Managing risks in strategic alliances

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Executive Overview

Managing the different kinds of risk in strategic alliances is a complex task. We propose a comprehensive framework of risk management with two components. First, we discuss the roles of relational risk and performance risk in alliance resource management. The overall goal is to gain access to partner firms' valuable resources while keeping one's own resources intact. To that end, alliance managers may choose from four orientations—control, flexibility, security, and productivity. The second part of the framework focuses on various risks in the alliance management process, including the stages of partner selection, structuring, operation, and performance evaluation. Within each stage, we identify the key risk that may affect alliance success. These risks are related to fit, flexibility, collaboration, and planning for the future. Together, the two components of the framework provide insights and guidelines for managers to effectively deal with the major risks in the management of alliances.

More and more firms are joining together in strategic alliances. The alliance activities of the thousand largest U.S. firms are expected to account for 35 percent of their total revenue by 2002—up from less than two percent in 1980 and 21 percent in 1997.¹ The number of alliances has been growing at a rate of 25 percent per year since 1985.² Every day many alliances are formed, but many are also dissolved. The high failure rate may be due to unique risks inherent in strategic alliances. We try to identify these risks, and provide suggestions for managing alliances effectively.

Strategic alliances are interfirm cooperative agreements aimed at achieving competitive advantage for the partners. Such alliances are usually forged when any single firm finds it either too difficult or too costly to pursue worthwhile business objectives on its own. Although many firms have benefited from strategic alliances, many others have been disappointed by poor performance, and still more are skeptical about what an alliance could achieve for them. Strategic alliances are generally seen as a risky strategy whose success is often unrelated to an individual partner firm's efforts.

Consider the alliance between Northwest Airlines and KLM Royal Dutch Airlines,³ which started in 1992, when Northwest went almost bankrupt and KLM took a 25-percent stake in Northwest. By linking their hubs in Detroit and Amsterdam, the two firms offered transatlantic traveling under one brand. The results were highly encouraging: Their combined Atlantic market share increased from seven percent to 11 percent in just two years. Not only did Northwest turn itself around financially, but KLM also gained handsomely from its equity investment, which grew from $400 million to $1.6 billion.⁴ Despite its early success, though, the alliance ran into trouble in short order because the two disagreed on how much control KLM should have over Northwest.⁵ The relationship soon soured, as Northwest became understandably concerned about KLM's takeover attempt. A culture clash between Northwest's heavily debt-financed approach and KLM's cautious approach worsened the situation.

This case shows that managing alliances is much more complicated and difficult than managing single firms, mainly because of the additional factor of managing the partner firm. In fact, studies have consistently shown that the failure rate of alliances can be as high as 50 percent.⁶ Compared with such nonalliances as acquisitions and subsidiaries, the success rate of strategic alliances is significantly lower.⁷ Because there is a relatively high level of failure risk in alliances, strategic
alliances must be classified as a high-risk strategy. Thus, firms need to develop a good understanding of these risks and learn ways to systematically deal with them. Many of these risks are uniquely present in alliances and typically absent in single organizations. Managers whose experience is in single-firm strategies may not have an adequate appreciation of the nature and implications of the characteristic risks associated with alliances.

A systematic risk-based approach for alliance managers is lacking in the literature. We discuss the practical implications of two established alliance risk notions—relational risk and performance risk—in alliance resource management. We then analyze the risks involved in each stage of the alliance management process and suggest ways to cope with them. This framework can be applied to the entire range of alliances, from small and large to domestic and international.

Relational Risk Is Unique to Strategic Alliances

Risk is a significant concept in management studies. Researchers have developed so-called risk analysis techniques to aid investment decisions and strategic planning. In risk analysis, managers assign probabilities to a range of possible outcomes based on several strategies under consideration. A computer program then calculates the distribution of net present value (NPV) of each strategy. Managers choose the one with the most desirable distribution of NPV.

In reality, though, managers may not know about the kinds of possible outcomes, and it is very difficult for them to assign reasonable probabilities to possible outcomes. That is why managers usually do not rely on probability estimation. Quantifying risk, while desirable, may not be the best approach in aiding complicated strategic decisions such as those in strategic alliances. In fact, research shows that managers are far more concerned with negative outcome variances, or downside risk, than positive outcome variances.

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There are also many types of risk. Thus, a more productive approach appears to be to refine the concept of risk by classifying it into different categories of downside risk. In the case of strategic alliances, we suggest a differentiation between relational risk and performance risk. While relational risk is the risk of unsatisfactory interfirm cooperation, performance risk is all other factors that adversely affect alliance performance.

Relational risk is concerned with the probability that partner firms lack commitment to the alliance and that their possible opportunistic behavior could undermine the prospects of an alliance. Consider the example of the joint venture formed by Liz Claiborne and Avon. After Avon acquired Parfums Stern, a high-end cosmetics firm, Liz Claiborne regarded Avon as a direct competitor, and their relationship began to deteriorate. The joint venture was eventually acquired by Liz Claiborne. As this case shows, partner firms—not surprisingly—tend to be interested more in pursuing their self-interest than the common interest of the alliance. Alliance partners are primarily motivated in enhancing their self-interest at the cost of the partner firms and even the alliance. Such opportunistic behaviors include shirking, appropriating the partner's resources, distorting information, harboring hidden agendas, and delivering unsatisfactory products and services. Because these activities seriously jeopardize the viability of an alliance, relational risk is an important component of the overall risk in alliances. Relational risk is unique to strategic alliances and single-firm strategic moves are not subject to such risk. When firms pursue market opportunities on their own, there is little need to cooperate with others, so that there is no risk of unsatisfactory interfirm cooperation. Thus, relational risk is an unavoidable—and quite problematic—element of strategic alliances.

Performance risk is the probability that an alliance may fail even when partner firms commit themselves fully to the alliance. Despite the best efforts of the partner firms, an alliance can still fail because of internal and external factors (other than the relational risk discussed earlier). The sources of performance risk include environmental factors, such as government policy changes, war, and economic recession; market factors, such as fierce competition and demand fluctuations; and internal factors, such as a lack of competence in critical areas, or sheer bad luck. Unlike relational risk, however, performance risk is part of every strategic decision, because performance can always fall below one's expectations. Whereas relational risk is created and is present only in alliances, performance risk relating to any undertaking is something that is shared by all partner firms. For instance, joint bidding enables partner firms to share the costs as well the performance risk involved in a contract. Rather than pursue
projects alone, firms use strategic alliances to reduce their performance risk. Take the example of Montreal-based Bombardier, which competes in business jets and small airliners.\(^1\) In order to control development costs, the firm uses partners of many countries to share about half of the $1 billion development cost for its newest business jet. These partner firms share the development and manufacturing costs of key parts of the plane. Similarly, Boeing has arrangements with three airplane engine producers—GE, Rolls-Royce, and Pratt & Whitney—to share the risk and cost of airplane development.\(^2\) In both these cases it is clear that the risk-sharing in their alliances refers to performance risk only. We need to note, however, that this performance risk is in addition to whatever relational risk the alliances may have for individual partner firms.

Risks in Managing Alliance Resources

We now discuss the role of relational risk and performance risk in alliance resource management and show how they would influence the orientations of the partner firms in an alliance. A firm’s unique resources and capabilities constitute the key foundation of its competitive advantage in the marketplace. Resource management, which is about identifying, utilizing, and securing valuable resources, is a critical element in business performance. There are four different aspects in resource management in strategic alliances: optimally using one’s existing resources; developing new resources; protecting one’s resources, for example, by avoiding unintended transfer and imitation; and gaining access to other firms’ resources if necessary.

When companies do business on their own, they are involved in the first three aspects of resource management. Recognizing the importance of the fourth aspect—gaining access to resources—has led to the popularity of strategic alliances, which are all about taking advantage of others’ valuable resources. Of course, alliances open up new opportunities for the first two aspects as well. Through these strategies, firms identify creative and more productive ways of utilizing their own resources. They also discover fresh routes to developing new resources.

While alliances are particularly effective and nimble in gaining access to others’ resources, their disadvantage is that protecting their own resources also becomes more complicated. Firms need to explicitly protect their own resources from unintended transfers and imitations.

Thus, from the resource management perspective, one key challenge for firms in strategic alliances is to effectively protect themselves from losing critical resources at the same time as they attempt the fullest use of their contributed resources. In order to do that, firms need to develop a sense of priority, or orientation, in managing alliances. We refer to alliance orientation as the one aspect of an alliance that a partner firm deems the most critical, and to which, accordingly, it pays the most attention.\(^3\) For example, many firms have a flexibility orientation in their alliances in order to adapt to changing conditions more easily. The software company Lotus often negotiated vague agreements so that changes could be accommodated. In fact, Lotus does not have formal agreements in more than 50 percent of its alliances.\(^4\) We suggest that there are two dimensions that are important in what we have termed alliance orientation—the type of primary resource and the type of primary risk. The type of resource a firm brings to an alliance determines what is at stake, such as possible losses. But the primary risk reflects what hazard the firm faces—that is, the underlying reason for possible losses. A firm’s orientation in an alliance will depend on these two factors (see Figure 1).

Two Types of Resources—Property and Knowledge

Firms may contribute various types of resources to an alliance,\(^5\) including physical, financial, human, technological, managerial, and organizational resources. One useful way to classify these resources is in terms of the different protective arrangements they need. Resources can be classified as either property or knowledge.\(^6\) Resources are properties when there are clear property rights and a firm’s ownership is absolute and is protected by law. Physical and financial resources are examples of properties, as are patents, contracts, logos, and trademarks that are protected by law. The protection of properties has a fairly clear basis and is easy to implement. Properties cannot be freely obtained by others because of the ownership barrier. The protection of knowledge, however, relies on the knowledge barrier. That is, other firms do not have an easy way of appreciating the tacit skills and knowledge involved in one’s technological, managerial, and organizational resources. Because the knowledge barrier is the only protection against unintended transfer of knowledge, such knowledge may well be imitated by other firms, thereby negating the associated competitive advantage. There is little legal protection against such loss. For example, in the case of Ciba Corning
Strategic Alliance Orientations for Primary Risks and Resources

Diagnostics, a joint venture between Ciba-Geigy and Corning, both partner firms contributed such knowledge. Ciba is rich in its know-how in therapeutics and body mechanisms, while Corning leads in medical technology. In this alliance, each firm’s know-how will be exposed to the other firm—at least to some extent.

A partner firm’s resource contribution to an alliance can be either primarily property or primarily knowledge. It would be rare for a firm’s contribution to be equally split between property and knowledge. The primary resource is the type of resource that a partner firm deems more important and valuable. Multinational companies often contribute capital, patents, tacit technology, and managerial expertise to their joint ventures at the same time. However, one particular type—property or knowledge—is usually more heavily represented or is believed to be more valuable to the firm. Clearly, the protection of one’s primary resource should be a priority in the alliance. For example, Coca-Cola formed a joint venture with France’s Groupe Danone in order to sell its Minute Maid orange juice in both Europe and Latin America.

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Before the alliance, Coca-Cola was unsuccessful in its orange juice business in Europe mainly because of the lack of effective distribution channels. Danone’s delivery network provided the alliance with the primarily property-based resource—that is, distribution channels. Coca-Cola, by comparison, contributed both property, in the form of production capacity, and knowledge, in the form of marketing know-how. However, its contribution of the property resource in this case was far more important than its knowledge resource.

Strategic Alliance Orientations

We now discuss the ways in which firms with particular resource orientations can manage the two kinds of risks—relational and performance—inherent in strategic alliances. This will involve managing issues such as control, flexibility, security, and productivity (see Figure 1).

Control Orientation

When a partner firm contributes primarily property resources and considers relational risk to be the major risk, its concern is that its properties may be misused and that the other party may reap undue benefits. Although properties are protected through legal ownership—and cannot be taken away without the owner’s consent—these can still be employed in unintended ways. For example, in 1993, U S West invested $2.5 billion and obtained a 25.5 percent minority stake in Time Warner Entertainment, a division of Time Warner Inc. The alliance ran into trouble when Time Warner Entertainment proposed several deals with other telecommunication companies, such as AT&T. U S West claimed that these deals would potentially compete with its own local telephone franchise. These proposals were all vetoed by U S West. Apparently, with considerable properties at stake, the orientation of the firm in such circumstances will be tighter control—that is, making sure that its properties are used in consonance with its own interests and intentions. In essence, the issue is about dealing with the relational risk of the alliance.

Control can be achieved in different ways, such as...
as contractual control, equity control, and managerial control. Contractual control means specifying the details of usage of properties in the alliance agreement. There should be explicit specification of when, where, and how money, plants, distribution channels, and patents are to be used. Equity control is about ensuring desirable behavior and outcome in an alliance through equity ownership. While contractual control is useful in virtually all alliances, equity control is relevant only if an alliance involves equity creation, such as joint ventures, or other equity arrangements, such as minority equity alliances. Equity control can be exercised by having majority equity ownership, which implies more authority and bargaining power, or by inviting the partner on board, asking the partner to take some equity position in the alliance. Shared ownership aligns the interests of partners and deters opportunistic behavior. As a result, more collegial behavior may be expected. When Procter & Gamble first entered the Russian market in 1991, it did so with nonequity alliances. P&G transferred knowledge to its Russian partners so that they could produce P&G brand of products. Eventually, P&G realized that it needed to exercise more control over its alliances and chose to do so through equity participation. In its latest alliance with NBKh, P&G acquired a $50 million stake, and the alliance has thus far been successful.22

A third type of control for a partner firm is managerial, which ensures tight monitoring of alliance operations. To have one’s own staff in key posts in an alliance is a significant mechanism for effective managerial control. Partner firms can also have regular meetings to prevent sudden complications in operations. In an alliance between Kodak and Chinon, a medium-sized Japanese camera company, Kodak insisted on having its division manager manage the relationship.23 The manager exercised managerial control through frequent interactions and communications, which helped make the alliance work.

Flexibility Orientation

When performance risk is the major risk and a firm contributes mainly properties, its orientation in the alliance will be flexibility. Flexibility enables a partner firm to be free from rigid, engaging, and long-term agreements, enhancing the ability to adapt to changing circumstances. Because the major risk is that the alliance may fail even if the partners are fully committed, the firm should be concerned about losing its invested resources—in this case, mainly properties. The firm may not be able to recover financial and physical resources that are invested in the alliance. For example, a firm may plan to build a new production facility but may be apprehensive that the market situation may worsen. Thus, the key is to reduce the performance risk of the alliance, which can be achieved by reducing the probability of a failure, and by reducing the adverse impact of a possible failure.

One way to enhance the odds of alliance success is to invest additional resources, but that could increase the adverse impact of a failure farther along. Also, there is a limit to what additional investments can do to help achieve desired results. External factors—such as the economy, market, and competition—can sometimes be more important than resource commitment. By this reasoning, reducing the potential adverse impact of a failure can be a safer course of action for controlling significant performance risk. Firms therefore need to achieve a relatively high level of flexibility. Flexibility enables a firm to minimize sunk costs, adapt to new situations, and recover more investment should the alliance fail.

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There are a number of ways for partner firms to be flexible. First, they can opt for short-term, recurrent contracts. These contracts specify an incremental process of alliance making. Additional investments beyond the initial amount are not made until the results of the preceding periods meet expectations. Merck, for example, adopted this approach in its partnership with Astra AB of Sweden.24 Merck started with a distribution agreement that allowed it to market Astra’s new drugs. Initial success led Merck to set up a new venture to handle a wide range of Astra products. Encouraged by satisfactory results, Merck strengthened the tie by inviting Astra to take a 50 percent stake in the venture. It is apparent that, as compared with long-term agreements, recurrent contracts are more adaptive to changes in the environment and the needs of the partner.

Second, partner firms can choose alliance forms that are relatively less engaging. Whereas joint ventures and minority equity alliances represent more engaging forms, the less engaging ones include licensing, funded research, shared distribution and product-bundling. Less engaging alliances not only require less investment and are more easily terminated, but their termination usu-
ally also does not mean incurring huge costs. In the biopharmaceutical industry, joint ventures represent only 20 percent of all alliances. Most of the alliances are so-called virtual, or informal, alliances that involve no separate entities. For example, Abbott Laboratories has formed many marketing alliances with biotech companies such as North American Vaccine (NAV).\(^{25}\) Whereas Abbott profits from getting NAV’s products to the market, NAV benefits from Abbott’s massive sales force plus a one-time payment of $42 million and royalties on sales. Such agreements are relatively easy to terminate and are considerably more flexible than joint ventures.

Third, partner firms can emphasize exit provisions in the alliance arrangements. Exit provisions lay out how an alliance termination will be executed, should there be one. Specific costing and pricing formulas should be featured explicitly, so that there is no uncertainty about who gets which part of the alliance. Although ownership rights of properties are fairly clear, alliance activities can eventually blur the ownership contours. Without exit provisions, investing firms may be concerned that they will be dragged into ownership disputes. Thus, the utility of exit provisions is that the investing firm will feel less concerned about the recovery of their initial investment. In the alliance between IBM and Russian PC maker Kvant for the assembly and sale of IBM PCs in the Russian market, the partners negotiated “an escape clause that permitted either partner to leave the alliance due to changes beyond its control in the local market.”\(^{26}\) In 1995, two years after the alliance was formed, the Russian parliament amended the previous legislation that allowed IBM to import PC parts free of tariff. Because the key motivation behind the alliance was to take advantage of the tariff difference between complete PCs and PC parts, IBM concluded that it did not make sense to stay in the alliance any longer. Thanks to the escape clause, IBM was able to exit swiftly and even retrieve its equipment. Structural flexibility allowed IBM to avoid a major loss in this case.

**Security Orientation**

In the case of a partner firm that contributes mainly tacit knowledge and know-how to an alliance, but is concerned about high relational risk, the issue is the security of contributed resources. Relational risk here is mostly in terms of the likelihood of one’s technological and managerial know-how being stolen by a partner firm. Obviously, knowledge plays an increasingly important role in today’s competitive market and knowledge-based competition is gaining in momentum. Thus, firms often form alliances to learn others’ knowledge. Alliances become learning races,\(^{27}\) in which the partner that more quickly grasps the other’s knowledge gains more bargaining power and obtains an upper hand in the relationship. For instance, JVC of Japan and Thomson of France are direct competitors, as they both make VCRs. In their alliance, it was clear that JVC’s knowledge of the fragmented European market, while Thomson was interested in technological know-how.\(^{28}\) In this case, whichever partner acquires the needed knowledge will reap benefits faster.

As we mentioned earlier, the protection available for knowledge is essentially the knowledge barrier, as there are hardly any clear ownership rights. Such rights are difficult to delineate because that involves protecting something that is basically tacit in character. Thus, firms may relatively easily obtain other firms’ valuable knowledge in an alliance. Some scholars warn that joint ventures with Japanese firms are eroding the competitive advantage of American firms because Japanese firms are motivated by a need to learn while American firms are motivated by a need to avoid investment.\(^{29}\) Of course, it could go in the other direction as well. For instance, the U.S. company Ralston Purina had an alliance with Taiyo Fishery Company of Japan for 20 years. The alliance was later terminated by Ralston Purina after it concluded that it had successfully acquired Taiyo’s local knowledge through the alliance.\(^{30}\) Given the relational risk involved with knowledge resources, firms need to deal with knowledge imitation and focus on securing their distinctive know-how. Hence, knowledge security should be the alliance orientation.

To ensure such security, firms should attempt to limit the exposure of tacit knowledge and know-how to their partner firms. Instead of forming alliances, such as joint ventures, in which firms work closely, firms may choose to form alliances in which partners work separately—as in the case of funded R&D and outsourcing agreements. Unauthorized learning tends to be curbed when the operations of an alliance are carried out separately by partner firms. Firms should also make it clear prior to alliance formation that they are aware of the possibility of unauthorized learning and are committed to preventing it from happening. Once this message is conveyed, false expectations on the part of the other party will be minimized. Accordingly, those who are interested only in secretly acquiring knowledge will be discouraged. Finally, firms should also warn their alliance staff to be
careful about unauthorized sharing of sensitive knowledge and information. It is helpful to specify the kind of information that can be shared.

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Productivity Orientation

When high performance risk is the major risk and the firm contributes mainly knowledge, there is a concern that one's knowledge—in combination with other resources—may not result in acceptable alliance performance. To deal with this risk and enhance the odds for success, firms need to focus on the productivity of knowledge, that is, on how its knowledge and know-how should be used to yield effective results in an alliance. The superior knowledge of individual partners often fails to bring about superior alliance performance. Because of incompatible organizational routines and cultures, partner firms often do not work together efficiently. For example, large firms with rigid organizational cultures sometimes have trouble working with smaller firms, which tend to have more dynamic and informal cultures. In 1983, AT&T and Olivetti formed an alliance in the end-user market in office equipment. Although both firms had significant amounts of complementary resources, the alliance was later dissolved because AT&T's bureaucratic organizational culture clashed with Olivetti's dynamic and entrepreneurial culture. Thus, firms need to figure out ways to expeditiously integrate these intangible elements of their systems.

Another reason for unsatisfactory alliance performance is that firms have what has been called internal stickiness, because of which they fail to adopt partner firms' superior knowledge and know-how. To address this problem, firms need to overcome organizational learning barriers and let knowledge and know-how cross firm boundaries. In contrast to the learning races associated with high relational risk, the issue here is the inability to make learning happen and the resulting lack of desired integration of each other's knowledge.

Unsatisfactory performance may also result when superior knowledge and know-how are used outside their appropriate context. When AT&T acquired NCR, it hoped to transfer its know-how in the telecommunications field to the PC business. The strategy did not work, partly because such a transfer was not feasible. A group of engineers visited AT&T's Bell Labs and failed to identify possible technological know-how that could be used at NCR. Although the acquisition was not an alliance, it illustrates that not all knowledge can be simply transplanted without modification. Superior knowledge can be productive only if it meets the needs of the alliance.

Risks in Different Stages of Alliance Management

So far we have discussed the role of relational risk and performance risk in alliance resource management. Now we turn to the role of these two types of risk in the overall process of alliance management. Alliance management can be viewed as a process consisting of various stages. Here, we focus on four essential stages of a strategic alliance—selecting partners, structuring the alliance, operating the alliance, and evaluating alliance performance. We examine in some detail the key risk issues—and their management—relevant to each of the four alliance stages. (See Figure 2.)

Risks in Achieving Partner Fit: Selecting Alliance Partners

The first stage in forming alliances is the selection of partner firms. This is not an easy decision because there are many different criteria for a good partner. Bleeke and Ernst suggest that certain patterns of alliances tend to fail, among them alliances between competitors, between weak and strong firms, and between weak firms. They suggest that alliances of strong equals are more likely to succeed. Others suggest that high levels of interfirm trust and complementarity of resources are essential conditions.

From the point of view of risk, partner selection boils down to the risk of finding a fit between partner firms. Partner firms have resource fit and strategic fit. Resource fit refers to the degree to which partners possess compatible resources, that is, resources that can be effectively integrated into a value-creating strategy. Strategic fit is the degree to which partners have compatible goals in the alliance. These two types of fit need to be achieved simultaneously in an alliance. Hence the special risk of failing to ensure proper partner fit.

Resource fit is important for alliance partners because resources and capabilities of alliance partners are ultimately responsible for alliance performance. Indeed, it is the need for critical resources that motivates firms to approach their potential partners. Resource fit means that partners' resources are somewhat related; they either com-
Alliance Management Stages

1. Selecting alliance partners
2. Structuring the alliance
3. Operating the alliance
4. Evaluating the alliance

Risks in finding fit
Do both resource fit and strategic fit exist between the partner firms?

Risks in maintaining flexibility
Is there a balance between structural flexibility and rigidity?

Risks in managing collaboration
Is there a balance between cooperation and competition?

Risks in planning for the future
Is there a balance between a short-term and a long-term orientation?

Effective alliance performance

No
Misfit: The alliance should not be formed.

Yes

No
Mismanagement of risks: Poor performance.

Yes

No
Mismanagement of risks: Poor performance.

Yes

No
Mismanagement of risks: Poor performance.

Yes

FIGURE 2
Managing Risks and Their Impact on Performance

In finding resource fit, partners often risk ignoring the question of compatibility of strategic objectives, or strategic fit. Strategic fit of the alliance means that the firms know each other's real objectives in the alliance, and that these objectives can be accommodated in the alliance without harming the alliance or the partner firms. Many firms falsely assume that partner firms share objectives in an alliance. In fact, firms often harbor hidden agendas in alliances. For instance, alliances are often used as a cover from eventual acquisition or divestiture. Even if hidden agendas are not present, an alliance may serve vastly different purposes for the individual partners. One firm may seek market penetration, another reputation. Knowing each other's real objectives in an alliance is not an easy task. However, not knowing is dangerous, and often leaves a firm in a vulnerable position. In the alliance between Northwest and KLM, Northwest did not fully realize KLM's intention to gain substantial control over its partner. As a result, an equity alliance evolved into a corporate governance battle.

Partners need not necessarily worry about having different objectives. The key is whether these objectives are compatible, that is, whether they can be achieved simultaneously. When different
objectives are not in line, there will be no compatibility. General Motors and South Korea's Daewoo formed an alliance, although GM was interested mainly in staying with existing models and keeping costs down, and Daewoo was more interested in upgrading technology and designing new models. The alliance failed eventually, partly because of this mismatch between a cost orientation and an R&D orientation. Since partners' objectives often shift with the passage of time, it is important—and difficult—to anticipate future conflicts. For example, firms can employ scenario analyses to help assess how the alliance and the partner firms may evolve over time and how the evolution may change the relative positions of each partner. When KLM first invested $200 million in Northwest, its objective was a transatlantic alliance. Eventually, KLM became interested in acquiring Northwest as a way to get into the U.S. market.

Risks in Maintaining Flexibility: Structuring the Alliance

In the second stage of alliance management, partner firms negotiate the structure of the alliance. As we noted earlier, alliances can have various structures, ranging from joint ventures and minority equity alliances to joint production, joint marketing, funded R&D, and licensing, each arrangement serving different needs. According to Yoshino and Rangan, managers with alliance experience stress the importance of having the most appropriate type of alliance structure.

As compared with single organizations, strategic alliances denote a more flexible arrangement. Indeed, flexibility is one of the key advantages of alliances. Partner firms can afford to be involved in alliances in various degrees. Because they share only a part of the total investment in an alliance, terminating a project is also easier. While mergers and acquisitions provide permanent access to other firms' resources, alliances enable partners to gain access to those resources temporarily—and with much more flexibility. In a highly competitive and volatile environment, the advantage of being flexible is quite important for alliance formation and success.

The risk in maintaining a high level of flexibility, however, is that flexibility is not always an advantage. Our earlier discussion on alliance resource management showed that flexibility is particularly needed under certain circumstances. Structural rigidity—the opposite of flexibility—is often necessary as well. Structural rigidity involves a high degree of connectedness and tightness, whereby members in an ongoing relationship are linked with each other in some tangible way. Partner firms are in the same boat and the relationship cannot be terminated easily. Strategic alliances have often been seen as being too loosely coupled, so that they lacked a strong authority structure and significant commitment. Structural rigidity helps consolidate the relationship and force partners to focus on the success of the alliance rather than on preparing for an exit at any time. Because highly interconnected partners share more common interests, possible opportunistic behavior will be contained.

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Clearly, given the inherent conflict between flexibility and rigidity, firms should not be single-minded in their pursuit of flexibility. A balance is required between the two desirable but opposing conditions. Because some alliance structures, such as funded R&D and licensing, are, by design, more flexible than others, such as joint ventures and equity swaps, firms may wish to bring in some complementary elements. For example, in a flexible comarketing agreement, one firm may choose to acquire the other's equity to strengthen the bond. In an equity joint venture, firms can have clauses that allow partners to renegotiate the deal at a future date. When Siemens and Allis-Chalmers initially hammered out their joint venture agreement, they decided that they could renegotiate the deal and that Siemens would have the right to purchase the venture. The two partners eventually did go through the renegotiating and Siemens exercised its option.

Risks in Managing Collaboration: Operating the Alliance

After an alliance is structured and set up, partner firms work together to operate the alliance. The risk becomes managing the collaboration, and having either insufficient cooperation or too much. Sufficient cooperation is the foundation for a successful alliance as it is necessary for partner firms to work for the realization of collaborative advantage. Cooperation means that firms pursue common interests in the alliances, so that they restrain their self-interested activities that may harm their partners. In the absence of sufficient cooperation, firms will tend to ex-
ploit the alliance and their partners for their private interests.

By contrast, overemphasizing cooperation or ignoring the importance of competition in alliances is also fraught with danger. In fact, a certain level of competition is essential in alliances because private interests are inevitable. Competition implies that firms realize that their interests are not entirely similar or compatible, so they attempt to protect their own interests, even if it means undermining their partners. The difference between competition and opportunistic behavior, however, is that competition is open and legitimate whereas opportunistic behavior is self-interested with guile. Competition in alliances takes such forms as learning from partners, protecting one's own tacit knowledge and personnel, and preventing the alliance from becoming a direct competitor in one's core business. Competition is the universal rule of the marketplace. Since strategic alliances are a combination of market transactions and internal operations, competition will still have an important role in alliances. Goodyear, for instance, has a joint production alliance with Japan's Sumitomo. Although the two manufacture tires for each other in Asia and North America, they remain competitors in many markets. Alliances do not provide a safe haven for colluding with competitors, as competitors remain competitors even when they have alliances. Oracle uses a concept known as co-operation to manage its alliances—which means that competition and cooperation are handled simultaneously. Whereas 30 percent of its alliances are with competitors, Oracle makes sure that it does not lose any competitive advantage.

Thus, the risk in operating an alliance is that partners often overemphasize either cooperation or competition. The challenge is to have both of them present in an alliance. Without adequate cooperation, alliances cannot be operated smoothly. Without sufficient attention to competition, alliances will unwittingly lose their competitive advantage and equitable rights and rewards. Both cooperation and competition must be preserved in an alliance as dynamic and permanent conditions. A sense of competition should be interwoven with the spirit of cooperation.

In evaluating alliance performance, the risk is that a partner may rely completely on either a short-term orientation or a long-term orientation. With a short-term orientation, partner firms view alliances as transitional in nature and capable of delivering only quick and tangible results. Partners demand quick results in the short run and tend to be less patient with long-term investment and commitment. Consequently, alliance performance evaluation will rely heavily on financial and market-based indicators. A short-term orientation may well be valuable for an alliance, as alliances are often under pressure to deliver results in a rapid fashion. By the very nature of alliances as joint entities, the partner firms probably cannot be as patient as they are regarding their own separate operation and performance. Tangible results are important to keep an alliance going. If short-term performance is ignored, the alliance may lose its focus and fail to enlist sustained support of the partners.

Both cooperation and competition must be preserved in an alliance as dynamic and permanent conditions. A sense of competition should be interwoven with the spirit of cooperation.

On the other hand, a long-term orientation has its own value in alliances. When partners adopt a long-term orientation, they view the alliance as at least semipermanent—an entity that will grow and adapt to the changing environment in the future. As a result, more patience, investment, and commitment are likely to be generated. In evaluating alliance performance, partner firms will look more at the overall state of the alliance—that is, cooperation and morale—rather than only the financial and market aspects of the alliance. Such a long-term orientation is particularly helpful when there is a high degree of uncertainty—for example, technological uncertainty—in the market. With a fairly long-term orientation, partners are better able to overcome the initial problems in an alliance. Often, however, alliance partners have the problem of expecting results much too soon. They dissolve alliances too quickly, before tangible results could reasonably be expected to be achieved. In fact, alliances are time-consuming projects because partner firms have to learn to work together smoothly and efficiently. Unfortunately, that takes more time than most firms like. But partner firms should be prepared for this extended process and adjust their expectations accordingly. The exper-
ence of Advanced Elastomer Systems, a joint venture between Monsanto and Exxon, is revealing in this regard. From the very beginning, the venture was expected to be a quick success because it had outstanding technology and a rapidly emerging market. It took some time for managers to realize that something was wrong—namely, the corporate culture. Because managers came from two successful firms with very rigid and systematic decision-making styles, they were uncomfortable with a more adventurous style needed in an emerging market. The managers, therefore, decided to design and create an effective organizational culture and leader/manager profiles. These efforts eventually paid off and the venture grew successfully, a lesson that there are many factors working against a quick success.

Given the importance of both short-term and long-term orientation in alliances, the two need to be integrated somehow. To reduce the risk in planning for the future—that is, the risk of relying on only one time orientation—partner firms should settle on reasonable, concrete objectives for each stage of the alliance management process. Initially, financial and market measures should not be emphasized. An incremental approach, which allows both timely feedback and long-term adaptation, should work well with alliances.

Guidelines for Managing Risks

Strategic alliances stand out as a high-risk strategy because a partner firm has less control over the alliance than it has over its own subsidiaries.

The two major types of risk in alliances—relational risk and performance risk—represent two major sources of unsatisfactory performance, one internal to the relationship and the other external to the relationship. Alliance resource management must explicitly take the unique alliance risks into account. Partners should pay simultaneous attention to their resource procurement and resource protection strategies.

Risks that are important at each stage of the alliance management process have also to be managed. These risks relate essentially to balancing the competing demands in each stage, such as the demand for flexibility and the demand for rigidity. The risk is in ignoring any one of the opposing demands.

The difficult task of managing risks in strategic alliances can be carried out only if managers first understand the complex nature of these risks. Managers would do well to employ the following guidelines to effectively manage the various risks in strategic alliances.

- Emphasize protection of your own primary resource. Remember that:
  - Risks are relatively low in protecting physical and financial resources, including patents, contracts, logos, and trademarks (ownership protected by law).
  - Risks are high in protecting technological, managerial, and organizational resources. Be careful about unintended transfer of knowledge and imitation; you have little legal protection here.

- Exercise control through contracts, equity, and management. Employ, as appropriate:
  - Contractual control (specify usage of properties).
  - Equity control (majority or shared ownership).
  - Managerial control (have one’s own staff in key positions, regular meetings, frequent interactions and communications).

- Retain flexibility through short-term recurrent contracts, limiting commitment, and effective exit provisions. You need the ability to adapt, to be free from rigid contracts, and to be able to recover invested resources. Hence:
  - Have contracts specifying an incremental process of alliance making.
  - Avoid joint ventures and minority equity alliances in favor of less engaging forms such as licensing, shared distribution, and product bundling.
  - Insist on specific costing and pricing formulas and clear property rights, as alliance activities tend to blur ownership contours.

- Safeguard continued security by limiting exposure to know-how:
  - Maintain the knowledge barrier by forming alliances in which partners work separately, such as in funded R&D and outsourcing agreements—unless you are willing to work closely with partners, as in joint ventures.
  - Make clear to partners and your own staff that unauthorized learning will need to be prevented.

- Ensure increased productivity by emphasizing superior alliance performance:
  - Focus on knowledge productivity, particularly by seeking compatibility of organizational routines and culture of partners.
  - Identify and eliminate internal stickiness and learning barriers that prevent integration with partner’s superior knowledge.
Endnotes


14 Das & Teng, 1996a, op. cit.


26 Bruton & Samiee, op. cit., p. 56.


41 Bleeke & Ernst, 1995, op. cit.


43 Tully, op. cit.


Yoshino & Rangan, op. cit.

Das & Teng, 1999a, op. cit.

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