EXECUTIVE INSIGHTS

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Strategic Alliances: Exploiting Economic Uncertainty to Create Value

Over the last two decades, companies have sought competitive advantage by cutting costs and improving efficiencies. Although these steps succeeded for a while, companies discovered during this period that the playing field was changing. The accelerating pace of globalization resulted in a host of new competitors from both developed and emerging economies. In today's recessionary climate, companies are being challenged to reduce costs that traditionally would have been considered "sacred cows." L.E.K. Consulting believes that in this turbulent environment, forging strategic alliances represents a low-risk, cost-effective way to gain competitive advantage.

Old wine in a new bottle? No. More accurately, *a battle-tested idea in a newly applicable context.*

This issue of *Executive Insights* explores the opportunities that well-planned strategic alliances offer for short- and long-term improvements to bottom-line performance, as well as top-line growth.

L.E.K. Consulting has broad experience and expertise assisting companies around the world in developing strategic alliances. We help companies screen potential targets, operationalize partnerships, and maximize the benefits of alliances.

Introduction

Beyond traditional efficiency and cost-cutting measures, where should companies look to find cost-based competitive advantage? Our research and experience leads us to believe that strategic alliances represent an important opportunity for firms to improve performance and compete more effectively in the global arena.

In the past twenty years, companies in the United States and around the world have cut their operating costs by many billions of dollars. Successive waves of managerial and technological innovations deserve most of the credit for this positive change. CEOs everywhere have become well versed in such concepts as re-engineering, lean manufacturing, outsourcing, overhead reduction, purchasing cost reductions, cycle time reduction and any number of innovative information technology applications.

While some of these programs have delivered sustainable bottom-line improvements, others have had only short-term impacts. Many corporate leaders have discovered, to their dismay, that cost-cutting over the long term often proves to be a strategy of declining returns. And, revisiting the same mechanism a second or third time tends to yield even more meager results. For example, take head-count reduction. Often, there is not alignment between the strategic and operational objectives of an organization. When line managers are forced to make head-count reductions for the second or third time to meet business needs, it forces efficiencies in the organization but can lead to missed revenue-generating opportunities or increased contractor spending. Ultimately, *increasing* operating expenses, as head count is decreased.

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Even high-impact initiatives like outsourcing of manufacturing and the IT function can shift quickly from competitive advantage to competitive disadvantage. Many factors can cause this kind of abrupt reversal – – For example: changes in energy and commodity costs, fluctuations in currencies, and inflation and wage increases in the countries to which operations have been outsourced.

At the same time, savvy suppliers have learned to protect themselves against the relentless grinding away at their margins when traditional cost-saving purchasing strategies are employed. They've had no choice: If they don't push back,they'll be driven from the field. (Think of the automotive suppliers or Walmart's vendors.) In self defense, they find ways to build in enough cushion to manage variability and withstand short-term setbacks.

In this challenging economic environment, many companies are now looking for new ways to achieve sustainable cost reductions – and, by extension, competitive advantage.

Strategic Alliances: The Logical Next Step Toward Better Operations

Many companies have discovered the advantages of strategic alliances. Since the 1980s, such alliances have proliferated, increasing at a rate of 25 percent per year. Revenue generated by alliance activities of the 1,000 largest firms in the United States has grown from 2 percent of overall revenue in 1980 to an estimated 40 percent in 2006.

The concept of strategic alliances is far from new, but its importance is increasing. In an age when both competition and volatility are increasing, the lines between "products" and "services" are becoming blurred, and one's best supplier can also be one's fiercest competitor, companies are finding that partnerships give them an edge. Whether it is a question of survival or simply a desire to exploit an opportunity, strategic alliances give companies important advantages they could not gain on their own.

Let's develop some context from a few historical examples:

In 1974, GE and Snecma realized the potential of a trans-Atlantic strategic partnership that would let them sell aircraft engines not only to the two biggest commercial airframe manufacturers in the world, but to the defense industries across Europe and in the U.S. Thus, they combined their technological and marketing expertise and produced a reliable, highly efficient, and market-relevant family of engines – the CFM56 series (by combining two of their core products – GE's CF6 and Snecma's M56 engines). Since the alliance's inception, CFM International has delivered over 18,000 engines to airframe manufacturers all over the world. And, most recently, they were selected as the sole engine of choice on the Boeing 737 and the Airbus A34 – two of the most successful short – and long-range aircraft. In 2005, three global auto manufacturers – Daimler Chrysler, Hyundai, and Mitsubishi Motors – pooled their R&D, manufacturing best practices, and financial resources to form "Global Engine Manufacturing Alliance," or GEMA. Through GEMA, the three automakers shared financial resources and technologies. In the process, they created one of the most efficient and flexible manufacturing auto plants in the world: the GEMA facility in Dundee, Michigan, which uses lean manufacturing principles to produce up to 2 million units per year.

It is certainly fair to ask how well this alliance has performed in light of the Daimler Chrysler break-up, Chrysler's continuing troubles, and the overall decline of the auto industry. The short answer is that, yes, GEMA has struggled during the past few years, but by all accounts has served its intended purpose of providing the alliance members with technology and platform sharing, cost efficiencies, and production scalability.

Objections – and Responses

If strategic alliances are so great, why don't all companies jump into them?

One answer is *fear*. Historically, strategic alliances have frightened companies – in many cases, for good reason. Alliances prompt concerns about product and process allocation, customer perception, capital write-offs, and overhead duplication. To many firms, strategic alliances raise the disturbing specter of violating antitrust laws or other government regulations. There have been spectacular, well-publicized failures of doomed partnerships in which companies became inextricably mired in governance and ownership challenges long before they could lay claim to any of the benefits of that alliance.

Fair enough. Our work at L.E.K. suggests that *only strategic alliances that are properly structured can provide both operational efficiencies and a low-risk path to sustainable value.* No one should sign on to a ship that does not have an agreed-upon destination.

For other companies, the idea of sharing costs, processes, and product information with their competitors can feel like the violation of a cardinal rule of business. Such information has long been viewed as the wellspring of competitive differentiation, and the notion of sharing it with a competitor is unthinkable.

Respectfully, we argue that this paradigm is outmoded. Most of the research, development, and manufacturing data which used to be considered closely guarded trade secrets, can now be found quickly (and legally) on the Internet or through other publicly available resources.

In other words, a misplaced paranoia can get in the way of a perfectly sensible match. A few years ago, L.E.K. consulted with two companies that were edging up to the idea of a manufacturing alliance. The problem: Managers in each firm were convinced that their particular metal-forming processes were unique and that this uniqueness gave them significant cost advantages over all other competitors – including the prospective suitor. Our research soon revealed that *not only did the two companies use nearly identical processes, but both used the same equipment and suppliers.* The only reason they had different cost structures, it turned out, was because they used different accounting methodologies!

Some companies and managers find it hard to accept the idea that a firm can create value for itself by helping a competitor. But as they learn more about how cooperation works in today's global marketplace, they tend to discover that the benefits of cooperation accrue to all parties.

Another fear about strategic alliances arises from the misconception that they are necessarily extensive, firm-wide transformations, involving asset swaps and complex ownership structures. This is simply not true. This is a key point: *Strategic alliances do not need to be "all-or-nothing."* In fact, they don't even have to be strategic, in the traditional sense of that word. A simple tactical alliance, or an even simpler transactional alliance, can often deliver significant value while causing minimal disruption to either organization.

Strategic Alliances Can Serve Multiple Objectives

Strategic alliances and joint ventures benefit businesses in a number of ways.

First, of course, is the efficiencies perspective, which we've emphasized up to this point: As traditional cost-control processes reach their inherent limits, strategic alliances provide an alternate route to competitive advantage. Consolidating duplicative organizational structures and marketing channels can bring efficiencies and synergies to a firm's manufacturing, distribution, purchasing, and R&D, either individually or in combination.

Successful alliances can also provide other advantages, including economies of scale, risk diversification, and access to new markets, distribution channels, and technologies. Alliances allow for more flexibility in product development and manufacturing, and they give the parties more buying power vis-à-vis their suppliers.

For multinational companies, strategic alliances are often essential. The risk and expense of international expansion places great demands on a firm, and multinationals routinely forge relationships with local players as a way to enter foreign markets. This is one reason why strategic alliances can work for mature firms, as well as for young, fast-growing companies.

Again, let's use some examples from real life to illustrate the range of ways in which companies of various shapes and sizes have benefited from strategic alliances. And, in the spirit of full disclosure, let's look at the preliminary (and provisional) "verdict" of the following examples:

- The Auto Alliance International (AAI) enables Ford and Mazda to piggyback on each other's strengths, and thereby compete more effectively in the marketplace. "Mazda offers excellent capabilities in product engineering and production engineering of small volume with a variety of products,"then–president Henry Wallace of Mazda Motor Corporation explained at the launch of AAI,"while Ford has proven success in high-volume manufacturing and marketing and sales. In the process of working together, we each become a better company."

AAI – now run as a separate entity with its own management and productions teams – is a clear-cut success for both Ford and Mazda. Even though Ford has struggled in the recent past, AAI has enabled its American parent to sustain production capacity around the world, and enhance its manufacturing flexibility during times of volatile demand. In addition, it has enabled both Ford and Mazda to successfully share technologies and platforms.

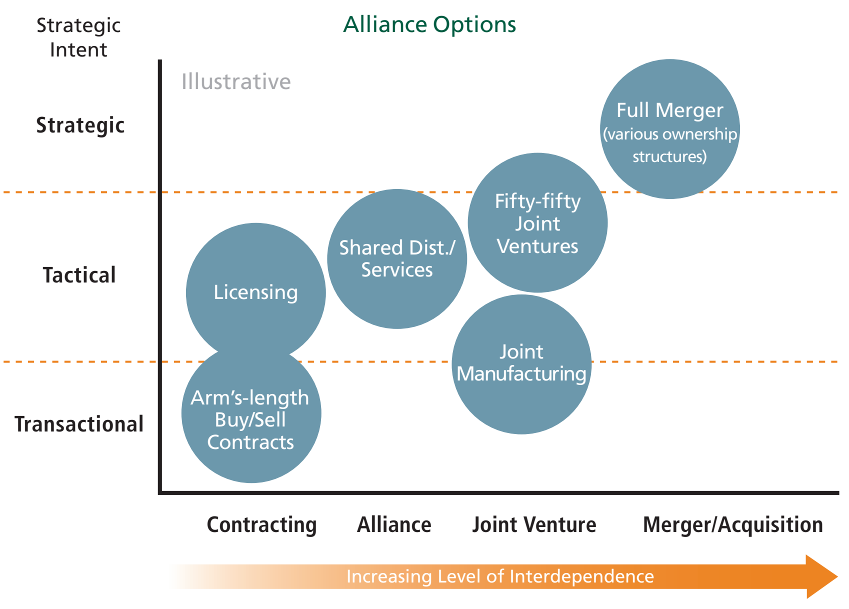
Mazda, too, seems satisfied. "Auto Alliance International symbolizes the strong cooperative relationship that has benefited both Mazda and Ford for many years," said Mazda CEO Hisakazu Imaki in July 2008. "Going forward, we will continue to provide our customers with the highest-quality products in order to further strengthen Mazda's presence in North America."

- Hospira Inc.'s recently announced manufacturing alliance with Human Genome Sciences (HGS) is designed to allow Hospira to postpone expensive investments in technologies that may or may not prove out in the future. "By securing access to HGS's leading-edge technology in late-stage process development and large-scale biopharmaceutical manufacturing capability," says John Lane, vice president of Biologics at Hospira, "we also defer the immediate need to invest in additional Hospira facilities for the manufacture of these biologic products."

Because this alliance was only recently launched (in the third quarter of 2008), it is premature to pass judgment on it. But the logic behind it – leveraging HGS's proven capabilities, and husbanding Hospira's production resources – seems compelling, and appears to address a central concern in the larger pharma industry.

Figure 1

Hierarchy of Alliances



Not All Strategic Alliances Are Created Equal

As the cases cited so far indicate, strategic alliances can comprise a broad spectrum of relationships. They can be transactional or tactical arrangements, such as arms-length buy-sell contracts or licensing deals. They can be more strategic in nature, ranging from joint ventures to full-blown mergers. They can adopt a simple approach with a single, clear objective, or they can be highly complex, comprising a veritable thicket of obligations and contractual agreements (*see Figure 1*).

Is an Alliance the Right Choice?

Companies considering a strategic alliance must decide first if such an arrangement has significant potential. The following are good indicators that a firm may find advantage in entering into an appropriate strategic alliance:

- The need to compete globally and in new markets, but limited experience and/or resources to deploy outside of current markets
- A need to compete with low-cost producers, but limited resources to invest in new facilities in low-cost areas
- A mature product facing intense competition, commoditization, and falling margins, which requires a point of differentiation, access to new markets, or better production processes to improve margins

- The need to meet the high up-front costs required to enter an attractive market
- A fast-growing business that needs to expand production, but has limited time and/or resources to achieve scale
- Overcapacity across a company and industry, and the resulting need for consolidation
- Common components, technologies, or suppliers across the industry
- The need for access to new R&D critical to grow a business

Assuming that many of these preconditions which are needed to enter into an alliance pertain, how do two potential partners strike a "good" deal (which we will define as "one that is advantageous to both")? While a full road map to success is beyond the scope of this article, we can point to a number of factors that go into making an alliance successful. For example:

- Clear and complementary objectives for the partnering entities
- A strong and mutual cost/benefit proposition
- Careful up-front planning and issue resolution
- Short- and long-term alignment of the partners' goals
- Mechanisms for balancing competition and cooperation
- A reasonably high level of trust between the partners
- Effective governance mandates and principles

Implementation: Avoiding the Third Rail

The implementation phase of a strategic alliance has its own list of imperatives. For example:

- Define a clear and common vision for the alliance and then determine commitment levels.
- Ensure that the organizational cultures are aligned with the vision.
- Identify the key people who will lead the alliance.
- Set up an integration team consisting of people from both organizations.
- Ensure that accountability and deliverables are clear to all involved.
- Conduct pre-alliance human resources assessment to start addressing potential personnel and corporate culture issues.
- Create and follow a detailed execution and communication plan.
- Establish a balanced measurement system to keep the benefits delivery on track.
- Ensure that internal issues do not cause either company to lose external focus.

A Case Study: Red Cell Corp. and White Cell Inc.[1]

Red Cell Corporation and White Cell Incorporated are the two largest players in their specialty medical device segment, together controlling about a 60% market share. Several years ago, the principals of Red Cell and White Cell approached L.E.K. to assess the feasibility and inherent potential of a strategic alliance.

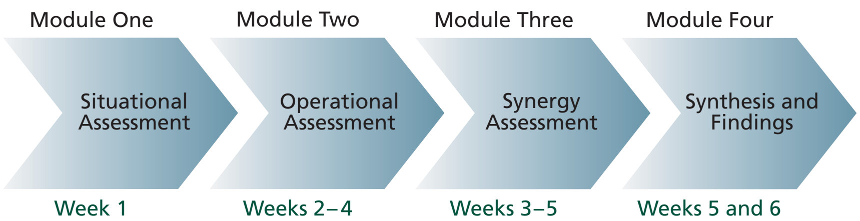
By the time of this initial contact, Red Cell had established a high-volume position in the market, but was reliant upon outside suppliers for key technologies to deliver its product. White Cell, by contrast, had developed a specialized technology and sophisticated manufacturing process – two strengths that helped them to be price competitive with Red Cell in the marketplace – but lacked the volume needed to radically reduce their cost structure.

In addition, both companies were faced with continued price erosion of their core products. New entrants from emerging markets were starting to hurt profitability, and the longer-term outlook seemed bleak.

At the outset of this engagement, L.E.K. defined a series of ground rules to facilitate discussion between the two companies, and to give both Red Cell and White Cell adequate assurances that confidential trade secrets would be protected as part of the process.

Figure 2

L.E.K. Organized the Alliance /JV Assessment in Four Modules



For example:

- Each party was assigned a dedicated L.E.K. team member who was responsible for sending and receiving any communications
- Both companies agreed not to share or discuss market share, pricing, and specific competitive positions
- Analyses were shared only in joint sessions that were attended by representatives of both companies
- Comparative metrics and analysis were only shown relative to industry averages or related benchmarks

Next, L.E.K. conducted what we refer to as a "No-Risk Assessment," performed in four distinct modules, as summarized above *(see Figure 2)*.

As part of this analysis, we performed a comprehensive assessment of the required inputs and cost-reduction opportunities inherent in various alliance possibilities. Some of the findings of this assessment are summarized below in *(see Figure 3)*.

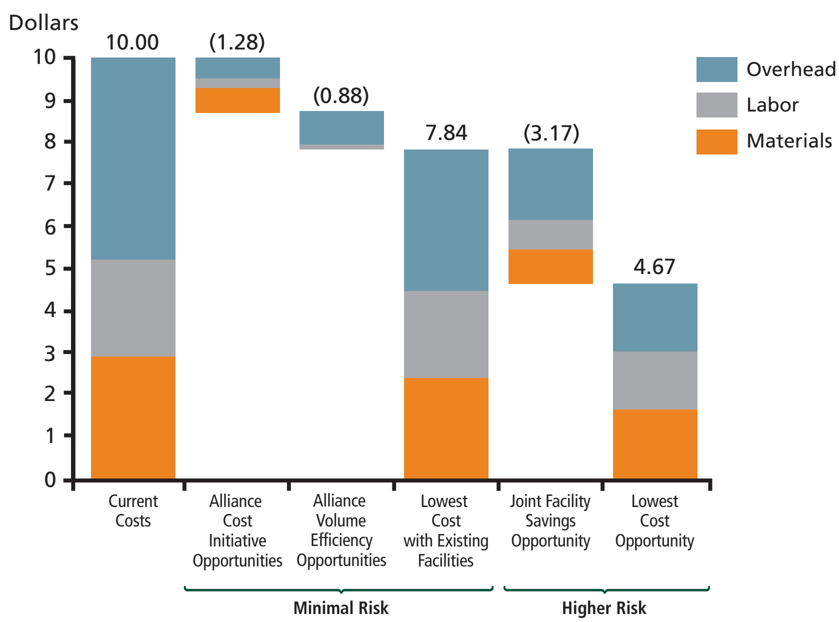
This analysis explored each opportunity in light of the level of risk and commitment required from both parties under various scenarios. We developed specific details regarding facility requirements, head count, equipment, systems, and management. In addition, a risk assessment and mitigation analysis was provided to both parties to help them assess their strategic alliance options. Finally, we delivered a recommendation as to whether or not it was advantageous for both parties to continue to pursue a potential alliance.

Following our analysis, Red Cell and White Cell separately considered the alliance opportunity for several months.

It was clear that each company had its own reasons to refrain from committing to the alliance, and – appropriately – each took advantage of this interlude to explore whether they could derive the benefits of the alliance on their own. Ultimately, both companies concluded that the benefits of the alliance far outweighed the costs or risks.

Figure 3

Illustrative Alliance Cost-Reduction Opportunities



[1] The details of this case, which is drawn from an actual L.E.K. engagement, have been substantially altered to protect client confidentiality.

Structuring and Restructuring the Alliance

The alliance between Red Cell and White Cell progressed from an arm's-length purchasing union to a jointly owned NewCo.

The details are illuminating. Red Cell and White Cell first agreed to a common set of raw materials and specifications that they could purchase jointly – an initial step toward developing mutual trust. L.E.K. identified a third-party purchasing aggregator who negotiated contracts and processed orders for each company – all without disclosing sensitive volume and specification information. Throughout this process, L.E.K. tracked the savings enjoyed by each company relative to their existing costs. In keeping with our projections, both companies saw their gross margins improve by between 400 and 600 basis points in the first year.

After the success of the purchasing relationship, a manufacturing/supply relationship was developed between the two companies: Red Cell would manufacture product for White Cell at one of its underutilized plants. This was a big step for both companies, and it was far from easy to achieve. Difficult and intense negotiations were held to iron out specifics of the supply agreement. How would shortages be handled? What assurances did White Cell have that their products would be produced on time and on spec? Who would be responsible for quality?

Again, the intensified alliance proved a winning proposition for both parties. Red Cell was able to improve its cost structure by leveraging its fixed overhead across more units. In addition, it was able to earn a profit on the manufacturing it performed for White Cell. White Cell, for its part, significantly improved its cost structure by 1) shutting down an unproductive factory and 2) using the lower-cost manufacturing services provided by Red Cell.

After a successful year of the manufacturing/supply relationship, both companies decided that the true benefits – and biggest cost-saving opportunities – inherent in the alliance could best be achieved by forming a NewCo. The NewCo would hold the consolidated manufacturing assets of both companies and be governed by representatives of both companies. L.E.K. helped Red Cell and White Cell determine the valuation of the NewCo operation, as well as the fair ownership share for each company. Given the last couple of years of increasing cooperation – throughout the assessment, purchasing/outsourcing agreement, and manufacturing/supply relationship – a solid base of trust and understanding had been established between the two parties. At this point in the process, for the first time, key volume and cost data began to be shared.

The cost and scale benefits achieved by the NewCo have surpassed initial estimates. In addition to helping the companies work together on existing products, the NewCo has been able to leverage expertise from both companies to identify and pursue next-generation, lower-cost product opportunities. As a result, each company has been able to re-establish a stronger competitive position against emerging market entrants while increasing its profitability. Fast-forwarding to the present, the two companies are now considering a full-on merger of their operations, which would have been inconceivable only a few years ago.

Of course, not every alliance that L.E.K. has been involved in has evolved to the same level as Red Cell and White Cell. However, almost all of its alliance projects have spotlighted synergistic value that each organization would have difficulty achieving alone.

Conclusion

Strategic alliances continue to be a pragmatic and relevant tool for growth, especially given the speed at which they can be analyzed and executed. Although today's recessionary climate has brought new challenges with no clear answers, companies with a mandate for growth can still find opportunities if they look beyond traditional cost-cutting measures to find cost-based, operational competitive advantage.

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