other times, it can't. When a firm cannot realize the cost savings from economies of scale all by itself, it may join in a strategic alliance with other firms. Jointly, these firms may have sufficient volume to be able to gain the cost advantages of economies of scale.

But, why wouldn't a firm be able to realize these economies all by itself? There are several reasons why a firm may have to turn to alliance partners to help realize economies of scale. For example, if the volume of production required to realize these economies is very large, a single firm might have to dominate an entire industry in order to obtain these advantages. It is often very difficult for a single firm to obtain such a dominant position in an industry. And even if they do so, they may be subject to anti-monopoly regulation by the government. Also, while a particular part or technology may be very important to several firms, no one of these firms may generate sufficient demand for this part or technology to realize economies of scale in its development and production. In this setting, as well, independent firms may join together to form an alliance to realize economies of scale in the development and production of the part or technology.

Firms can also use alliances to improve their current operations by learning from their competitors. As suggested in Chapter 3, different firms in an industry may have different resources and capabilities. These resources can give some firms competitive advantages over other firms. Firms that are at a competitive disadvantage may want to form alliances with the firms that have an advantage in order to learn about their resources and capabilities.

General Motors formed this kind of alliance with Toyota. In the early 1990s, GM and Toyota jointly invested in a previously closed General Motors plant in Fremont, California. This joint venture—called NUMI—
was to build compact cars to be distributed through GM's distribution network. But why did GM decide to build these cars in an alliance with Toyota? Obviously, GM could have built these cars in any of its own plants. However, GM was very interested in learning about how Toyota was able to manufacture high quality small cars at a profit. Indeed, in the NUMI plant, Toyota agreed to take total responsibility for the manufacturing process, using former General Motors employees to install and operate the “lean manufacturing” system that had enabled Toyota to become the quality leader in the small car segment of the automobile industry. However, Toyota also agreed to let GM managers work in the plant and directly observe how Toyota managed this production process. Since its inception, GM has rotated thousands of its managers from other GM plants through the NUMI plant so that they can be exposed to Toyota’s lean manufacturing methods.

It's clear why GM would want this alliance with Toyota. But, why would Toyota want this alliance with GM? Certainly, Toyota was not looking to learn about lean manufacturing, per se. However, since Toyota was contemplating entering into the U.S. by building its own manufacturing facility, it did need to learn how to implement lean manufacturing in the United States with U.S. employees. Thus, Toyota also had something to learn from this alliance.

When both parties to an alliance are seeking to learn something from that alliance, an interesting dynamic called a learning race can evolve. This dynamic is described in more detail in the Advanced Topics Box.

**Advanced Topics Box:** Winning Learning Races

A learning race exists in a strategic alliance when both parties to that alliance seek to learn from each other, but when the rate at which these two firms learn varies. In this setting, the first firm to learn what it wants to learn from an alliance has the option to begin to under-invest in, and perhaps even withdraw from, an alliance. In this way, the firm that learns the fastest is able to prevent the slow learning firm from learning all it wanted from an alliance. If, outside of this alliance, these firms are competitors, winning a learning race can create a sustained competitive advantage for the fast learning firm over the slow learning firm.

There are a variety of reasons why firms in an alliance may vary in the rate they learn from each other. First, they may be looking to learn different things, and some things are easier to learn than others. For example, in the GM Toyota example, GM wanted to learn about how to use “lean manufacturing” to build high quality small cars profitably. Toyota wanted to learn how to apply the “lean manufacturing” skills it already possessed in the US.
Which of these are easier to learn—about “lean manufacturing” or about how to apply “lean manufacturing” in the US?

An argument can be made that GM’s learning task was much more complicated than Toyota’s learning task. At the very least, in order for GM to apply knowledge about “lean manufacturing” gleaned from Toyota, it would have to transfer that knowledge to several of its currently operating plants. Using this knowledge in these plants would require these plants to change their current operations—a difficult and time consuming process. Toyota, on the other hand, only had to transfer its knowledge of how to operate a “lean manufacturing” operation in the US to its other US plants—plants that at the time this alliance was first created had yet to be built. Because GM’s learning task was more complicated than Toyota’s, it is very likely that Toyota’s rate of learning was greater than GM’s rate of learning.

Second, firms may differ in terms of their ability to learn. This ability has been called a firm’s absorptive capacity. Firms with high levels of absorptive capacity will learn at higher rates than firms with low levels of absorptive capacity, even if these two firms are trying to learn exactly the same things in an alliance. Absorptive capacity has been shown to be an important organizational capability in a wide variety of settings.

Third, firms can engage in activities to try to slow the rate of learning of their alliance partners. For example, while firms might make their technology available to an alliance partner—thereby fulfilling the alliance agreement—they may not provide all the know-how necessary to exploit this technology. This can slow a partner’s learning. Also, a firm might withhold critical employees from an alliance, thereby slowing the learning of an alliance partner. All these actions, to the extent that they slow the rate of a partner’s learning without also slowing the rate at which the firm engaging in these activities learns, can help this firm win the learning race.

While learning race dynamics have been described in a wide variety of settings, they are particularly common in relations between entrepreneurial and large firms. In these alliances, entrepreneurial firms are often looking to learn about all the managerial functions required to bring a product to market, including manufacturing, sales, distribution, and so forth. This is a difficult learning task. Large firms in these alliances, on the other hand, often are only looking to learn about the entrepreneurial firm’s technology. This is a less difficult learning task. Because the learning task facing entrepreneurial firms is more challenging than the learning task facing their large firm partners, larger firms in these alliances typically win the learning race. Once these large firms learn what they wanted from their alliance partners, they often under-invest or even withdraw from these alliances. This is why, in
one study, almost 80% of the managers in entrepreneurial firms felt unfairly exploited by their large firm alliance partners.

Sources:


*End Advanced Topics Box*

Finally, firms can use alliances to improve their current operations through sharing costs and risks. Indeed, most of HBO’s alliances with independent producers are created to share costs and risks. Producing new television shows can be costly. Development and production costs can run into the hundreds of millions of dollars, especially for long and complicated mini-series like HBO’s “Band of Brothers.” And, despite audience testing and careful market analyses, the production of these new shows is also very risky. Even bankable stars like Dustin Hoffman and Warren Beatty—remember “Ishtar”?—and Ben Affleck and Jennifer Lopez—remember “Gigli”—cannot guarantee success.

In this context, it is not surprising that HBO decides to not “go it alone” in its production efforts. If HBO was to be the sole producer of its original programming, not only would it have to absorb all the production costs, but it would also bear all the risk if a production turned out to not be successful. Of course, by getting other firms involved in its production efforts, HBO also has to share whatever profits a particular production generates. However, apparently HBO has concluded that sharing this upside potential is more than compensated for by sharing the costs and risks of these productions.

*Creating a Favorable Competitive Environment*

Firms can also use strategic alliances to create a competitive environment that is more conducive to superior performance. This can be done in at least two ways. First, firms can use alliances to help set technology standards in an industry. With these standards in place, technology-based products can be developed and consumers can be confident that the products they buy will be useful for some time to come.
Such technologic standards are particular important in what are called network industries. Such industries are characterized by increasing returns to scale. Consider, for example, fax machines. How valuable is one fax machine, all by itself? Obviously, not very valuable. Two fax machines that can talk to each other are a little more valuable, three that can talk to each other are still more valuable, and so forth. The value of each individual fax machine depends on the total number of fax machines that can talk to each other that are in operation. This is what is meant by increasing returns to scale—the value (or returns) on each product increases as the number of these products (or scale) increases.

Now, if there are 100 million fax machines in operation, but none of these machines can talk to each other, none of these machines has any value whatsoever—except as a large paper weight. To realize the full value of these fax machines, they need to be able to talk to each other. And to talk to each other, they must all adapt the same—or at least compatible—communication standards. This is why setting technology standards is so important in network industries.

There are two ways that these standards can be set. First, different firms can introduce different standards, and consumers can decide which they prefer. This is how the standard for home video tapes was set. Sony sold one type of video tape machine—the Betamax—and Matsushita sold a second type of video tape machine—VHS. These two technologies were incompatible. Some consumers preferred Beta and purchased Sony’s technology. Others preferred VHS and bought Matsushita’s technology. However, since Matsushita licensed its VHS technology to numerous other firms, while Sony refused to do so, more and more consumers started buying VHS machines, until VHS became the de facto standard. This was the case even though most observers agreed that Beta was superior to VHS on several dimensions.

Of course, the biggest problem with letting customers and competition set technology standards is that customers may end up purchasing technologies that are incompatible with the standard that is ultimately set in the industry. What about all those consumers that purchased Beta products? For this reason, customers may be unwilling to invest in a new technology until the standards of that technology are established.

This is where strategic alliances come in. Sometimes, firms form strategic alliances, the sole purpose of which is to evaluate and then choose a technology standard in an industry. With such a standard in place, technologies can be turned into products, and customers are likely to be more willing to purchase these products since they know that they will compatible with industry standards for at least some period of time. Thus, in this setting—network industries with increasing returns to scale where standards are important—strategic alliances can be used to create a more favorable competitive environment.
Such alliances have been important in setting standards in a wide variety of industries, including the mobile telephone industry. The history of standard setting in this industry, and how it has affected competition in the mobile phone industry around the world, is described in the International Box.

International Box: Can You Hear Me Now?

The mobile telephone industry is a classic example of a network industry—that is, an industry with increasing returns to scale where standards are important. The more people that own mobile phones that can talk to each other, the more valuable those mobile phones are. Because of the role that standards play in realizing these increasing returns to scale, standard setting has been an important determinant of competition in the mobile phone industry around the world.

However, this standard setting process has been anything but smooth. Nor has there been agreement around the world about what the technological standard in the industry should be. While alliances can facilitate the creation of standards, sometimes sets of competing alliances can make it more difficult, not less difficult, to create a standard for an entire industry. This has been the case in the world-wide mobile telecommunications industry.

The first round of technical standards in mobile telephones were developed in the early 1980s. In the United States, the federal government adopted Ameritech’s AMPS standard and required all mobile phone operators to use this analogue system. In Europe, two analogue standards emerged—NMT-450 developed by an alliance between Ericsson and Nokia dominated in the Scandinavian countries and much of continental Europe—and TACS—developed by an alliance between Vodaphone and Cellnet for operations in the UK and Italy. Many mobile phones operating in the UK still use the TACS standard. And in Japan, two additional analogue standards were created—NTT created by Nippon Telephone and Telegraph and JTACS created in by an alliance that involved Toyota Motor Corporation. None of these standards were compatible with each other. A person with a phone that operated on, say, the NMT-450 standard could not talk to a person with a phone operating on, say, the AMPS standard.

The emergence of digital technology in the late 1980s led to a new round of standard setting. In the U.S., several potential standards were allowed to compete. The two dominant competing digital standards in the U.S. were known as TDMA and CDMA. In Europe, an alliance among all the major mobile phone companies, with government support, developed a single pan-European standard known as GSM—for Global System for Mobile Communication. In Japan two competing digital standards emerged: PDC—supported by an alliance that included Nissan Motors—and PHS—a system that relies on a dense network of antennas each with a very restricted range to provide mobile telephone
services. Countries around the world have generally adopted one or more of these standard technologies. As was the case with analogue standards, none of these digital standards are compatible.

This cacophony of standards has led to a search for a third generation standard that would be applicable around the world. This standard—known as 3G—would have to be backward compatible (i.e., previous standards would have to be able to operate in conjunction with the new standard) and facilitate the full range of digital communications technology around the world. Two standards are currently competing for the right to become the world-wide 3G standard: UMTS—a standard supported by an alliance of European and Japanese mobile telecommunications companies—and CDMA-2000—a standard supported by most American mobile telecommunications companies. How this standards competition will unfold is still not entirely known.

Sources:
www.cellular-news.com/history_of_telecoms/

End International Box

Another incentive for cooperating in strategic alliances is that such activities may facilitate the development of tacit collusion. Collusion exists when two or more firms in an industry coordinate their strategic choices to reduce competition in an industry. This reduction in competition usually makes it easier for colluding firms to earn high levels of performance. A common example of collusion is when firms cooperate to reduce the quantity of products being produced in an industry in order to drive prices for these products up. Explicit collusion exists when firms directly communicate with each other to coordinate their levels of production, their prices, and so forth. Explicit collusion is illegal in most countries.

Since managers that engage in explicit collusion can end up in jail, most collusion that exists in the economy must be tacit in character. Tacit collusion exists when firms coordinate their production and pricing decisions, not by directly communicating with each other, but by sending and receiving signals sent by other firms about their intent to cooperate. Examples of such signals might include public announcements about price increases, public announcements about reductions in a firm’s productive output, public announcements about decisions to not pursue a new technology, and so forth.
Sometimes, signals of intent to collude are very ambiguous. For example, when firms in an industry do not reduce their prices in response to a decrease in demand, they may be sending a signal that they want to collude, or they may be attempting to exploit their product differentiation to maintain high margins. When firms do not reduce their prices in response to reduced supply costs, they may be sending a signal that they want to collude, or they may be individually maximizing their economic performance. In both these cases, a firm’s intent to collude or not, as implied by its activities, are ambiguous at best.

In this context, strategic alliances can facilitate tacit collusion. Separate firms, even if they are in the same industry, can form strategic alliances. Although communication between these firms cannot legally include sharing information about prices and costs for products or services that are produced outside the alliance, such interaction does help create the social setting within which tacit collusion may develop. As suggested in the Research Box, most early research on strategic alliances focused on their implications for tacit collusion. More recently, research suggests that alliances do not usually facilitate tacit collusion, although this is still a possibility.

**Insert Research Box: Do Strategic Alliances Facilitate Tacit Collusion?**

Several authors have concluded that joint ventures, as a form of alliance, do increase the probability of tacit collusion in an industry. As reviewed in books by Scherer and Barney, one study found that joint ventures created two industrial groups, besides U.S. Steel, in the U.S. iron and steel industry in the early 1900s. In this sense, joint ventures in the steel industry were a substitute for U.S. Steel’s vertical integration and had the effect of creating an oligopoly in what (without joint ventures) would have been a more competitive market. Other studies found that over 50 percent of joint-venture parents belong to the same industry. After examining 885 joint-venture bids for oil and gas leases, yet another study found only 16 instances where joint-venture partners competed with one another on another tract in the same sale. These results suggest that joint ventures might encourage subsequent tacit collusion among firms in the same industry.

In a particularly influential study, Pfeffer and Nowak found that joint ventures were most likely in industries of moderate concentration. These authors argued that in highly concentrated industries—where there were only a small number of competing firms—joint ventures were not necessary to create conditions conducive to collusion. In highly fragmented industries, these small numbers conditions could not be created by joint ventures. Only when joint venture activity could effectively create concentrated industries—that is, only when industries were moderately concentrated—were joint venture likely.
Scherer and Barney also review more recent work that disputes these findings. Joint ventures between firms in the same industry may be valuable for a variety of reasons that have little or nothing to do with collusion. Moreover, by using a lower level of aggregation, several authors have disputed the finding that joint ventures are most likely in moderately concentrated industries. The original study defined industries using very broad industry categories—"the electronics industry," "the automobile industry," and so forth. By defining industries less broadly—"consumer electronics" and "automobile part manufacturers"—subsequent work found that 73 percent of the joint ventures had parent firms coming from different industries. Although joint ventures between firms in the same industry (defined at this lower level of aggregation) may have collusive implications, subsequent work has shown that these kinds of joint ventures are relatively rare.

Sources:

End Research Box

Facilitating Entry and Exit

A final way that strategic alliances can be used to create value is by facilitating either a firm’s entry into a new market or industry or its exit from a market or industry. Strategic alliances are particularly valuable in this context when the value of market entry or exit is uncertain.

With respect to low cost entry into new markets, strategic alliances are especially important for firms looking to enter into new foreign markets. In this context, one partner typically brings products or services (as resources) to the alliance, and the other partner brings local knowledge, local distribution networks, and local political influence (as resources) to the relationship. The development of local distribution networks can be a costly and difficult process. Such actions generally require a great deal of knowledge about local conditions. Local alliance partners may already possess this knowledge. They may even already have a local distribution network in place. By cooperating with local partners, firms can substantially reduce the cost of entry into these markets.
Of course, some governments require new entrants to have local alliance partners. Governments see such relationships not only as a way to facilitate entry of foreign firms into their market place, but also as a way that domestic firms can learn from foreign firms. This has been the case with General Electric’s entry into the Chinese electricity production market. The Chinese government has required GE, if it wants to sell its generators into China, to form joint ventures with local Chinese companies. This has enabled GE to sell over $900 million of generators into the Chinese market.

However, recently China began to require GE to provide its Chinese joint venture partners information about its generator technology and information about how to manufacture that technology. GE has spent over $500 million developing its new line of generators and obviously does not want to share this knowledge with firms that might some day become its competitors. But the Chinese government is now saying: “If you want to sell in China, you need to share your technology.” Several other firms, besides GE, have had to share technology with their Chinese alliance partners to continue doing business in China as well, including Motorola, Microsoft, Siemens, and Nokia.¹

Strategic alliances can also facilitate a firm’s entry into a new industry or into new segments of an industry. Entry into an industry can require skills, abilities, and products that a potential entrant does not possess. Strategic alliances can help a firm enter a new industry, by avoiding the high costs of creating these skills, abilities, and products.

For example, recently DuPont wanted to enter into the electronics industry. However, building the skills and abilities need to develop competitive products in this industry can be very difficult and costly. Rather than absorbing these costs, DuPont developed a strategic alliance (DuPont/Phillips Optical) with an established electronics firm, Phillips, to distribute some of Phillips’s products in the United States. In this way DuPont was able to enter into a new industry (electronics) without having to absorb all the costs of creating electronics resources and abilities from the ground up.

Of course, for this joint venture to succeed, Phillips must have had an incentive to cooperate with DuPont. Where DuPont was looking to reduce its cost of entry into a new industry, Phillips was looking to reduce its cost of continued entry into a new market: the United States. Phillips used its alliance with DuPont to sell in the United States the compact discs it already was selling in Europe.⁵

Alliances to facilitate entry into new industries can be valuable even when the skills needed in these industries are not as complex and difficult to learn as skills in the electronics industry. For example, rather than developing their own frozen novelty foods, Welch Foods, Inc., and Leaf, Inc. (maker of Heath candy bars), asked Eskimo Pie to
formulate products for this industry. Eskimo Pie developed Welch’s frozen grape-juice bar and the Heath toffee ice-cream bar. These firms then split the profits derived from these products. As long as the cost of using an alliance to enter a new industry is less than the cost of learning new skills and capabilities, an alliance can be a valuable strategic opportunity.

Some firms use strategic alliances as a mechanism to withdraw from industries or industry segments in a low cost way. Firms are motivated to withdraw from an industry or industry segment when their level of performance in that business is less than what was expected and when there are few prospects of its improving. Often, when a firm desires to exit an industry or industry segment, it will need to dispose of the assets it has developed to compete in that industry or industry segment. These assets often include tangible resources and capabilities such as factories, distribution centers, and product technologies and intangible resources and capabilities such as brand name, relationships with suppliers and customers, a loyal and committed work force, and so forth.

Firms will often have difficulty in obtaining the full economic value of these tangible and intangible assets as they exit an industry or industry segment. This reflects an important information asymmetry that exists between the firms that currently own these assets and firms that may want to purchase these assets. By forming an alliance with a firm that may want to purchase its assets, a firm is giving its partner an opportunity to directly observe how valuable those assets are. If those assets are actually valuable, then this “sneak preview” can lead the assets to be more appropriately priced and thereby facilitate the exit of the firm that is looking to sell its assets. These issues will be discussed in more detail in Chapter 10’s discussion of mergers and acquisitions.

One firm that has used strategic alliances to facilitate its exit from an industry or industry segment is Corning. In the late 1980s, Corning entered into the medical diagnostics industry. After several years, however, Corning concluded that its resources and capabilities could be more productively used in other businesses. For this reason, it began to extract itself from the medical diagnostics business. However, to make sure it received the full value of the assets it had created in the medical diagnostics business upon exiting this business it formed a strategic alliance with the Swiss specialty chemical company, Ciba-Geigy. Ciba-Geigy paid $75 million to purchase half of Corning’s medical diagnostics business. A couple of years later, Corning finished exiting from the medical diagnostics business by selling its remaining assets in this industry to Ciba-Geigy. However, where Ciba-Geigy had paid $75 million for the first half of Corning’s assets in the medical diagnostics business, they paid $150 million for the second half of these assets. Corning’s alliance with Ciba-Geigy had made it possible for Ciba-Geigy to fully value Corning’s medical diagnostics
capabilities. Any information asymmetry that might have existed was reduced, and Corning was able to get more of the full value of its assets upon exiting this industry.7

Finally, firms may use strategic alliances to manage uncertainty. Under conditions of high uncertainty, firms may not be able to tell, at a particular point in time, which of several different strategies they should pursue. Firms in this setting have an incentive to retain the flexibility to move quickly into a particular market or industry once the full value of that strategy is revealed. In this sense, strategic alliances enable a firm to maintain a point of entry into a market or industry, without incurring the costs associated with full-scale entry.

Based on this logic, strategic alliances have been analyzed as real options.8 In this sense, a joint venture is an option that a firm buys, under conditions of uncertainty, to retain the ability to move quickly into a market or industry if valuable opportunities present themselves. One way in which firms can move quickly into a market is simply to buy out their partner(s) in the joint venture. Moreover, by investing in a joint venture, a firm may gain access to the information it needs to evaluate full-scale entry into a market. In this approach to analyzing strategic alliances, firms that invest in alliances as options will acquire their alliance partners only after the market signals an unexpected increase in value of the venture—that is, only after uncertainty is reduced and the true, positive value of entering into a market is known. Empirical findings are consistent with these expectations.9

Given these observations, it is not surprising to see firms in new and uncertain environments develop numerous strategic alliances. This is one of the reasons that strategic alliances are so common in the biotechnology industry. While there is relatively little uncertainty that at least some drugs created through bio-technology will ultimately prove to be very valuable, which specific drugs are going to turn out to be the most valuable is very uncertain. Rather than investing in a small number of biotechnology drugs on their own, pharmaceutical companies have invested in numerous strategic alliances with small biotechnology firms. Each of these smaller firms represent a particular “bet” about the value of biotechnology in a particular class of drugs. If one of these “bets” turns out to be valuable, then the large pharmaceutical firm that has invested in that firm has the right, but not the obligation, to purchase the rest of this biotechnology company. In this sense, the alliances between large pharmaceutical firms and small bio-technology firms can be thought of as real options from the point of view of the pharmaceutical firms.

ALLIANCE THREATS: INCENTIVES TO CHEAT ON STRATEGIC ALLIANCES

Just as there are incentives to cooperate in strategic alliances, there are also incentives to cheat on these cooperative agreements. Indeed, research shows that as many as 1/3 of all strategic alliances do not meet the
expectations of at least one alliance partner.\textsuperscript{10} While some of these alliance “failures” may be due to firms forming alliances that do not have the potential for creating value, some are also due to parties to an alliance cheating—that is, not cooperating in a way the maximizes the value of the alliance. Cheating can occur in at least the three different ways presented in Table 7.2: adverse selection, moral hazard, and holdup.\textsuperscript{11}

[Insert Table 7.2 About Here]

Table 7.2. Ways to Cheat in Strategic Alliances

*Adverse selection:* Potential partners misrepresent the value of the skills and abilities they bring to the alliance.

*Moral hazard:* Partners provide to the alliance skills and abilities of lower quality than they promised.

*Holdup:* Partners exploit the transaction-specific investments made by others in the alliance.

**Adverse Selection**

Potential cooperative partners can misrepresent the skills, abilities, and other resources that they will bring to an alliance. This form of cheating, called *adverse selection*, exists when an alliance partner promises to bring to an alliance certain resources that it either does not control or cannot acquire. For example, a local firm engages in adverse selection when it promises to make available to alliance partners a local distribution network that does not currently exist. Firms engaging in adverse selection are not competent alliance partners.

Adverse selection in a strategic alliance is likely only when it is difficult or costly to observe the resources or capabilities that a partner brings to an alliance. If potential partners can easily see that a firm is misrepresenting the resources and capabilities it possesses, they will not create a strategic alliance with that firm. Armed with such understanding, they will seek a different alliance partner, develop the needed skills and resources internally, or perhaps forgo this particular business opportunity.

However, evaluating the veracity of the claims of potential alliance partners is often not easy. The ability to evaluate these claims depends on information that a firm may not possess. To fully evaluate claims about a potential partner’s political contacts, for example, a firm needs its own political contacts; to fully evaluate claims about potential partners’ market knowledge, a firm needs significant market knowledge. A firm that can completely, and at low cost, evaluate the resources and capabilities of potential alliance partners probably does not really need these partners in a strategic alliance. The fact that a firm is seeking an alliance partner is in some sense an indication that the firm has limited abilities to evaluate potential partners.

In general, the less tangible the resources and capabilities that are to be brought to a strategic alliance, the more costly it will be to estimate their value before an alliance is created and the more likely is adverse selection to occur.
Firms considering alliances with partners bringing intangible resources such as “knowledge of local conditions” or “contacts with key political figures” will need to guard against this form of cheating.

**Moral Hazard**

Partners in an alliance may possess high-quality resources and capabilities of significant value in an alliance but fail to make those resources and capabilities available to alliance partners. This form of cheating is called *moral hazard*. For example, a partner in an engineering strategic alliance may agree to send only its most talented and best trained engineers to work in the alliance but then actually send less talented, poorly trained engineers. These less qualified engineers may not be able to contribute substantially to making the alliance successful, but they may be able to learn a great deal from the highly qualified engineers provided by other alliance partners. In this way, the less qualified engineers effectively transfer wealth from other alliance partners to their own firm.\(^\text{12}\)

Often both parties in a failed alliance accuse each other of moral hazard. This was the case in the recently abandoned alliance between Disney and Pixar, described in the *Small Business and Entrepreneurship* box.

**Insert Entrepreneurship and Small Business Box:** Disney and Pixar Have a Falling Out

In 1994, Pixar was a struggling start-up company in Northern California that was trying to compete in an industry that really didn’t yet exist—the computer graphics animated motion picture industry. Headed by the former founder of Apple Computer, Steven Jobs, Pixar was desperately looking for a partner that could help finance and distribute its new brand of animated movies. Who better, Pixar thought, than the world’s leader in animated feature length films—Disney? And thus, a strategic alliance between Pixar and Disney was formed.

In the alliance, Disney agreed to help finance and distribute Pixar’s films. In return, they would share in any profits these films generated. Also, Disney would retain the right to produce any sequels to Pixar’s films—after first offering Pixar the right to make these sequels. This agreement effectively gave Disney control of any library of characters that Pixar happened to develop through its movies. Of course, at the time the alliance was originally formed, there were no such characters. Indeed, Pixar had yet to produce any movies. So, when Pixar was a weak alliance partner, Disney was able to gain control of any characters Pixar developed in the future. Disney, after all, had the track record of success.

A funny thing happened over the next ten years. Pixar produced blockbuster animated features like *Toy Story* ($362 million in revenues in 1995); *A Bug’s Life* ($363 million in revenues in 1998); *Toy Story 2* ($485 million in revenues in 1999); *Monsters, Inc.* ($524 million in revenues in 2001); and *Finding Nemo* ($844 million in revenues in
During this same time period, Disney's traditional animated fare performed much more poorly—*Treasure Planet* generated only $112 million in revenues in 2002; *The Emperor's New Groove* only $169 million in revenues in 2000, and *Brother Bear* only $126 million in revenues in 2003. Disney's "big hit" during this time period was *Lilo & Stitch*, with 2002 revenues of $269 million—smaller than any of the movies produced by Pixar.

Oops. The firm with the "proven track record" of producing hit animated features—Disney—stumbled badly, and the upstart company with no track record—Pixar—had all the success. Since Disney did not have many of its own characters upon which to base sequels, it began to eye Pixar's characters. And Disney's approach to making sequels made Pixar manager's blanche—poor production values, not well developed story lines, limited distribution, lower quality talent. Do you remember seeing the "direct to video hit," *The Lion King: Another Viewpoint*?

Fast forward to 2004. It's time to renew this alliance. But now Pixar has the upper hand, because it has the track record. Disney comes knocking and asks Pixar to redo the alliance. What does Pixar say, "OK, but ... we want control of our characters, we want Disney to act just as a distributor"—in other words, "we want Disney out of our business!" Disney balks at these demands, and Pixar—well, Pixar just cancelled the alliance.

But Disney is not done. They still control the rights to Pixar's old characters. So, in 1994, Disney announces that is will be producing *Toy Story 3*. Whether this new production will be up to the standards established by Pixar, or will be more similar to Disney's track record from 2000 on is yet to be seen. But now, Disney seems to need Pixar more than Pixar needs Disney.

One final irony in this alliance. Some observers have suggested that Disney's inability to maintain its alliance with Pixar was one of the reasons that Comcast was able to launch an unfriendly takeover bid for Disney in February of 2004.

Sources:


**End Entrepreneurship and Small Business Box**

The existence of moral hazard in a strategic alliance does not necessarily mean that one or more parties to that alliance are malicious or dishonest. Rather, what often happens is that market conditions change after an alliance is formed, requiring one or more partners to an alliance to change their strategies.
For example, in the early days of the personal computer industry, Compaq Computer Corporation relied on a network of independent distributors to sell its computers. However, as competition in the personal computer industry increased, Internet, mail order and so-called computer superstores became much more valuable distribution networks, and alliances between Compaq and its traditional distributors became strained. Over time, Compaq's traditional distributors were unable to obtain all the inventory they wanted in a timely manner. Indeed, to satisfy the needs of large accounts, some traditional distributors actually purchased Compaq computers from local computer superstores and then shipped them to their customers. Compaq's shift from independent dealers to alternative distributors looked like moral hazard—at least from the point of view of the independent dealers. However, from Compaq's perspective, this change simply reflected economic realities in the personal computer industry.\cite{footnote:13}

**Holdup**

Even if alliance partners engage in neither adverse selection nor moral hazard, another form of cheating may evolve. Once a strategic alliance has been created, partner firms may make investments that have value only in the context of that alliance and in no other economic exchanges. These are the transaction specific investments mentioned in Chapter 6. For example, managers from one alliance partner may have to develop close, trusting relationships with managers from other alliance partners. These close relationships are very valuable in the context of the alliance but have limited economic value in other economic exchanges. Also, one partner may have to customize its manufacturing equipment, distribution network, and key organizational policies to cooperate with other partners. These modifications have significant value in the context of the alliance but do not help the firm, and may even hurt it, in economic exchanges outside the alliance. As was the case in Chapter 6, whenever an investment's value in its first best use (in this case, within the alliance) is much greater than its value in its second best use (in this case, outside the alliance), that investment is said to be **transaction specific**.\cite{footnote:14}

When one firm makes more transaction-specific investments in a strategic alliance than partner firms make, that firm may be subject to the form of cheating called **holdup**. Holdup occurs when a firm that has not made significant transaction-specific investments demands from an alliance returns that are higher than what the partners agreed to when they created the alliance.

For example, suppose two alliance partners agree to a fifty-fifty split of the costs and profits associated with an alliance. To make the alliance work, Firm A has to customize its production process. Firm B, however, does not have to
modify itself to cooperate with Firm A. The value to Firm A of this customized production process, if it is used in the strategic alliance, is $5,000. However, outside the alliance, this customized process is only worth $200 (as scrap).

Obviously, Firm A has made a transaction-specific investment in this alliance, and Firm B has not. Consequently Firm A may be subject to holdup by Firm B. In particular, Firm B may threaten to leave the alliance unless Firm A agrees to give Firm B part of the $5,000 value that Firm A obtains by using the modified production process in the alliance. Rather than lose all the value that could be generated by its investment, Firm A may be willing to give up some of its $5,000 to avoid gaining only $200. Indeed, if Firm B extracts up to the value of Firm A’s production process in its next best use (here, only $200), Firm A will still be better off continuing in this relationship rather than dissolving it. Thus, even though Firm A and Firm B agree on a fifty-fifty split from this strategic alliance, the agreement may be modified if one party to the alliance makes significant transaction-specific investments. Research on international joint ventures suggests that the existence of transaction-specific investments in these relationships often leads to holdup problems.\textsuperscript{1546}

Although holdup is a form of cheating in strategic alliances, the threat of holdup can also be a motivation for creating an alliance. Bauxite-smelting companies often join in joint ventures with mining companies in order to exploit economies of scale in mining. However, these firms have another option: They could choose to operate large and efficient mines by themselves and then sell the excess bauxite (over and above their needs for their own smelters) on the open market. Unfortunately, bauxite is not a homogeneous commodity. Moreover, different kinds of bauxite require different smelting technologies. In order for one firm to sell its excess bauxite on the market, other smelting firms would have to make enormous investments, the sole purpose of which would be to refine that particular firm’s bauxite. These investments would be transaction specific and subject these other smelters to holdup problems.

In this context, a strategic alliance can be thought of as a way of reducing the threat of holdup by creating an explicit management framework for resolving holdup problems. In other words, although holdup problems might still exist in these strategic alliances, the alliance framework may still be a better way to manage these problems than attempt to manage them in arm’s-length market relationships. Some of the ethical dimensions of adverse selection, moral hazard, and hold-up are all discussed in the *ethics box*.

**Ethics Box:** When It Comes to Alliances, Do “Cheaters Never Prosper?”

So, firms in strategic alliances can cheat on their alliance partners by engaging in adverse selection, moral hazard, or hold-up. These three activities all have at least one thing in common—they all involve one alliance partner
lying to another alliance partner. And these lies can often payoff big, in the form of the lying firm appropriating more than its “fair share” of the value created in an alliance. Are alliances one place in the economy where the adage “cheaters never prosper” does not hold?

There is little doubt that, in the short-run, firms that cheat on their alliance partners can gain some advantages. But research suggests that cheating does not pay in the long run. In the long run, firms that cheat on their alliance partners find it difficult to form alliances with new partners and thus have many valuable exchange opportunities foreclosed to them.

One study that examined the long term return to “cheaters” in strategic alliances examined alliances using a simple game called the “Prisoner’s Dilemma.” In a “Prisoner’s Dilemma” game, firms have two options: to continue cooperating in a strategic alliance or to “cheat” on that alliance through adverse selection, moral hazard, or hold-up. The payoffs to firms in this game depend on the decisions made by both firms. As shown in the Table below, if both firms decide to cooperate, they each get a good size payoff from the alliance ($3,000 in the Table); if they both decide to cheat on the alliance, they each get a very small payoff ($1,000 in the Table); and if one decides to cheat while the other decides to cooperate, then the cheating firm gets a very big payoff ($5,000 in the Table) while the cooperating firm gets a very small payoff ($0 in the Table).

[Insert Table About Here]

Table. Returns from Cooperating and Cheating in a “Prisoner’s Dilemma” Strategic Alliance

<table>
<thead>
<tr>
<th>Firm One</th>
<th>Cooperates</th>
<th>Cheats</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cooperates</td>
<td>I: $3,000</td>
<td>I: $5,000</td>
</tr>
<tr>
<td></td>
<td>II: $3,000</td>
<td>II: $0</td>
</tr>
<tr>
<td>Firm Two</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cheats</td>
<td>I: $0</td>
<td>I: $1,000</td>
</tr>
<tr>
<td></td>
<td>II: $5,000</td>
<td>II: $1,000</td>
</tr>
</tbody>
</table>

If Firm One and Two in this game are only ever going to engage in just one strategic alliance, then they have a very strong incentive to “cheat” on this alliance. The worst that could happen if they cheat is to earn a $1,000 payoff; but there is a possibility of a $5,000 payoff. However, research has shown if firms are contemplating engaging in multiple strategic alliances over time, then the optimal strategy is to cooperate in all that firm’s alliances. This is true even if all these alliances are not with the same partner firm.
The specific "winning" strategy in repeated "Prisoner Dilemma" games is called a "tit for tat" strategy. "Tit for tat" means that Firm One will cooperate in an alliance as long as Firm Two cooperates. However, as soon as Firm Two cheats on an alliance, Firm One cheats as well. "Tit for tat" works well in this setting because adopting a cooperative posture in an alliance insures that, most of the time, the alliance will generate a high pay-off (of $3,000 in the Table). However, by immediately responding to cheaters by cheating, the firm implementing a "tit for tat" strategy also minimizes the times when it will earn the lowest payoff in the Table ($0). So, "tit for tat" maximizes the upside potential of an alliance while minimizing its downside.

All this analysis suggests that while cheating on an alliance can give a firm competitive advantages in the short to medium term, in the long run, "cheaters never prosper."

Sources:


**End Ethics Box**

**STRATEGIC ALLIANCES AND SUSTAINED COMPETITIVE ADVANTAGE**

The ability of strategic alliances, like all the other strategies discussed in this book, to be sources of sustained competitive advantage can be analyzed by using the VRIO framework developed in Chapter 3. An alliance is economically valuable when it exploits any of the opportunities listed in Table 7.1 but avoids the threats in Table 7.2. In addition, for a strategic alliance to be a source of sustained competitive advantage, it must be rare and costly to imitate.

**THE RARITY OF STRATEGIC ALLIANCES**

The rarity of strategic alliances does not just depend on the number of competing firms that have already implemented an alliance. It also depends on whether or not the benefits that firms obtain from their alliances are not common across firms competing in an industry.

Consider, for example, the automobile industry in the United States. Over the last several years, strategic alliances have become very common in this industry, especially with Japanese auto firms. GM developed an alliance with Toyota that has already been described, Ford developed an alliance with Mazda before it purchased this Japanese firm outright, and Daimler-Chrysler developed an alliance with Mitsubishi. Given the frequency with which alliances
have developed in this industry, it is tempting to conclude that strategic alliances are not rare and thus not a source of competitive advantage.

Closer examination, however, suggests that these alliances may have been created for different reasons. For example, until recently GM and Toyota have cooperated only in building a single line of cars, the Chevrolet Nova. GM has been less interested in learning design skills from Toyota and has been more interested in learning about manufacturing high-quality small cars profitably. Ford and Mazda, in contrast, have worked closely together in designing new cars and have joint manufacturing operations. Indeed, Ford and Mazda have worked so closely together that Ford finally purchased Mazda. Mitsubishi has acted primarily as a supplier to Daimler-Chrysler, and (until recently) there has been relatively little joint development or manufacturing. Thus although all three U.S. firms have strategic alliances, the alliances serve different purposes and therefore each may be rare.16

One of the reasons why the benefits that accrue from a particular strategic alliance may be rare is that relatively few firms may have the complementary resources and abilities needed to form an alliance. This is particularly likely when an alliance is formed to enter into a new market and especially a new foreign market. In many less developed economies, only one local firm or a very few local firms may exist with the local knowledge, contacts, and distribution network needed to facilitate entry into that market. Moreover, sometimes the government acts to limit the number of these local firms. Although several firms may seek entry into this market, only a very small number will be able to form a strategic alliance with the local entity and therefore the benefits that accrue to the allied firms will likely be rare.

THE IMITABILITY OF STRATEGIC ALLIANCES

As discussed in Chapter 3, the resources and capabilities that enable firms to conceive of and implement valuable strategies may be imitated in two ways: direct duplication and substitution. Both duplication and substitution are important considerations in analyzing the imitability of strategic alliances.

Direct Duplication of Strategic Alliances

Recent research suggests that successful strategic alliances are often based on socially complex relations among alliance partners.17 In this sense, successful strategic alliances often go well beyond simple legal contracts and are characterized by socially complex phenomena such as a trusting relationship between alliance partners, friendship, and even (perhaps) a willingness to suspend narrow self-interest for the longer-term good of the relationship.
Some research has shown that the development of trusting relationships between alliance partners is both difficult to do and essential to the success of strategic alliances. In one study, the most common reason that alliances fail to meet the expectations of partner firms was the partners' inability to trust one another. Interpersonal communication, tolerance for cultural differences, patience, and willingness to sacrifice short-term profits for longer-term success were all important determinants of the level of trust among alliance partners.\(^{18}\)

Of course, not all firms in an industry are likely to have the organizational and relationship-building skills required for successful alliance building. If these skills and abilities are rare among a set of competing firms and costly to develop, then firms that are able to exploit these abilities by creating alliances may gain competitive advantages. Examples of firms that have developed these specialized skills include Corning and Cisco, firms with several hundred strategic alliances each.\(^{19}\)

**Substitutes for Strategic Alliances**

Even if the purpose and objectives of a strategic alliance are valuable and rare, and even if the relationships on which an alliance is created are socially complex and costly to imitate, that alliance will still not generate a sustained competitive advantage if low-cost substitutes are available. At least two possible substitutes for strategic alliances exist: "going it alone" and acquisitions.\(^{20}\)

*Going It Alone.* Firms "go it alone" when they attempt to develop all the resources and capabilities they need to exploit market opportunities and neutralize market threats by themselves. Sometimes "going it alone" can create the same—or even more—value than using alliances to exploit opportunities and neutralize threats. In these settings, "going it alone" is a substitute for a strategic alliance. However, in other settings, using an alliance can create substantially more value than "going it alone." In these settings, "going it alone" is not a substitute for a strategic alliance.

So, when will firms prefer an alliance over "going it alone?" Not surprisingly, the three models that were used to analyze vertical integration choices—in Chapter 6—are also relevant here. Those three models were transactions cost economics, capabilities theory, and real options theory. If you need to review these three models, they are described in detail in Chapter 6. They are relevant here because "going it alone"—as a potential substitute for a strategic alliance—is an example of vertical integration. The implications of these three models for when strategic alliances will be preferred over "going it alone" are summarized in Table 7.3. If any of the conditions listed in Table 7.3 exist, then "going it alone" will not be a substitute for strategic alliances.
Table 7.3. When Alliances Will Be Preferred Over “Going It Alone”

Alliances will be preferred over “going it alone” when...

1. the level of transaction specific investment required to complete an exchange is moderate (transactions cost economics);
2. when an exchange partner possesses valuable, rare, and costly to imitate resources and capabilities (capabilities theory);
3. when there is great uncertainty about the future value of an exchange (real options theory).

Recall from Chapter 6 that transactions cost economics suggests that firms will want to vertically integrate an economic exchange when they have made high levels of transaction specific investment in that exchange. That is, using language developed in this chapter, firms will want to vertically integrate an economic exchange when using an alliance to manage that exchange could subject them to hold-up. Extending this logic to strategic alliances, transactions cost theory seems to suggest that strategic alliances will be preferred over “going it alone” when the level of transaction specific investment required to complete an exchange is moderate. If the level of this specific investment is low, then market forms of exchange will be preferred; if the level of this specific investment is high, then “going it alone” in a vertically integrated way will be preferred; if the level of this specific investment is moderate, then some sort of strategic alliance will be preferred. So, transactions cost economics suggests that “going it alone” is not a substitute for strategic alliances when the level of specific investment required to complete an exchange is moderate.

Capabilities theory suggests that an alliance will be preferred over “going it alone” when an exchange partner possesses valuable, rare, and costly to imitate resources and capabilities. A firm without these capabilities may find them to be too costly to develop on their own. If a firm must have access to capabilities it cannot develop on its own, it must use an alliance in gain access to those capabilities. In this setting, “going it alone” is not a substitute for a strategic alliance.  

Finally, it has already been suggested that, under conditions of high uncertainty, firms may be unwilling to commit to a particular course of action by engaging in an exchange within a firm. In such settings, firms may choose the strategic flexibility associated with alliances. As suggested earlier in this chapter, alliances can be thought of as real options that give a firm the right, but not the obligation, to invest further in an exchange—perhaps by bringing it within the boundaries of a firm—if that exchange turns out to be valuable sometime in the future. Thus, under conditions of high uncertainty, “going it alone” is not a substitute for strategic alliances.
**Acquisitions.** The acquisition of other firms can also be a substitute for alliances. In this case, rather than developing a strategic alliance or attempting to develop and exploit the relevant resources by “going it alone,” a firm seeking to exploit the opportunities listed in Table 7.1 may simply acquire another firm that already possesses the relevant resources and capabilities. However, such acquisitions have four characteristics that often limit the extent to which they can act as substitutes for strategic alliances. These are summarized in Table 7.4.²²

[Insert Table 7.4 About Here]

**TABLE 7.4**

Reasons Why Strategic Alliances May Be More Attractive than Acquisitions to Realize Exchange Opportunities

Alliances will be preferred to acquisitions when . . .

1. there are legal constraints on acquisitions.
2. acquisitions limit a firm’s flexibility under conditions of high uncertainty.
3. there is substantial unwanted organizational “baggage” in an acquired firm.
4. the value of a firm’s resources and capabilities depend on its independence.

First, there may be legal constraints on acquisitions. These are especially likely if firms are seeking advantages by combining with other firms in their own industry. Thus, for example, using acquisitions as a substitute for strategic alliances in the aluminum industry would lead to a very concentrated industry and subject some of these firms to serious antitrust liabilities. These firms have acquisitions foreclosed to them and must look elsewhere to gain advantages from cooperating with their competition.

Second, as has already been suggested, strategic alliances enable a firm to retain its flexibility either to enter or not to enter into a new business. Acquisitions limit that flexibility, because they represent a strong commitment to engage in a certain business activity. Consequently, under conditions of high uncertainty, firms may choose strategic alliances over acquisitions as a way to exploit opportunities while maintaining the flexibility that alliances create.

Third, firms may choose strategic alliances over acquisitions because of the unwanted organizational baggage that often comes with an acquisition. Sometimes, the value created by combining firms depends on combining particular functions, divisions, or other assets in the firms. A strategic alliance can focus on exploiting the value of combining just those parts of firms that create the most value. Acquisitions, in contrast, generally include the entire organization, both the parts of a firm where value is likely to be created and parts of a firm where value is not likely to be created.

From the point of view of the acquiring firm, parts of a firm that do not create value are essentially unwanted baggage. These parts of the firm may be sold off subsequent to an acquisition. However, this sell-off may be costly and
time consuming. If enough baggage exists, firms may determine that an acquisition is not a viable option, even though important economic value could be created between a firm and a potential acquisition target. To gain this value, an alternative approach—a strategic alliance—may be preferred. These issues will be explored in more detail in Chapter 10.

Finally, sometimes a firm’s resources and capabilities are valuable because that firm is independent. In this setting, the act of acquiring a firm can actually reduce the value of a firm. When this is the case, the realization of any value between two firms is best realized through an alliance, not an acquisition.

For example, the international growth of numerous marketing-oriented companies in the 1980s led to strong pressures for advertising agencies to develop global marketing capabilities. During the 1990s, many domestic-only advertising firms acquired nondomestic agencies to form a few large international advertising agencies. However, one firm that was reluctant to be acquired in order to be part of an international advertising network was the French advertising company Publicis. Over and above the personal interests of Publicis’ owners to retain control of the company, Publicis wanted to remain an independent French agency in order to retain its stable of French and French-speaking clients—including Renault and Nestlé. These firms had indicated that they preferred working with a French advertising agency, and that they would look for alternative suppliers if Publicis were acquired by a foreign firm. Because much of the value that Publicis created in a potential acquisition depended on obtaining access to its stable of clients, the act of acquiring Publicis would have had the effect of destroying the very thing that made the acquisition attractive. For this reason, rather than allowing itself to be acquired by foreign advertising agencies, Publicis developed a complex equity strategic alliance and joint venture with a U.S. advertising firm, Foote, Coyne, and Belding. Although, ultimately, this alliance was not successful in providing an international network for either of these two partner firms, an acquisition of Publicis by Foote, Coyne, and Belding would almost certainly have destroyed some of the economic value that Publicis enjoyed as a stand-alone company.

**ORGANIZING FOR STRATEGIC ALLIANCES**

One of the most important determinants of the success of strategic alliances is their organization. The primary purpose of organizing a strategic alliance is to enable partners in the alliance to gain all the benefits associated with cooperation while minimizing the probability that cooperating firms will cheat on their cooperative agreements. The organizing skills required in managing alliances are, in many ways, unique. It often takes some time for firms to learn these skills and thus to realize the full potential of their alliances. This is why some firms are able to gain competitive
advantages from managing alliances more effectively than their competitors. Indeed, sometimes firms may have to choose alternatives to alliances—including “going it alone” and acquisitions—even when those alternatives are not preferred simply because they do not have the skills required to organize and manage alliances.

A variety of tools and mechanisms can be used to help realize the value and minimize the threat of cheating in alliances. These include: contracts, equity investments, firm reputations, joint ventures, and trust.

**EXPLICIT CONTRACTS AND LEGAL SANCTIONS**

One way to avoid cheating in strategic alliances is for parties to an alliance to anticipate the ways in which cheating may occur (including adverse selection, moral hazard, and holdup) and to write explicit contracts that define legal liability if cheating does occur. Writing these contracts, together with the close monitoring of contractual compliance and the threat of legal sanctions, can reduce the probability of cheating. Earlier in this chapter, such strategic alliances were called **non-equity alliances**.

However, as was discussed in detail in Chapter 6, contracts sometimes fail to anticipate all forms of cheating that might occur in a relationship—and firms may cheat on cooperative agreements in subtle ways that are difficult to evaluate in terms of contractual requirements. Thus, for example, a contract may require parties in a strategic alliance to make available to the alliance certain proprietary technologies or processes. However, it may be very difficult to communicate the subtleties of these technologies or processes to alliance partners. Does this failure in communication represent a clear violation of contractual requirements, or does it represent a good-faith effort by alliance partners? Moreover, how can one partner tell whether it is obtaining all the necessary information about a technology or process when it is unaware of all the information that exists in another firm? Hence, although contracts are an important component of most strategic alliances, they do not resolve all the problems associated with cheating.

Although most contracts associated with strategic alliances are highly customized, these different contracts do have some common features. These common features of alliance contracts are described in detail in Table 7.5. In general, firms contemplating a strategic alliance that will be at least partially governed by a contract will have to include clauses that address the issues presented in Table 7.5.

[Insert Table 7.5 About Here]

**TABLE 7.5**

| Common Clauses in Contracts Used to Govern Strategic Alliances |

11-29
Establishment Issues
Shareholdings
If an equity alliance or joint venture is to be formed, what percentage of equity is to be purchased by each firm involved in the alliance.

Voting rights
The number of votes assigned to each partner in an alliance. May or may not be equal to shareholding percentages.

Dividend percentage
How the profits from an alliance will be allocated among cooperating firms. May or may not be equal to shareholding percentages.

Minority protection
Description of the kinds of decisions that can be vetoed by firms with a minority interest in an alliance.

Board of directors
Initial board of directors, plus mechanisms for dismissing and appointing board members.

Articles of association
Procedures for passing resolutions, share issuance, share disposal, etc.

Place of incorporation
If a joint venture, geographic location of incorporation.

Advisors
Lawyers, accountants, and other consultants to the alliance.

Identification of parties
Legal entities directly involved in an alliance.

Operating Issues
Performance clauses
Duties and obligations of alliance partners, including warranties and minimum performance levels expected.

Non-compete clauses
Partners are restricted from entering the primary business of the alliance.

Non-solicitation clauses
Partners are restricted from recruiting employees from each other.

Confidentiality clauses
Proprietary information from partners or from the alliance cannot be shared outside the alliance.

Licensing intellectual property rights
Who owns the intellectual property created by an alliance and how this property is licensed to other firms.

Liability
Liability of the alliance and liability of cooperating partners.

Changes to the contract
Process by which the contract can be amended.

Dispute resolution
Process by which disputes among partners will be resolved.

Termination Issues
Preemption rights
If one partner wishes to sell its shares, it must first offer them to the other partner.

Variations on preemption rights
Partners are forbidden from ever discussing the sale of their shares to an outsider without first informing their partner of their intention to do so.

Call options
When one partner can force the other partner to sell its shares to it. Includes discussion on how these shares will be valued and the circumstances under which a call option can be exercised.

Put options
A partner has the right to force another partner to buy its alliance shares.
Drag-along rights
One partner can arrange a sale to an outside firm and force the other partner to sell shares as well.

Tag-along rights
A partner can prevent the sale of the second partner’s shares to an outside firm unless that outside firm also buys the first partner’s shares.

Initial public offering (IPO)
Circumstances under which an IPO will be pursued.

Termination
Conditions under which contract can be terminated and consequences of termination for partners.

EQUITY INVESTMENTS

The effectiveness of contracts can be enhanced by having partners in an alliance make equity investments in each other. When Firm A buys a substantial equity position in its alliance partner, Firm B, the market value of Firm A now depends, to some extent, on the economic performance of that partner. The incentive of Firm A to cheat Firm B falls, for to do so would be to reduce the economic performance of Firm B and thus the value of Firm A’s investment in its partner. These kinds of strategic alliances are called equity alliances.

Many firms use cross-equity investments to help manage their strategic alliances. These arrangements are particularly common in Japan, where a firm’s largest equity holders often include several of its key suppliers, including its main banks. These equity investments, because they reduce the threat of cheating in alliances with suppliers, can reduce these firms’ supply costs. In turn, not only do firms have equity positions in their suppliers, but suppliers often have substantial equity positions in the firms to which they sell.  

FIRM REPUTATIONS

A third constraint on incentives to cheat in strategic alliances exists in the effect that a reputation for cheating has on a firm’s future opportunities. Although it is often difficult to anticipate all the different ways in which an alliance partner may cheat, it is often easier to describe after the fact how an alliance partner has cheated. Information about an alliance partner that has cheated is likely to become widely known. A firm with a reputation as a cheater is not likely to be able to develop strategic alliances with other partners in the future, despite any special resources or capabilities that it might be able to bring to an alliance. In this way, cheating in a current alliance may foreclose opportunities for developing valuable alliances. For this reason, firms may decide not to cheat in their current alliances.

There is substantial evidence that the effect of reputation on future business opportunities is important. Firms go to great lengths to make sure that they do not develop this negative reputation. Nevertheless, this reputational control of cheating in strategic alliances does have several limitations.
First, subtle cheating in a strategic alliance may not become public; and if it does become public, the responsibility for the failure of the strategic alliance may not be totally unambiguous. In one equity joint venture attempting to perfect the design of a new turbine for power generation, financial troubles made one partner considerably more anxious than the other partner to complete product development. The financially healthy and thus patient partner believed that if the alliance required an additional infusion of capital, the financially troubled partner would have to abandon the alliance and would have to sell its part of the alliance at a relatively low price. The patient partner thus encouraged alliance engineers to work slowly and carefully in the guise of developing the technology to reach its full potential. The financially troubled and thus impatient partner encouraged alliance engineers to work quickly, perhaps sacrificing some quality to develop the technology sooner. Eventually, the impatient partner ran out of money, sold its share of the alliance to the patient partner at a reduced price and accused the patient partner of not acting in good faith to facilitate the rapid development of the new technology. The patient partner accused the other firm of pushing the technology too quickly, thereby sacrificing quality and, perhaps, worker safety. In some sense, both firms were cheating on their agreement to develop the new technology cooperatively. However, this cheating was subtle and difficult to spot and had relatively little impact on the reputation of either firm or on the ability of either firm to establish alliances in the future. It is likely that most observers would simply conclude that the patient partner obtained a windfall because of the impatient partner’s bad luck.26

Second, although one partner to an alliance may be unambiguously cheating on the relationship, one or both of the firms may not be sufficiently connected into a network with other firms to make this information public. When information about cheating remains private, public reputations are not tarnished and future opportunities are not forgone. This is especially likely to happen if one or both alliance partners operate in less developed economies where information about partner behavior may not be rapidly diffused to other firms or to other countries.

Finally, the effect of a tarnished reputation, as long as cheating in an alliance is unambiguous and publicly known, may foreclose future opportunities for a firm, but it does little to address the current losses experienced by the firm that was cheated. Moreover, any of the forms of cheating discussed earlier—adverse selection, moral hazard, or holdup—can result in substantial losses for a firm currently in an alliance. Indeed, the wealth created by cheating in a current alliance may be large enough to make a firm willing to forgo future alliances. In this case, a tarnished reputation may be of minor consequence to a cheating firm.27
JOINT VENTURES

A fourth way to reduce the threat of cheating is for partners in a strategic alliance to invest in a joint venture. Creating a separate legal entity, in which alliance partners invest and from whose profits they earn returns on their investments, reduces some of the risks of cheating in strategic alliances. When a joint venture is created, the ability of partners to earn returns on their investments depends on the economic success of the joint venture. Partners in joint ventures have limited interests in behaving in ways that hurt the performance of the joint venture, because such behaviors end up hurting themselves. Moreover, unlike reputational consequences of cheating, cheating in a joint venture does not just foreclose future alliance opportunities; it can hurt the cheating firm in the current period as well.

Given the advantages of joint ventures in controlling cheating, it is not surprising that when the probability of cheating in a cooperative relationship is greatest, a joint venture is usually the preferred form of cooperation. There are some clear economies of scale in bauxite mining, for example. However, transaction-specific investments would lead to significant holdup problems in selling excess bauxite in the open market, and legal constraints prevent the acquisition of other smelter companies to create an intra-organizational demand for excess bauxite. Holdup problems would continue to exist in any mining strategic alliances that might be created. Non-equity alliances, equity alliances, and reputational effects are not likely to restrain cheating in this situation, because the returns to holdup, once transaction-specific investments are in place, can be very large. Thus most of the strategic alliances created to mine bauxite take the form of joint ventures. Only this form of strategic alliance is likely to create incentives strong enough to reduce the probability of cheating significantly.²⁸

Despite these strengths, joint ventures are not able to costlessly reduce all cheating in an alliance. Sometimes the value of cheating in a joint venture is sufficiently large that a firm cheats even though doing so hurts the joint venture and forecloses future opportunities. For example, through a joint venture, a particular firm may gain access to a technology that would be valuable if used in another of its lines of business. This firm may be tempted to transfer this technology to this other line of business even if it has agreed not to do so and even if doing so would limit the performance of its joint venture. Because the profits earned in this other line of business may have a greater value than the returns that could have been earned in the joint venture and the returns that could have been earned in the future with other strategic alliances, cheating may occur in a joint venture.

TRUST
It is sometimes the case that alliance partners rely only on legalistic and narrowly economic approaches to manage their alliance. However, recent work seems to suggest that although successful alliance partners do not ignore legal and economic disincentives to cheating, they strongly support these narrower linkages with a rich set of interpersonal relations and trust. Trust, in combination with contracts, can help reduce the threat of cheating. More important, trust may enable partners to explore exchange opportunities that they could not explore if only legal and economic organizing mechanisms were in place.29

At first glance, this argument may seem far-fetched. However, some research offers support for this approach to managing strategic alliances. This work suggests that successful alliance partners typically do not specify all the terms and conditions in their relationship in a legal contract and do not specify all possible forms of cheating and their consequences. Moreover, when joint ventures are formed, partners do not always insist on simple fifty-fifty splits of equity ownership and profit sharing. Rather, successful alliances involve trust, a willingness to be flexible, a willingness to learn, and a willingness to let the alliance develop in ways that the partners could not have anticipated.30

Commitment, coordination, and trust are all important determinants of alliance success. Put another way, a strategic alliance is a relationship that evolves over time. Allowing the lawyers and economists to too-rigorously define, a priori, the boundaries of that relationship may limit it and stunt its development.31

This “trust” approach also has implications for the extent to which strategic alliances may be sources of sustained competitive advantage for firms. The ability to move into strategic alliances in this trusting way may be very valuable over the long run. There is strong reason to believe that this ability is not uniformly distributed across all firms that might have an interest in forming strategic alliances, and that this ability may be history dependent and socially complex and thus costly to imitate. Firms with these skills may be able to gain sustained competitive advantages from their alliance relationships. The observation that just a few firms, including Corning and Cisco, are well known for their strategic alliance successes is consistent with the observation that these alliance management skills may be valuable, rare, and costly to imitate.

**SUMMARY**

Strategic alliances exist whenever two or more organizations cooperate in the development, manufacture, or sale of products or services. Strategic alliances can be grouped into three large categories: non-equity alliances, equity alliances, and joint ventures.
There are three broad reasons firms join in strategic alliances: to improve the performance of their current operations, to improve the competitive environment within which they are operating, and to facilitate entry or exit into markets and industries. Just as there are incentives to cooperate in strategic alliances, there are also incentives to cheat. Cheating generally takes one or a combination of three forms: adverse selection, moral hazard, or holdup.

Strategic alliances can be a source of sustained competitive advantage. The rarity of alliances depends not only on the number of competing firms that have developed an alliance but also on the benefits that firms gain through their alliances.

Imitation through direct duplication of an alliance may be costly because of the socially complex relations that underlie an alliance. However, imitation through substitution is more likely. Two substitutes for alliances may be “going it alone,” where firms develop and exploit the relevant sets of resources and capabilities on their own, and acquisitions. Transactions cost, capabilities, and real options theories can be used to specify conditions under which “going it alone” will not be a substitute for a strategic alliance. Acquisitions may be a substitute for strategic alliances when there are no legal constraints in acquisitions, strategic flexibility is not an important consideration, when the acquired firm has relatively little unwanted “organizational baggage,” and when the value of a firm’s resources and capabilities do not depend on its remaining independent. However, when these conditions do not exist, acquisitions are not a substitute for alliances.

The key issue facing firms in organizing their alliances is to facilitate cooperation while avoiding the threat of cheating. Contacts, equity investments, firm reputations, joint ventures, and trust can all reduce the threat of cheating in different contexts.

**CHALLENGE QUESTIONS**

1. One reason why firms might want to pursue a strategic alliance strategy is to exploit economies of scale. Exploiting economies of scale should reduce a firm’s costs. Does this mean that a firm pursuing an alliance strategy to exploit economies of scale is actually pursuing a cost-leadership strategy? Why or why not?

2. Consider the joint venture between General Motors and Toyota. GM has been interested in learning how to manufacture profitably high-quality small cars from its alliance with Toyota. Toyota has been interested in gaining access to GM’s U.S. distribution network and in reducing the political liability associated with local content laws. Which of these firms do you think is more likely to accomplish its objectives, and why? What implications, if any, does your answer have for a possible “learning race” in this alliance?
3. Some have argued that strategic alliances are one way in which firms can help facilitate the development of a tacit collusion strategy. In your view, what are the critical differences between tacit collusion strategies and strategic alliance strategies? How can one tell whether two firms are engaging in alliances to facilitate collusion or are engaging in an alliance for other purposes?

4. Some have argued that alliances can be used to help firms evaluate the economic potential of entering into a new industry or market. Under what conditions will a firm seeking to evaluate these opportunities need to invest in an alliance to accomplish this evaluation? Why couldn’t such a firm simply hire some smart managers, consultants, and industry experts to evaluate the economic potential of entering into a new industry? What, if anything, about an alliance makes this a better way to evaluate entry opportunities than alternatives?

5. If adverse selection, moral hazard, and holdup are such significant problems for firms pursuing alliance strategies, why do firms even bother with alliances? Why don’t they instead adopt a “go it alone” strategy to replace strategic alliances?
1. Which of the following firms face the greater threat of “cheating” in the alliances described, and why:
   
a. Firm I and Firm II form a strategic alliance. As part of the alliance, Firm I agrees to build a new plant right next to Firm II’s primary facility. In return, Firm II promises to buy most of the output of this new plant. Who is at risk: Firm I or Firm II?

   b. Firm A and Firm B form a strategic alliance. As part of the alliance, Firm A promises to begin selling products it already sells around the world into the home country of Firm B. In return, Firm B promises to provide Firm A with crucial contacts in its home country’s government. These contacts are essential if Firm A is going to be able to sell into Firm B’s home country. Who is at risk, Firm A or Firm B?

   c. Firm 1 and Firm 2 form a strategic alliance. As part of the alliance, Firm 1 promises to provide Firm 2 access to some new and untested technology that Firm 2 will use in its products. In return, Firm 2 will share some of the profits from its sales with Firm 1. Who is at risk, Firm 1 or Firm 2?

2. For each of the strategic alliances described in the above question, what actions could be taken to reduce the likelihood that partner firms will “cheat” in these alliances?

3. Examine the web sites of the following strategic alliances and determine which of the sources of value presented in Table 7.1 are present:
   
a. Dow-Corning (an alliance between Dow Chemical and Corning)

   b. CFM (an alliance between General Electric and SNECMA)

   c. Cingular (an alliance between SBC and BellSouth)

   d. NCAA (an alliance among colleges and universities in the United States)

   e. Visa (an alliance among banks in the United States)

   f. The alliance among United, Delta, Singapore Airlines, AeroMexico, Alitalia, and Korean Air.
Endnotes

1See Badaracco and Hasegawa (1988); Ernst and Bleake (1993); and all the other notes in footnote 2 of the 2nd edition footnote 44 in Hitt et al.


9These are issues discussed in Chapter 5. In Chapter 12, the costly to imitate nature of these kinds of reasons and capabilities is seen as a primary motivation of firm diversification strategies. See Teece, D. (1977). "Technology transfer by multinational firms," Economic Journal, 87, pp. 242-261.


11-39


10 Citations on alliance failures


62 Personal communication. DATE?

63 Personal communication. DATE?


64 T


65 Scherer


