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# Cooperative Strategy

*Managing Alliances, Networks, and Joint Ventures*

SECOND EDITION

**John Child, David Faulkner, and Stephen Tallman**

Cooperative Strategy

'The authors have provided an ambitious overview of the cooperative strategy literature. The book will be welcomed by serious students and scholars focussed on this important phenomenon.'

Paul W. Beamish, Canada Research Chair in International Business, Ivey Business School, University of Western Ontario

'This book provides a comprehensive, well-organized and richly illustrated analysis of inter-firm cooperation. While relevant for managers and business students, it extensively draws on the most up-to-date research, making it also a valuable source for academics studying strategic alliances and the wide array of management issues they raise. Child, Faulkner, and Tallman have done a remarkable job of putting together in a highly consistent way all the knowledge available on what has become an essential facet of business development, namely Cooperative Strategy.'

Pierre Dussauge, Professor of Strategic Management, HEC – School of Management, Paris

'I highly recommend this book for alliance scholars and practitioners. The breadth of coverage of the practical and theoretical literature on cooperative strategy is one of the book's primary contributions. The authors demonstrate a comprehensive understanding of the subject matter and the numerous case studies demonstrate a close connection with actual experience.'

Andrew Inkpen, J. Kenneth and Jeanette Seward Chair in Global Strategy, Thunderbird, The Garvin School of International Management

'Companies need to know not just how to compete with other firms, but how to co-operate with them. The proliferation of joint ventures, partnerships, and strategic alliances reflect the increasingly dispersed and networked structure of modern business organisation.

This book is a manager's guide to this significant trend. In particular it emphasizes the importance of not merely building co-operative structures but of making them work, both nationally and across borders, to bring benefits to all the participants.'

Frances Cairncross, Rector, Exeter College, Oxford and former Management Editor, *The Economist*

'In today's environment, alliances and networks provide essential building blocks to access dispersed capabilities as well as end markets. As such, they have far-reaching implications for strategy, organization, and managerial skill sets. John Child, David Faulkner, and Steve Tallman have skilfully connected theory and day-to-day practice to offer a guide to some of the most important decisions and processes managers must handle.'

Jeffrey J. Reuer, Associate Professor of Strategy, University of North Carolina

'Broad in scope and rich in detail, Cooperative Strategy is a great primer for both academics and practitioners.'

Professor Oded Shenkar, Ford Motor Company Chair in Global Business Management, Fisher College of Business, The Ohio State University

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| | |
|---|---|
| AGM | Alliance General Manager |
| ASEAN | Association of South-East Asian Nations |
| BATNA | Best Alternative to a Negotiated Agreement |
| CEO | Chief Executive Officer |
| CBIS | Cincinnati Bell Information Systems |
| CEE | Central and Eastern Europe |
| DMNCs | Decentralized MultiNational Corporations |
| DCF | Discounted Cash Flow |
| EJVs | Equity Joint Ventures |
| ISAs | International Strategic Alliances |
| ICV | International Cooperative Venture |
| ICT | Information and Communications Technology |
| IJV | International Joint Venture |
| IJVGM | International Joint Venture General Manager |
| IS | Information Systems |
| IORs | Inter-Organizational Relationships |
| JVs | Joint Ventures |
| JIT | Just-in-time |
| FDI | Foreign Direct Investment |
| IT | Information Technology |
| GRIT | Graduated Reciprocation and Tension Reduction |
| HRM | Human Resource Management |
| MNE | MultiNational Enterprise |
| MNC | MultiNational Corporation |
| MPT | Market-Power Theory |
| NPV | Net Present Value |
| PVC | Physical Value Chain |
| RBT | Resource-Based Theory |
| RDP | Resource-Dependence Perspective |
| RBS | Royal Bank of Scotland |
| SMT | Strategic-Management Theory |
| SMEs | Small and Medium-sized Enterprises |
| TCE | Transaction-Cost Economics |
| TNC | Transnational Corporation |
| TQM | Total Quality Management |
| VVC | Virtual Value Chain |
| WTO | World Trade Organization |
| WFOE | Wholly Owned Foreign Enterprise |

# 1 Introduction

## 1.1 What this chapter covers

This introductory chapter defines cooperative strategy, and compares it with competitive and corporate strategy. Cooperative strategy can help to improve competitive strategy by enhancing the qualities that afford competitive advantage. It can also strengthen corporate strategy by making the corporate mission more attainable. The chapter then identifies the focus of the book and describes how it is organized into parts and chapters.

## 1.2 Cooperative strategy

Cooperative strategy is the attempt by organizations to realize their objectives through cooperation with other organizations rather than in competition with them. It focuses on the benefits that can be gained through cooperation and how to manage the cooperation so as to realize them. A cooperative strategy can offer significant advantages for companies that are lacking in particular competencies or resources to secure these through links with others possessing complementary skills or assets; it may also offer easier access to new markets, and opportunities for mutual synergy and learning.

A distinction is made between competitive and corporate strategy (Bowman and Faulkner 1997), and it is important to see how cooperative strategy relates to them. Competitive strategy is concerned with the question of how a firm can gain advantage over its competitors. There are two broad traditions of thinking about competitive strategy. The first emphasizes how superior profits can derive from the structure of the industry in which a firm is located, and from the pursuit of generic strategies—cost leadership, differentiation, or focus—in ways which suit the conditions of that industry (Porter 1980, 1985). The second draws attention to the competitive advantage that can be gained from a firm's unique competencies and resources, which combine to deliver valued products and are difficult to imitate or acquire (Collis 1996). A strategy of cooperation with one or more other firms can be a counterpart to the pursuit of competitive advantage in the ways identified by both these traditions of thinking about competitive strategy. Chapter 5 further examines the motives behind a cooperative strategy, and Chapter 13 elaborates the ability of alliances to enhance a firm's competencies through learning.

The ability to maintain both the structure of an industry and a firm's position within it can be enhanced by cooperation with competitors. This could be a primarily defensive alliance against dominant firms, or a more offensive alliance intended to secure a stronger position within the industry and/or reduce opportunities for new entrants. Both these kinds of alliance are currently evident within the global telecom industry. The proposed, but abortive, merger in 1996 between British Telecom and Cable & Wireless illustrates an offensive alliance aimed at securing a dominant industry position as the first truly global telecom operator. Other telecom companies, emerging from protected domestic markets and facing aggressive companies such as AT&T and BT, have formed more defensive joint ventures (JVs)—for example GlobalOne formed between Deutsche Telekom and France Télécom.

Sometimes, entry into an industry or regional sector is only feasible in the first place via a partner. The ability to enter some markets, especially in developing countries or those with invisible entry barriers like Japan, may be possible only through cooperation with a local firm. The local firm is able to offer a capability that the foreign partner does not at the time possess. This leads to the second tradition of thinking about competitive strategy, which draws attention to the competitive advantage that can be gained from possessing unique capabilities. Valued competencies and resources are often available only from a partner or from sharing their development with a partner. Alliances may enable firms to gain access to partners' advanced technology or to share the high cost of developing new capabilities through research and development (R&D). The JV with Motorola, for example, gave Toshiba access to the former's microprocessor technology. Cooperation between firms can also permit the pooling of their complementary strengths so as to secure creative synergies. The successful collaboration between Rover and Honda, which ceased only with the decision of Rover's owners to sell it to BMW, was based on identifiable complementarities that gave rise to fruitful synergies. Rover could offer access to a network of component suppliers and subcontractors, spare capacity in its factories, and an understanding of European automobile tastes. Honda was able to offer Rover the quality engineering it badly lacked and models to revitalize its model range (Faulkner 1995). CFM International gave SNECMA of France and General Electric of the USA access to the commercial jet engine market at a time when neither was a major factor in a lucrative market.

Competitive strategy tends to focus on the particular industry and product. Many firms, however, are in, or have the capacity to be in, several businesses and various geographical locations. So there are also the questions of what business, market, and locations should a firm be in and how should it run them? This draws attention to the domain of corporate strategy, which is concerned with selecting businesses and operational areas, and resourcing and controlling them (Bowman and Faulkner 1997). It is the ability to make and sustain these strategic decisions that justifies having a corporate function in the first place rather than constituting each business separately.

The issue of cooperation comes within the purview of corporate strategy in several ways. First, it should reflect the mission and objectives that corporate management sets for a company. If one objective is to become more innovative, alliances may well be sought that promise access to superior know-how and technology. Second, as we have already noted, cooperation may be sought as a means of sharing the resourcing, or its risk, of desired new developments. Third, it may be incumbent on the corporate function to superimpose a controlling and coordinating framework over a firm's different businesses, especially if these are developing through alliances with different partners in a given country where the company has to maintain a cohesive voice vis-à-vis governmental authorities. These authorities may, as in China, be the customer for several of the separate businesses. A more fundamental connection between corporate and cooperative strategy stems from the trend of firms to seek a global presence and competitive advantage through working within complex networks of cooperative arrangements with other companies. This trend, as Chapter 8 discusses, raises significant questions about the future role of corporate centers.

Cooperative strategy is therefore not an alternative to either competitive or corporate strategy. It amounts to a further domain of policy options whose purpose is to enable firms to compete more effectively. Questions about the configuration and constitution of actual and potential alliances are important items on the agenda of corporate strategy. Figure 1.1 illustrates how cooperation can exist alongside competition but not without tensions and variable results. Where cooperation is high and competition low, there will be strong pressures for the partners to merge, or for one to acquire the other, once an alliance has demonstrated its utility over a period of time. The absorption of ICL, the UK computer services company, by Japan's Fujitsu after many years of cooperation provides an example. Where both competition and cooperation are high, the abiding tensions between the partners will be apparent but the partners will be concerned to learn from each other rapidly, lest one partner defect. In some cases, such as the alliance between Nissan and Renault, mutual stockholding has reduced the risk of defection and opportunism. Where both cooperation and competition are low, the alliance will cease to engage the minds of top management and is likely to achieve only limited results and fail. The alliance between Disney and Pixar in computer-animated films, described in Chapter 18, eventually ended up in this category, accompanied by disputes over revenue-sharing, and broke up. However, where competitive forces between the partners are very apparent even after the alliance has been set up, yet actual cooperation is low, the risk of one partner appropriating the skills and knowledge of the other is high. This situation was evident in the alliances between western and Japanese partners described by Hamel (1991) and it also applies in some degree to the failed JV between GM and Daewoo (Luo 2004: 142–51).

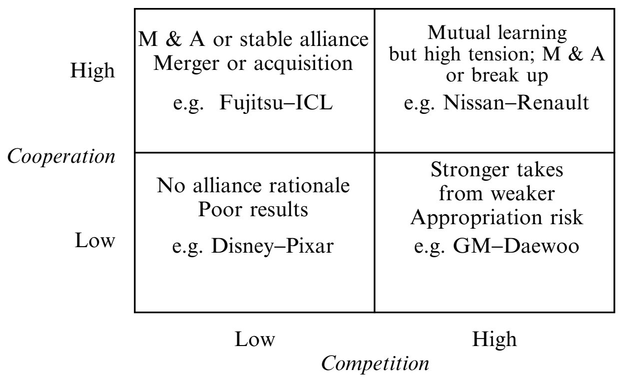


**Figure 1.1** Different combinations of cooperation and competition.

Luo (2004) adapts the framework in Figure 1.1 to analyze the different possibilities of competition and cooperation between rival firms, particularly global players. He argues that a considered balance needs to be drawn between the two, informed by a firm's strengths, needs, and the history of relations it has with other major global players:

> Overly depending on one rival's cooperation increases the firm's vulnerability to opportunistic and conflictual behaviors of the latter. Overly focusing on global competition against one rival is likely to deter optimal resource allocation, risk diversification, asset utilization, and opportunity exploitation. (Luo 2004: 37)

Luo identifies four strategies:

1. A *partner* is a global player that pursues a strategy of high cooperation combined with low competition towards another global player. A high level of complementarity between their capabilities and resources and a low overlap of their markets are two necessary conditions under which global rivals may become partners in certain areas. An example is the collaboration over many years of the US's McDonnell Douglas and Japan's Kawasaki Heavy Industries in aircraft and commercial helicopters.
2. An *adapter* is a global player that has a cooperative mutual dependence with another global player in certain areas, but competes strongly with it at the same time. For example, Hitachi and HP compete strongly for global market share in areas such as rewritable DVD drives, and yet have cooperated successfully for many years in the RISC computer field through technology agreements, joint product supply, and so forth.
3. A *monoplayer* is a global company that maintains both low levels of cooperation and competition with other global players, not interacting much with them. This type of firm enjoys a strong position either in a niche market, such as LKK in Chinese specialty sauces, or a dominant global position in a specialized area where the firm has unique and difficult-to-copy know-how not available to rivals—for example Intel in microchips.
4. A *contender* is a global player that is maintaining high competition with another global player and cooperating very little, if at all, with it. Long-standing rivalries such as those between Airbus and Boeing, or Coca-Cola and Pepsi, are good examples. In such situations, a cooperative strategy is absent and instead the rivals vie for market share and competitive position.

## 1.3 A key theme

Cooperative strategy has attracted increasing attention over the last decade or so, particularly in the popular management press and the academic journals. Books tackling the subject in a wider and more all-embracing way than is possible in single-theme articles have been less plentiful. A number of coexisting contemporary trends fuel current interest. Companies have looked increasingly to cooperate with each other due to the limitations of coping successfully on their own with a world where markets are becoming global in scope, technologies are changing rapidly, huge investment funds are regularly demanded to develop new products with ever-shortening life cycles, and the economic scene is becoming characterized by high uncertainty and turbulence.

At the same time the economies of the East are showing distinct signs of upstaging those of the West in an increasing number of industries. Despite the economic dominance of the West during the nineteenth century and the first half of the twentieth, and its emergence from the Second World War in a position of supreme power, world leadership in automobiles, electronics, shipbuilding, steel, and textiles either has been, or arguably is, in the process of passing to the East. If there is one key difference between the West and the East in business philosophies, it is that the West is individualistic and competitive right down to an interpersonal level, whilst the East is collective and cooperative within dense networks of relationships. This, many commentators argue, is the basis of its strength. If so, it is important that Western companies understand the philosophy and practice of cooperation, and perhaps adopt those aspects of it that are culturally congruent with their own way of doing things.

The movement away from the traditional concept of the firm is accentuated by the growth of 'federated organizations' (Handy 1992). This concept places a limited life on integrated multinational corporations (MNCs), which often suffer from high overheads, a bias towards the culture of their national headquarters, and low flexibility. Figure 1.2 portrays the move toward the federated firm. A well-known example of a federated firm is Hewlett-Packard, the computer and printer giant, which has long been organized around highly independent global business units with real profit responsibilities.

A more recent convert to the concept of federation is IBM, one of the most powerful MNCs in the world. After experiencing a significant decline in performance and suspecting a loss of competitive advantage, it decided in 1991 to restructure its operations radically from those of an integrated worldwide firm with a strong single culture to a federation of fourteen potentially competitive companies. This fundamental change clearly placed a premium on the ability of the federated companies to cooperate, where appropriate, whereas previously their activities were coordinated through hierarchical channels. The culture shock was so great, and the immediate results so mixed, that the

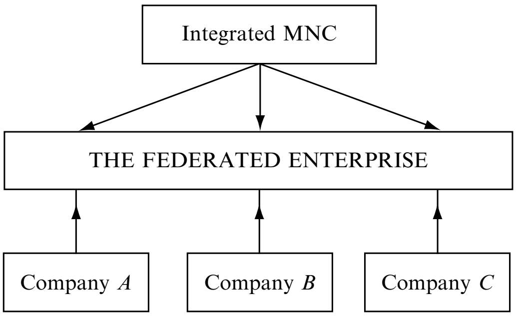


**Figure 1.2** The move towards the federated enterprise.

chief executive officer resigned, and his successor, Lou Gerstner came from outside the computer industry. The IBM of today is a more federated enterprise, an advantage as it has shifted its strategic focus to consulting and systems support, while still maintaining a large presence in its traditional hardware and software sectors.

The concurrent growth of alliances approaches the flexible transnational structure from the other end. In other words, it involves the amalgamation of previously independent resources and competencies in contrast to the federation of previously hierarchically controlled resources and competencies. Where the traditional concepts of firm, industry, and national economy start to become concepts of declining clarity, and thus to lose their exclusive usefulness as tools for strategic analysis, the need for an adequate understanding of strategic alliances and other cooperative network strategies assumes increased importance.

## 1.4 The growing significance of strategic alliances

Strategic alliances and other forms of interfirm cooperation have grown remarkably since the mid-1980s. They are one of the more important new organizational forms. Despite the managerial and organizational challenges they undoubtedly present, there is no sign that alliances are a transient phenomenon. A survey based on 323 questionnaire responses and over 400 interviews with senior executives in 2000 indicated that alliances were 'expected to account for 16 percent to 25 percent of median company value within five years and, astonishingly, more than 40 percent of market value for one-quarter of companies' (Contractor and Lorange 2002: 4).

Alliances are, along with outsourcing and virtual value-chains, one of the defining forms of modern networking among firms. As noted, they represent a clear break away from the internalized, hierarchical model of the firm, of which General Electric and IBM were salient examples in the 1980s. Today, leading corporations such as these have as many as 1,000 alliances. In the past, such corporations might have regarded alliances as a relatively peripheral activity, primarily for entering emerging country markets in which risks were high or government regulations required JVs or licensing agreements. Today, alliances are regarded as a means to achieving fundamental strategic objectives such as a strong market position, significant knowledge acquisition, and major cost reductions.

## 1.5 Focus of the book

This book attempts to take stock of current thinking on the subject of cooperative strategy. The focus will be on cooperation between firms, though many of the insights into establishing and managing interfirm cooperation can also be applied to partnerships between other types of organization. Alliances, which are partnerships between firms, are the normal agent for cooperative strategy. They are often 'strategic' in the sense that they have been formed as a direct response to major strategic challenges or opportunities which the partner firms face. Alliances are a means to an end, and consequently they are not necessarily formed with a long-term cooperative relationship in mind. But they may be established with this intention, the more so when the partners invest substantially in them. Once alliances are up and running, partners may also perceive unanticipated benefits from cooperation, such as mutual learning, which lead them to reevaluate it positively.

However, alliances can also be formed with shorter-term objectives in view. A firm may intend to use an alliance as a means of appropriating competencies and knowledge from its partner, which it continues to regard as an actual or potential competitor. Or it may enter into an alliance as a way of taking out an option for the future in conditions of uncertainty—for example, entering an unfamiliar national market. Once it has mastered the uncertainty, it may no longer attach much value to continuing the cooperation.

Whatever the underlying motivation for its formation, any alliance requires an ability to manage cooperation in order to generate returns to the partners. The ever-growing prevalence of alliances, and the need to understand the basis for their successful management, provides the main justification for the present book. It is informed by John Child's work on JVs in China and to a lesser extent Brazil and Eastern Europe, David Faulkner's work on strategic alliances between companies in developed nations, and Stephen Tallman's work on understanding the processes and motivations for alliance strategies. It also attempts to integrate what the authors believe to be the salient ideas of other writers on cooperative strategy in tackling some of the key issues currently under debate in the field. A number of important ideas emerge from the writers' efforts in this endeavor, which are perhaps worth capturing before the reader embarks on the task of a detailed reading of the book:

1. Cooperative strategy is not new; it has always been with us. It means what it suggests, namely the achievement of an agreement and a plan to work together; not the giving of orders down hierarchies. Firms embarking upon alliances with other firms need to keep this in the forefront of their consciousness when devising systems and controls, and activating them in the joint enterprise. This book, whilst concentrating on perhaps the pre-eminent form of cooperation—namely, the various forms of strategic alliance—encompasses other forms of cooperation as well that are met in business activity, even down to the humble distributor or supplier agreement.
2. Commitment and trust are the key attitudes most strongly associated with success in alliances. No amount of energy and clear direction will compensate for their absence. And it should be noted that commitment can exist without trust and vice versa, but both are necessary for a lasting and stable relationship.
3. Strategic alliances, including JVs, collaborations, and consortia, are at base all about organizational learning, and should be structured towards that end. However, many other types of cooperation, such as networks or virtual corporations, are primarily about skill substitution—that is, Company A cooperates with Company B because it sees that its partner can exercise a particular skill better than it can.
4. Other forms of cooperative strategy, such as virtual organizations, networks, and outsourced corporations, are about capability substitution. Their strength lies in

their specialization, adaptability, and flexibility, but not necessarily in the learning opportunities they afford.

5. Cooperative enterprises do not do away with the need for intelligent purpose, a brain, and a central nervous (information) system if they are to achieve competitive advantage in relation to integrated corporations that more self-evidently have these characteristics.
6. To cooperate does not mean to allow all proprietary information to pass unchecked to the partner. As Richardson (1972) warns: 'Firms form partners for the dance but, when the music stops, they can change them.'
7. Issues of control need to be addressed, but more subtly than in hierarchies, as too great a degree of control in cooperative enterprises stifles innovation and motivation, and can lead to the breakdown of the cooperation.
8. A successful alliance is one that evolves into something more than was perhaps foreseen at the outset. Conscious attempts must be made to cause the alliance to develop if it is to attract the best people, and contribute most to the partner companies.
9. The interface between the two (and sometimes more) company cultures is the crucible of potential achievement. Sensitivity to each other's cultures is vital to effective joint operation. Its absence leads to a failed alliance, however great the potential economic synergies between the partners.
10. Information technology (IT) makes the task of coordinating cooperative strategy that much easier, but it cannot and must not be allowed to substitute for bonding between cooperating company executives.

## 1.6 Organization of the book

These and other key lessons from the research behind this book are developed in more detail in the chapters that follow (see Figure 1.3).

Part I is concerned with the nature of cooperation and its role in strategy. Chapter 2 outlines the main perspectives from economics that contribute to an understanding of cooperative strategy. The theory of cooperative strategy is related to market-power theory, transaction-cost economics, agency theory, resource-based theory, transaction value theory, real options theory, and increasing-returns theory. Chapter 3 continues to address major theoretical models of cooperation, but from managerial and organizational perspectives, such as game theory, strategic-management theory, resource dependence, social network theory, and organizational theory. It summarizes the relevance of these theories and draws out the complementarities between them.

Cooperation depends on trust between partners. Chapter 4 presents the insights into trust that can be derived from psychological and sociological research. This identifies the factors on which trust can be based and through which it can develop. The first step is to find a basis on which the risks of depending on partners become mutually acceptable.

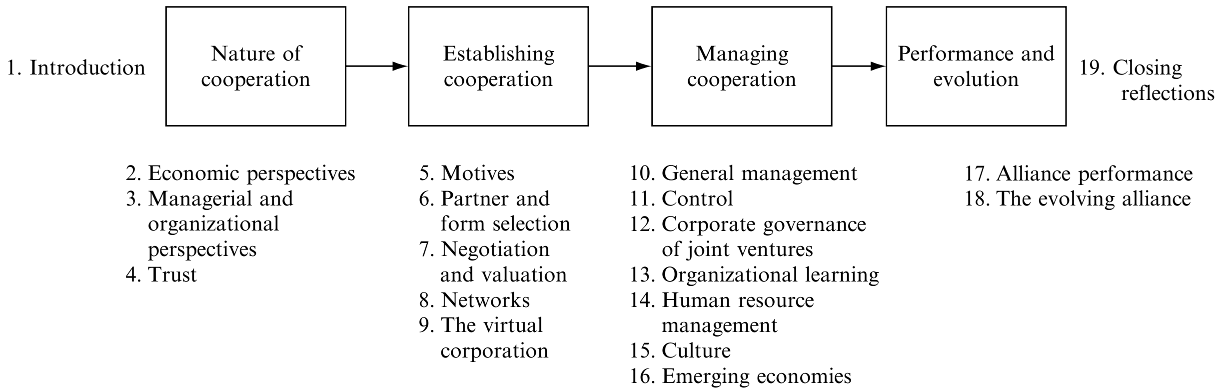


**Figure 1.3** Alliance development, as traced through the book.

As the partners get to know more about each other, this improved understanding should breed further mutual confidence. Eventually, the cooperation may become firmly established on the basis of genuine personal friendships between the key participants. These elements in trust development can support the phases through which cooperation within an alliance can develop. The chapter closes with guidelines for developing trust within cooperative relationships between firms.

Part II is concerned with how cooperation between firms is established and the various forms it can take. Chapter 5 introduces the idea of an alliance process by which two firms find each other for a cooperative venture and discusses the principal motives behind a cooperative strategy. It considers the most common reasons for setting up a collaborative activity with a competitive or complementary firm. The various types of resource and skill deficiency are rated in relation to their importance as stimuli to cooperative activity. It is emphasized that it is not only competence vulnerabilities, but also the desire to spread risk and the need to reach markets fast, whilst 'windows of opportunity' last, that drive organizations to set up cooperative arrangements. Strategic, transaction-cost-reducing, and organizational learning motives for cooperative activity are compared and contrasted (Kogut 1988).

Chapter 6 considers the criteria to be highlighted in selecting a partner and deciding upon the appropriate form the alliance should take. Once a collaborative activity has been decided upon, it is necessary to find an appropriate partner. This chapter attempts to operationalize the strategic-fit/cultural-fit matrix. It emphasizes that the possible achievement of synergies through the use of complementary assets and competencies underlies the concept of strategic fit (Geringer 1991). It also draws the reader's attention to the need for intercultural sensitivity if the alliance is to succeed. The second half of the chapter considers the question of collaborative forms, and which one to select. The key characteristics of the various forms of cooperative activity are considered, as well as the circumstances in which each form is most appropriately adopted. In addition to the major strategic alliance forms of the joint venture, the collaboration and the consortium, the flexible nature of collaborative networks is discussed.

Chapter 7 addresses the question of how to negotiate in an alliance situation, and how to value your partner's and your own prospective contributions to the enterprise. It emphasizes that, whereas in a takeover situation, the negotiators are single-mindedly concerned to achieve the best price for their company—the highest or lowest price depending on the side of the negotiating table—this is not the case in an alliance. Unless both partners are concerned that the other has a good deal, the alliance will not prosper over time. A so-called win–win situation is sought. The problem of contribution valuation, however, is truly more an art than a science.

Chapter 8 looks at the strengths and limitations of network forms in greater detail. It considers the varied types of network that form the basis of much cooperative strategy. Networks are the loosest form of alliance between companies. At their weakest they represent a well-developed communication system within an industry that enables companies operating in that industry to keep abreast of developments. They are often crystallized in trade associations. In a stronger form they represent a ready-made band of would-be cooperating companies willing to tackle commercial opportunities together without setting up formal links that may compromise the individuality of networking firms. Dominant-partner and equal-partner networks are compared and contrasted.

Chapter 9 addresses the concept of the IT-based virtual corporation in the information economy. The 'Virtual Corporation' is the name for the network and IT-orientated form of organization based around centers of excellence in particular competencies. It can be created very rapidly to meet specific, sometimes transitory, sets of circumstances. It can equally easily be dismantled and re-formed as circumstances and profit opportunities change. This new concept is discussed and its strengths and limitations assessed. Many strategic alliances demonstrate characteristics of the virtual corporation.

In Part III different aspects of the management of cooperative activity are reviewed. Chapter 10 discusses the general and overall management of alliances. It emphasizes that the management of alliances differs in its essential nature from that of unitary companies. The ability to give instructions is replaced by the need to seek areas of mutual agreement and to develop constituencies behind a course of action (Kanter 1989). It is noted that appropriate management styles will differ, particularly in the circumstances of a JV, which can be treated much like an ordinary company, and a collaboration, where a sensitive boundary-spanning mechanism is necessary.

Chapter 11 looks at control as an issue in cooperation. It recognizes that control is not possible in a complete sense in alliances because of the consensual nature of alliance activities, but also that some control by each partner is necessary if the partners are not going to feel themselves to be in the hands of total uncertainty. The importance therefore is to specify controls that are at once clear yet flexible.

Chapter 12 addresses the issue of alliance corporate governance, which has been relatively neglected in the literature on alliances. The question of corporate governance arises particularly with equity JVs in which parent companies as owners appoint managers to run the ventures as their agents. This chapter suggests key elements in an analysis of JV governance, focusing on partner preferences. It adopts a broad definition of corporate governance as the process of control over and within the firm (i.e. the JV) that aims to reduce risks to its owners and to ensure that its activities bring a stream of acceptable returns to those owners in the long term.

Chapter 13 deals with organizational learning. It discusses the role of organizational learning in all its aspects as a primary driver in cooperative activity. It distinguishes different forms of learning in alliances, including learning about, from, and with an alliance partner. Learning is divided into technical, systemic, and strategic components and the implications of these distinctions for alliances are identified. Particular attention is given to the mechanisms and policies that help promote and transmit learning within alliances.

Chapter 14 addresses the specific area of human resources. It considers some of the key human resource issues that arise when personnel from different countries and different cultures are brought to work together in a new collaborative environment. The building of local management teams, the nature of training, and the role of the international manager are discussed, as is the role of human resource management (HRM) as a tool of control within alliances.

Chapter 15 is concerned with culture. It is now widely recognized that one of the most common reasons for the failure of alliances is the clash of the partners' contrasting company cultures. These can be reinforced by differences between national cultures in an international alliance. Yet there is evidence to suggest that the issue of cultural congruence is not high on the checklist of companies seeking partners. The chapter discusses the nature of cultural differences and how they can present barriers to performance and to bonding. It also considers measures to overcome such problems. The chapter deals in particular with two distinct forms of potential cultural problem—that between two partners from the developed world, and that between a developed world company and a partner from the developing world such as China, Central and Eastern Europe, and Latin America. In discussing these collaborative configurations, the 'culture problem' will be assessed in its broader institutional context.

Chapter 16 looks more specifically at how to manage cooperative strategy in relation to emerging economies. Cooperation between companies in developed and emerging economies is a particularly fast-expanding feature of global business relationships. The chapter discusses this issue with particular reference to Brazil, China, and India, and seeks to identify ways in which such collaborations differ from those between firms that are both in developed countries.

Part IV addresses the question of how cooperative activity can achieve positive performance, however defined, and be helped to evolve through time. Chapter 17 examines the issue of alliance performance. Unlike unitary forms of business organization, alliances, whether formal or informal, often face differing objectives and so find success and failure difficult to assess. Objectives may be less economic in scope than for other organizations, payoffs may be indirect through influences on other organizations, and economic performance is seldom reported directly. These considerations make both academic study and practical oversight difficult and challenging.

Chapter 18 emphasizes the importance of the role of evolution in the success of alliances. This implies the growth of the alliance in terms of new projects and new responsibilities. It is maintained that all alliances suffer potentially from entropy (Thorelli 1986), and that, unless the bonds brought about by the creation of the cooperative activity are constantly attended to and strengthened, there is an ever-present risk that the alliance will decline in importance to the partners, attract mediocre staff, and steadily become marginalized in the partners' priorities.

Chapter 19 presents some closing reflections on the ways in which progress needs to be made in bringing cooperative strategy further into the mainstream of management thinking. It gives reasons why cooperation between organizations is increasingly appropriate for operating in a complex global competitive economy.

As a whole, the book provides a broad view of the practical and theoretical literature concerning cooperative strategies and the alliance and network organizational forms that are the outcome of these strategies. While based on the research of the authors and representing their views of cooperation, it summarizes and evaluates the work of many other authors as well. It is tied to the academic literature, but is also grounded in cases developed by the authors and others and addresses practical issues of alliance management as well as alliance studies. It can be and has been, used as a textbook in MBA and executive programs.

## 1.8 Summary

The main points made in this introduction are:

1. Cooperative strategy between two or more companies can both improve competitive strategy and strengthen corporate strategy.
2. Cooperative strategy, although not new, is becoming increasingly important in a globalizing world.
3. Given that the initial match between partners is a sound one, their commitment and mutual trust are the attributes most likely to lead to success in alliances.
4. While information technology can assist the management of alliances and networks, trust-based personal relationships between the key actors involved remain crucial.
5. While some alliances are formed to find a needed source of finance or scarce skills, learning and knowledge transfer provide a rationale for most.
6. Virtual organizations are forms of cooperative strategy.
7. Control is a key aspect of cooperation, and one of particular concern to most alliance partners.
8. Successful alliances do more than just achieve their founding objectives, they evolve into something larger.
9. The interface between the companies is the crucible of potential achievement and successful alliance evolution.

## 1.9 Questions for discussion

1. Is cooperative strategy an alternative to competitive and corporate strategy or is it complementary?
2. Why has there been so much recent emphasis on cooperative strategy?
3. Can alliances ever be stable organizational forms?
4. Are virtual organizations the form for business in the future?
5. What makes for successful alliances?

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# PART I THE NATURE OF COOPERATION AND ITS ROLE IN STRATEGY

Part I looks at cooperative strategy from a number of different perspectives commonly found in the academic literature, as it concedes that there is no universally accepted theory of cooperation at a meta level acceptable to economist, sociologist, and anthropologist alike. One looks in vain for a unified theory or approach to provide the basis for understanding cooperative strategy. Useful, but partial, insights can be drawn from economics, game theory, strategic-management theory, and organization theory. Parkhe (1993*a*: 229) has remarked: 'An overarching theme is required to cohesively pull together the theoretical advances into a unified theory addressing the nature of the [cooperative] . . . relationship.' Although that unified theory is not yet available, it is possible to offer a systematic overview of the main perspectives that contribute to our understanding of the subject and to draw some comparisons between them.

The views of the economist are discussed in Chapter 2, as they are met in market-power theory, transaction-cost analysis, agency theory, resource-based theory, transaction-value theory, real-options theory, and increasing-returns theory.

Chapter 3 discusses the theoretical background of alliance strategies further, but from a managerial and organizational theory perspective. The contributions of strategic-management theory, game theory, network relationships, resource dependency, and organizational theory are covered. Strategic-management theory highlights strategic choice, and the importance of both strategic and cultural fit between partners if an alliance between firms is to be successful. Game theory points to trade-offs between cooperation and competition, and the issue of opportunism in alliance relationships. A major contribution of the organizational theorist is the so-called resource-dependency perspective, in which partners seek from each other the resources that they themselves most lack. Organizational theorists also draw attention to the relational characteristics of alliances, such as partner control, trust, and knowledge transfer.

Chapter 4 turns to the importance of the attitudes that partners have to each other in cooperative relationships. It emphasizes the pivotal role of trust in such relationships, and breaks this concept down into three aspects—calculative trust, which is necessary to set up an alliance when the partners' synergies are clear to see; predictive trust, which develops as both partners prove to be as good as their word; and bonding trust, which may develop as they come to enjoy working together.

Most of the theoretical perspectives relevant to cooperative strategy are still underdeveloped in two respects. First, there are still potential synergies to understanding that could come about from combining some of them. For example, both the iterated form of game theory and work on trust-based relations should, if brought together, offer valuable understandings on how cooperation can be strengthened as a cumulative process over time. In so doing, it would be useful to combine the rational calculative approach of game theory with the more sentient and normative features of social interaction that are given a prominent place in theories of trust. The second area of underdevelopment, which subsequent chapters of this book address, is the drawing-out of practical guidelines from the essentially academic insights offered by the various perspectives. We will see how such insights bear upon both the formulation of cooperative strategy and its implementation. Market-power theory, transaction-cost economics, game theory, and strategic-management theory are oriented toward cooperation as a strategic choice. Transaction-cost economics and game theory also address certain aspects of ongoing cooperative relationships, which are the primary concern of agency theory and organization theory.

# 2 Economic perspectives

## 2.1 What this chapter covers

This chapter considers the justification of cooperative strategy on the basis of a number of economic theories. It accepts that all these theories have some credibility and usefulness, but none of them is sufficient to explain cooperative strategy in its entirety. The theories are: (*a*) market-power theory, (*b*) transaction-cost analysis, (*c*) agency theory, (*d*) resource-based theory, (*e*) transaction-value theory, (*f*) real-options theory, and (*g*) increasing-returns theory.

## 2.2 Market-power theory

Market-power theory (MPT) is concerned with the ways in which firms can improve their competitive success by securing stronger positions in their markets. Porter (1980) argued that the relative position that firms occupy within their industry's structure determines the generic strategies that are the most viable and profitable for them. A cooperative strategy may offer a mutually advantageous opportunity for collaborating firms to modify the position that they occupy within their industry. In other words, it may enable them to increase their market power. Hymer (1976) was one of the first to apply MPT to the study of cooperative strategy when distinguishing offensive from defensive coalitions.

Offensive coalitions are intended to develop firms' competitive advantages and strengthen their position by diminishing other competitors' market share or by raising their production and/or distribution costs. A recent example has been the on-again, off-again alliance between American Airlines and British Airways. It has been fiercely opposed by other operators because, they claim, it would give the two partners an unfair competitive advantage, especially on North Atlantic routes, and hence would provide the basis for conservative and restrictive behavior. Indeed, Porter and Fuller (1986) showed that offensive coalitions can have a negative effect through reducing the partners' adaptability in the long run.

Firms form defensive coalitions to construct entry barriers that are intended to secure their position and stabilize the industry so as to increase their profits. Defensive coalitions may be sought by firms that have a weak position in the market in order to defend themselves against a dominant player. There may also be cooperation between a partner with a defensive intent and another with an offensive purpose for entering the alliance. For example, Rover collaborated with Honda in order to secure new model designs and engineering capabilities without which it could no longer survive in the British car market. Honda's main interest in the collaboration was more offensive, treating Rover as providing a bridge into the European market. Moreover, an alliance that starts off with primarily defensive intentions can become offensive in nature if it is successful in the market.

Porter (1985) subsequently introduced the concept of the 'value chain'. This distinguishes between primary activities ('inbound logistics', operations, 'outbound logistics', marketing and sales, after-sales logistics) and support activities (the firm's infrastructure, technology development, HRM, and procurement). The value-chain concept has been used to distinguish between cooperative strategies according to the type of resources pooled by the partners (Porter and Fuller 1986; Root 1988; Lorange and Roos 1992). One type of strategy is for partners to bring together similar resources to generate economies of scope, rationalize capacity, transfer knowledge, or share risk. This strategy has variously been termed 'additive', 'scale', 'scope', and 'symmetrical'. One example was the alliance between Ciba-Geigy and Chiron, which pooled teams of scientists to develop synthetic vaccines (Lorange and Roos 1992: 36). The intention to secure economies of scope and increase market share can be seen in the various alliances between companies in related businesses that created Cap Gemini Sogeti as Europe's largest computer services and consulting company (Elfring 1994).

Another type of cooperative strategy, that of forming 'complementary' alliances, refers to situations where partners contribute different value-chain activities that allow them to build on their respective strengths and competitive advantages. This latter strategy 'links' different activities to form a new value chain that realizes complementarities and gives the alliance a greater competitive advantage. One company, for example, may have a unique technology and associated range of products that it wishes to market globally. Rather than investing in its own sales and distribution network, it could seek to enter an alliance with partners who already control market networks.

MPT provides several insights into cooperative relationships. One is that greater market power, with consequentially enhanced returns, can be attained through cooperative strategies. Cooperation may be a quicker and cheaper way to gain market power. All-out competition is not the only option. At the same time, the choice between competitive and cooperative strategies describes what is often an uneasy balance of partner calculation. One of the reasons for the breakdown of alliances is that one partner decides it can in future gain more from resuming competition than from continuing the cooperation.

MPT does not, however, take into account the trust that collaboration may engender between the partners and that may progressively offset any inclination to dispense with the alliance. It is in this respect a fairly deterministic perspective, which does not readily accommodate the way in which evolving relationships between firms can alter the rationalities and strategic visions held by their policymakers. MPT therefore has some difficulty in dealing with the processes through which cooperative strategies evolve over time. It concentrates on how contextual features—national, industrial, and organizational—constrain and shape cooperative relationships at a particular point in time, rather than on how partners might use their collaboration proactively within that context. For instance, MPT assumes that the structure of the industry and national environment in which a firm is located dictates its most appropriate generic strategy—cost leadership, differentiation, or focus in Porter's (1980) terms. The process of forming cooperative alliances is in this way subsumed within an analysis of industrial and national structural determinants.

A further major contribution of MPT lies in the concepts and analytical techniques that it offers for understanding the links between cooperative strategies and national and industrial contexts. The value-chain concept and the identification of different competitive strategies are particularly helpful for demonstrating where, and for what purpose, an ally might be needed.

## 2.3 Transaction-cost economics

The perspective on strategic alliances offered by transaction-cost economics (TCE) views them as potentially cost-reducing methods of organizing international business transactions. In particular, writers such as Buckley and Casson (1985: 9) have applied the TCE perspective to explain how the internalization of production through foreign direct investment, including alliances, enables multinational enterprises 'to replace the market or alternatively augment it'.

Transaction costs are those that are incurred in arranging, managing, and monitoring transactions across markets, such as the costs of negotiation, drawing up contracts, managing the necessary logistics, and monitoring accounts receivable. TCE regards the basic choice in organizing economic transactions as being between effecting these through market exchanges and internalizing them within a single firm where they are governed by hierarchical relationships embedded in organization structures.

Oliver Williamson has been the main proponent of TCE. In his 1975 version of TCE, Williamson identified five factors that are relevant for the choice between internalizing the governance of transactions within firms as opposed to effecting them through market exchanges. These are opportunism, bounded rationality, small numbers, uncertainty and complexity, and information impactedness. Opportunism refers to behavior that is self-interested and deceptive. The notion of bounded rationality recognizes that there are informational and other limits to the exercise of rationality. Williamson regards these features as the two human factors that pose a problem for the governance of transactions because they respectively identify a major source of risk and limitations on the means for dealing with it. Williamson argues that when two or more parties transact recurrently under conditions where (1) there are limited numbers of partners to choose between (small numbers), (2) market conditions are uncertain and/or complex, and (3) accurate and adequate information relevant to the transaction(s) is known to one or more parties but not to others without their incurring considerable costs (information impactedness), then the more vulnerable partner is likely to benefit from internalizing the transaction or activity within its own more immediate managerial control.

In his 1985 analysis, Williamson gives more attention to asset specificity as a point of reference for choosing between transactions governance structures. Asset specificity refers to durable investments that cannot readily be redeployed to other uses and that are made in support of particular transactions. The commitment of such assets locks the partners concerned into the given type of transaction. Contractual and/or organizational safeguards are therefore called for to protect the investor in specific-use assets against the risks arising from opportunism, bounded rationality, and uncertainty. A contemporary example is the concern for legal safeguards against opportunistic infringement of intellectual property rights demanded by foreign companies investing technology in China, where their ability to control its use directly on location can often be limited.

According to Williamson, the attributes of a transaction, especially the degree of asset specificity, should play a key role in the choice of an appropriate governance structure. When transactions are one-off, of relatively short-term duration, and where the assets involved are nonspecific, market-based transactions are deemed to be suitable. Under such conditions, the market itself backed by the law of contract, should provide effective safeguards to the transacting parties. By contrast, when transactions are recurrent, have highly uncertain outcomes which may take a long time to mature, and require unique or transaction-specific investments, they should be conducted more effectively within organizations ('hierarchies'). The main legal basis for these unified governance structures is the employment contract, which provides for a structure of authority and command.

Williamson (1985) also recognizes that two possibilities lie between these two extremes. Both involve assets of mixed specificity, the first case where transactions are occasional and the second case where they are recurrent. In the first case, he suggests that market contracting backed by third-party assistance, such as arbitration and litigation, is an appropriate mode of governance. In the second case, he suggests that relational contracting and bilateral governance should prevail. Relational contracting involves a long-term investment in building relationships between the parties. Bilateral governance, however, can be implemented by the parties making mutual investments of specific assets that generate mutual dependence and serve as hostages against opportunism.

Relational contracting and bilateral governance admit the possibility of hybrid governance structures, intermediate between markets and hierarchies. Hybrids, such as joint ventures, are characterized by bilateral dependency between the partners, in that they mutually commit equity and assets, and agree on how costs and profits are to be divided between them. In contrast to hierarchies in which one set of owners and/or managers has unilateral authority, the partners to hybrids share rights to control and monitor activities, thus potentially weakening the control each can exercise. To overcome this problem, the partners have to rely on features such as long-term contracts, the offering of mutual hostages such as assets specific to the collaboration, and the development of mutual trust. Although hybrids offer advantages that TCE identifies—namely, avoidance of the high uncertainty caused by market failure and the high overhead costs of establishing hierarchies (Kogut 1988*a*; Williamson 1993)—their uneasy position with regard to control lends them an inherent instability (Buckley and Casson 1988; Kogut 1988*b*).

TCE analysis has been used to address a wide range of topics related to cooperative strategy and strategic alliances. These include modes of entry into foreign markets (Anderson and Gatignon 1986), the selection and structuring of alliance forms (Hennart

1988, 1991; Parkhe 1993*b*), and the formation of new ventures (Oviatt and McDougall 1994). Much of the empirical research conducted within a TCE framework has pointed out that equity joint ventures (EJVs) are used to bypass the inefficiencies of intermediate markets in respect of providing raw materials and components, tacit knowledge, loan capital, and distribution systems. For instance, a major international company producing industrial ink-jet and laser printers formed an EJV with another diversified transnational firm as a basis for undertaking product assembly and more extensive marketing in China. The latter firm had over ten years experience in China and was able to provide access to its distribution system, to managers who are competent in the local environment, and to its knowledge of how best to deal with government agencies.

Parkhe's (1993*b*) research on 111 interfirm alliances having at least one US partner tested several propositions drawn from TCE. He found that alliances buttressed by non-recoverable mutual investments are more likely to be high performers, and this supports the argument that the incorporation of deterrence against opportunism is beneficial in partnerships. However, many of the alliances studied were still relatively new, and Parkhe found at the same time that the perception of opportunism among other partners was reduced by a previous history of cooperation between them and by the anticipation of higher future pay-offs from the cooperation.

TCE contributes important insights into the governance forms that alliances may take in the light of the circumstances in which they are formed. The TCE perspective on cooperative relationships throws new light on the relevance of the partners' motives, the nature of the investments they commit to the collaboration, and the specific character of their transactions. Whereas MPT emphasizes motives for cooperative strategy that relate to market power and profit attainment, TCE stresses the efficiency and cost-minimizing rationales for cooperation. An alignment of the two perspectives draws attention to cases where a particular mode for governing transactions is preferred on the grounds of market power rather than efficiency alone; indeed Williamson has been criticized for ignoring the role of power in the choice between market and hierarchy (Francis et al. 1983).

Moreover, while TCE provides a sound framework for exploring the choice between market and hierarchy as governance modes, it does not take account of how the relational aspects of cooperation evolve over time and which, as Parkhe (1993*b*) suggested, affect the nature of the transactions themselves. TCE always emphasizes the rational aspects of transacting from a static nonevolutionary stance, in a way that does not take account of how growing trust and bonding between partner firms can reduce opportunism, and possibly reduce the boundedness of rationality through a growing willingness to share information. It deals only in terms of efficiency, and has little to say about questions of fairness or trust in the management of transactions. The qualitative history of business relationships, and the value placed on relationships per se, is relegated to the background in most TCE analyses.

This leads to another limitation of TCE in that it ignores those modes of economic organization which are not highly codified (as both markets and hierarchies are in their own ways), and where transactions are governed by more implicit understandings. As Boisot and Child (1988, 1996) point out, the hierarchy-market dimension, even when it allows for intermediate positions such as relational contracting, fails to account for how transactions are governed in societies such as those of East Asia on the basis of tacit trust-based cooperative relationships. Such modes of governance, which are not unknown in Western societies, offer important insights for the management of alliances that are intended to evolve and strengthen over the long term.

## 2.4 Agency theory

Agency theory is concerned with the ability of 'principals' to ensure that their 'agents' are fulfilling their objectives. Much of the work within this perspective has focused on the special case of the principal–agent relationship between the owners and managers of large public corporations (Berle and Means 1932). Other writers have, however, extended the principal–agent framework to other relationships such as that of employer to employee, client to lawyer, and buyer to supplier.

Agency theory is concerned with the governance mechanisms that limit the agent's self-serving behavior, including various control and incentive mechanisms (Jensen and Meckling 1976; Arrow 1985; Barney and Ouchi 1986; Eisenhardt 1989). Eisenhardt (1989) identifies the contract between a principal and an agent as the central unit of analysis for agency theory. She points out that agency theory contains a number of assumptions about the nature of human behavior, organizations, and information, that:

- human behavior is self-interested, subject to bounded rationality, and risk adverse
- organizations contain a degree of conflict between the goals of their members
- there is an asymmetry of information between principals and agents (with agents possessing specific information about what they are doing and relevant contextual conditions)
- efficiency is the criterion of effectiveness
- information is a purchasable commodity, so that, for example, principals can choose to spend more in order to secure better information about the conduct of their agents.

Given these assumptions, the focus of the theory has been on determining the most efficient contract governing the relationship between principal and agent. More precisely, the question becomes one of whether a behavior-oriented contract is more efficient than an outcome-oriented contract. Behavior-oriented contracts include those which offer a salary in return for being available to work during stated hours, or in given circumstances, and under the authority of a hierarchical superordinate (i.e. hierarchical governance). Outcome-oriented contracts include commissions, stock options, and having rewards or returns subject to performance within a market place.

Agency theory has reintroduced the importance of self-interest and incentives in thinking about organizations. More specifically, it draws attention to the implications of risk aversion for contractual behavior under conditions of uncertainty. It also brings to the fore the importance of information for the ability of principals to exercise control over their agents, and hence the role of systems which are designed to provide principals with suitable information.

Within the range of structures through which a cooperative strategy may be pursued, a principal–agent relationship is most clearly established when JVs are formed whose managers are accountable to their partner owners. Agency theory would regard the relationship between the partner owners and JV managers as a problematic one. The situation becomes more complicated if and when the partner companies themselves have different risk and time preferences. For example, one partner may be more risk averse and have a shorter time preference than the other, in which case they are likely to disagree over the scale of their shared investment and on whether to distribute or reinvest returns on it. Such disagreement could result in a failure to establish mutual trust between them. If situations like these give rise to mixed signals being sent to JV managers (the agents), there is a danger of agency costs rising (Buckley and Chapman 1993). The problem becomes even more complex when there are more than two principals and, possibly, multiple agents running the JV such as two general managers. Hennart (1993), using TCE analysis, has pointed out that the headquarters of multinational firms could use different control levers over their subsidiaries—either hierarchical command or price mechanisms. This choice could also apply to the control by partner companies of their JVs. Geringer and Hébert (1989) argue that more study should be undertaken into the control strategies adopted by JV partner owners, although, as Chapter 11 indicates, subsequent investigations have enhanced our understanding of this issue.

The implications of agency theory extend to forms of cooperative strategy other than JVs, for, in one sense, a cooperative relationship is one in which each partner becomes an agent for the other(s). There is a risk that one partner will engage in self-seeking opportunistic behavior at the expense of the other, and this raises the question of what monitoring may be appropriate within a cooperative partnership. In Chapter 13 we note how one partner in some alliances has exploited the cooperation as an opportunity to acquire new technology and enhance its competence, and how it has dissolved the partnership once that objective has been achieved. Game theory, discussed in Chapter 3, reminds us that in any cooperation a partner may maximize its own returns at the expense of the other partner, albeit that this is a high-risk strategy and one unlikely to succeed repetitively.

The practical implication of agency theory is therefore that, just as a principal is advised to put in place a combination of incentives and monitoring mechanisms to ensure that an agent's behavior remains consistent with the principal's objectives, so the partners to a cooperative venture would be advised to make clear to each other the basis on which each will share the returns from effective cooperation, and to put into place the systems for information to be shared between them. These provisions should reduce suspicion between the partners and so provide a basis for mutual trust to develop through their working relationship. As and when the partners do trust each other more, so the monitoring mechanisms emphasized by agency theory can become less prominent.

## 2.5 Resource-based theory

The resource-based theory (RBT) of the firm is a relatively recent approach to firm-level strategy. It has been developed further with a specific focus on knowledge resources or on the complex, embedded combinations of knowledge and skills known as capabilities or competencies. All of these models see the firm as a bundle of resources, some commonly available, some unique to the industry or sector, and some unique to the individual firm (Amit and Schoemaker 1993). According to RBT, assets and skills that are common to all or many firms or easily available in the marketplace cannot provide competitive advantage. Only strategic resources (assets, capabilities, knowledge) that meet the conditions of being valuable, rare, inimitable, and nonsubstitutable can generate competitive advantage (Barney 1991). These assets have value because they are capable of generating economic quasi-rents (economic profits) in the marketplace (Peteraf 1983). They are rare because they are based on unique holdings, access, or experience and cannot be sold freely in the market. They are also impossible (or at least very difficult) to replicate in other firms because their exact form and their unique value-adding structure are uncertain and tied to historical events—their generation of rents is causally ambiguous. Likewise, the value brought by these particular resources is difficult to generate with alternative resources. Thus, resources that are idiosyncratic to the firm and that generate economic value for customers provide access to rents for an extended period and so provide sustainable competitive advantage.

Barney (1991) says that such resources may be physical, human, or organizational. However, since physical resources tend to be used up or worn out, or are ultimately replaceable or duplicable, and since human resources can quickly leave, or threaten to leave and thereby appropriate more of the rents, only organizational resources can generate sustained competitive advantage. Such resources are often referred to as capabilities or competencies. They are typically seen as bundles of hard assets and knowledge or skills, and are said to be path dependent, embedded in and dispersed throughout the organization, complex, and tacit or difficult to describe fully.

Such capabilities are also subject to adaptation through evolutionary processes. As they are largely know-how based, application leads to evolutionary processes of random variation, environmental selection for fitness based on performance, and retention over older and less effective skill and asset combinations. The organization must be able to upgrade its resource and capability base as its environment changes, whether through internal development or externally focused learning. Static, unchanging competencies will eventually lose their relevance and stop generating advantage. It is also the case that while economic value derives from strategic assets or capabilities, the rents often are not available without a set of complementary assets that make the value available in the marketplace. For instance, a one of a kind consumer product, based on unique R&D capabilities, will generate no rents if its owner does not have, or have access to, a distribution system that can put it on the shelves of retail stores efficiently. RBT is concerned with the sources of organizational effectiveness rather than of governance efficiencies.

Alliances are critical sources of both strategic assets and of complementary resources for organizations. This is especially true in rapidly changing, technology intensive industries, but the model should be applicable in many settings. Madhok and Tallman (1998) suggest that the acquisition of new resources has a four-step logic:

1. The firm will develop its strategic and complementary resources internally, if it has the time and the basic capabilities to do so. However, firms frequently do not have

the requisite capabilities to develop resources outside their primary areas of competence, and seldom have the luxury of time to first develop capabilities and then to create specific resources.

2. The firm can outsource its search for new resources in the marketplace, through distributors, advertising agencies, contract manufacturing, and the like. While this may be a viable alternative for complementary resources, it is not going to bring in unique skills at below market price, and so will not add to profit potential. Also, unique capabilities based on tacit knowledge embedded in *other* firms will not be marketable independent of their owners.
3. The firm can acquire other firms to access their firm-specific assets, particularly knowledge assets possessed by their employees. However, the risk of paying for the full market value of these assets (or even a premium) is high, meaning that the cost of acquisition will match or exceed the profit potential of the acquired assets. In addition, knowledge assets are tied to employees, particularly highly knowledgeable employees, who have a tendency to leave after an acquisition, taking the assets with them.
4. The firm may want to consider a JV or alliance in order to tap into the partner's knowledge assets without committing to a single market price or buying the partner in whole or part. Cooperative approaches give both firms the incentive to generate the most profitable product at the lowest cost while retaining their knowledge assets for other applications. Key employees are not threatened or discomfited, and the two firms can structure a long-term alliance to encourage cooperative development of customized assets with even greater profit potential. For instance, in the symbiotic relationship of the pharmaceutical industry and the biotechnology industry, we see many alliances in which small, innovative biotech firms provide core recombinant DNA discoveries to allied large pharma companies that have the financial and organizational resources to carry the discovery through development, testing and approval, and marketing. Of course, as we shall see in this book, cooperative strategies have their own risks and costs, but properly applied can be an important source of co-specialized or complementary assets. The speed and flexibility of alliances have made them particularly attractive in technology-intensive industries such as information technology or biotechnology-base pharmaceuticals.

## 2.6 Transaction-value theory

From a theoretical perspective, the transaction value approach to cooperative strategy reflects aspects of both resource-based theory and transaction-cost theory. Resource-based models, as we see above, focus on maximizing rents to the bundle of assets in a venture while essentially ignoring cost differentials, while transaction-cost economics focuses on minimizing the costs of governing a transaction while assuming that the revenue stream to a set of assets will be constant across organizational forms. Transaction value models propose that the real issue is joint value maximization for the collaborative transaction (Zajac and Olsen 1993; Dyer 1997). A cooperative venture should be allowed to bear higher transaction costs if these added expenditures increase revenues to a greater degree by creating a unique asset bundle not available to a lower transaction-cost approach, and likewise lower rents might be accepted if they were tied to a much lower cost transaction form that provided a larger expected net value. Exactly how this transactional value focus plays out varies somewhat, but in all such analyses, the focal issue is avoiding attachment to cost reduction.

The work on this perspective was done by Zajac and Olsen (1993). Their concerns are with replacing a single-party cost minimization analysis with a focus on the interdependence of the partners and with replacing structural concerns with process concerns when considering alliance transactions. They suggest that a pure cost focus may make inter-organizational strategies seem to be irrational in cases where greater joint value is derived from less cost-efficient structures. Zajac and Olsen suggest that the inclination of a partner firm to act opportunistically in a small numbers situation (the fundamental tenet of transaction cost analysis) will be dominated by the desire to maximize the overall net present value of the collaboration. This analysis, they claim, begins as soon as the possibility of an alliance is considered and continues through periods of interorganizational learning, investment in value-enhancing assets, and expanding the scope of the collaboration. From a TCE perspective, all these activities will raise the potential cost of opportunism and should be accompanied by further expensive investment in safeguards. Transaction value, however, suggests that these activities will increase the expected value of the relationship and will reduce the risk of opportunism by raising its costs to the interorganizational system.

Dyer (1997) looks at the Japanese and American automobile manufacturing industries to reinforce the message of transactional value. He sees that the Japanese auto assemblers reduce their transaction costs by dealing repeatedly with a small group of suppliers for large contracts, sharing information freely, using self-enforcing safeguards (trust, exchanges of shares) rather than formal contracts, and investing in cospecialized, transaction-specific assets. Investments in the transaction are found to be credible signs of commitment to the partnership, relieving partner fears of opportunism, while also improving the productivity of the alliance's activities. While he focuses more on the trust building, safeguard reducing aspect of credible commitment and familiarity (and continues in this vein in subsequent articles) rather than Zajac and Olsen's rational analysis of economic benefit, Dyer reinforces their message that actions seen as increasing the cost of alliance transactions may actually increase value and reduce cost through the benefits of joint activities. In a more theoretical vein, Madhok (1997) states that by improving the chances for developing synergies through joint organizational capabilities, the fundamental transformation to small numbers may enhance the value of an alliance and reduce the risk of breakup.

The application of resource or capability arguments to alliance transactions suggests that properly assessed collaborations provide increased rents to the alliance or other inter-organizational system (Madhok and Tallman 1998). Rents can be earned from the combination of complementary assets in an alliance, avoiding wasteful replication of capabilities across multiple firms, and from the greater efficiency and effectiveness provided by cospecialized assets developed by the specific partners in a specific alliance relationship. If a partner acts opportunistically, it may appropriate the rents from the alliance on a short-term (or one-time) basis, but will lose future rents from the specific partnership and from its own (unavoidable) investments in hard, and more importantly in soft (relational), assets. Again, the argument is that relational and other highly specific investments from both, or all, partners actually make the persistence of an alliance more likely rather than less likely because the transactional value or benefits of the alliance outweigh any benefits from being opportunistic. So, the transactional value approach sees that one set of actions involving increased transaction specificity can both raise the value and lower the risk of breakup for an alliance.

## 2.7 Real-options theory

Yet another recent development in the strategic analysis of alliances, particularly JVs, is their treatment as real (call) options on the opportunity to invest in a foreign market, new technology, or possible acquisition of another company. The benefit of a financial call option is that the buyer of the option can, for a relatively small charge, hold the right to make a larger investment at a fixed price at a later date. The benefit of waiting is that uncertainties about the future are expected to be clarified as intervening events unfold. If things turn out well—for instance the economy improves, a key new product is approved or shows market success, or quarterly profits exceed expectations—the option holder can exercise his rights to buy low and can then either sell the newly appreciated asset or hold it for the future, having faced less risk in the process. Alternatively, the option holder can sell on the option until its exercise date. Should events be less favorable, the option can be allowed to expire unexercised, and the option holder is free of an unwanted obligation for a relatively low expenditure. Real options, as opposed to financial options, suggest that some investment is made on one or more real assets with the option of increasing the investment to the point of full ownership at some time in the future. Again, should the assets turn out to be less attractive than originally hoped or expected, the option can be disposed of at a lower cost than would have been incurred if the assets had been acquired in full in the first place, only to lose value over time.

Equity joint ventures (EJVs) can be described as real call options on further real investments (Kogut 1991), an idea that seems to be gaining momentum. The argument is that if a firm is considering entering a new field or new market, one that appears to be attractive but which is unfamiliar to the investing firm, it faces considerable uncertainty about the actual value of the investment. Acquisition of a competitor to internalize a new product or to establish a position in a foreign market might provide access to increased cash flows, market share, profitability, and so forth, but it might not. The less familiar the acquirer is with the business or market of the target, the greater the uncertainty and the more difficult the job of assigning a meaningful value to the investment. A JV, however, provides access to the new technology, product, or market in a way that allows the entrant access to some share of the current revenue stream, but full access to developing knowledge about the putative investment, all for a fraction of the investment of a full acquisition. The money saved can be used for other JVs (more options) or retained in a safe form and used to exercise the option (buy out the partner) if reduced uncertainty leads to expectations of positive future outcomes. Again, if the market proves unsatisfactory or the technology fails to perform, the share of a JV partner can be sold, either to a third party or to the partner, or the JV can be dissolved. In the first case, some of the option value will be recovered, but even the worst case will cost less than a complete acquisition that subsequently fails.

Kogut (1991) offered the first major effort to develop the idea of JVs as real options, 'to expand and acquire' as he put it. His tests showed how signals from the marketplace that the value of the JV is probably greater than the base forecast lead to rapid exercise—acquisition—of the partner's rights. However, negative signals do not lead to immediate dissolution of the JV—as predicted, so long as the cost of the option does not increase significantly, it tends to be maintained in the hope of future improvement. As option values increase as uncertainty increases, a real options strategy provides a way for firms to profit from uncertainty rather than simply protecting against it through internalization.

In a later paper, Folta (1998) points out that the option value of an equity participation is tied to 'purchase' of the option as well as 'exercise' of the option. That is, by investing in a JV, a firm can defer a decision made under high uncertainty to invest heavily in a new technology (or market). Once the option is owned, the firm can then decide whether to exercise, dissolve, or maintain the option (JV). Folta expects exercise to occur rapidly when the uncertainty is endogenous—due to the limitations of the firm in assessing the technology—because value is only recognized at exercise. On the other hand, exogeneous uncertainty due, for instance, to uncertainty about the state of the market, should lead to the decision to defer exercise, to take the option to wait on a larger investment while retaining the right to do so. In a later paper, Folta and Miller (2002) describe equity partnerships as 'two-stage compound [real] options' that allow firms to defer acquisitions under uncertain conditions while leading quickly to acquisitions when partner values climb. Chi (2000) discusses in detail characteristics of JVs as option vehicles with a particular analysis of the value of setting *ex ante* purchase values or negotiating *ex post*. In all cases, the empirical approaches suggest that a real options model can answer many of the questions raised in studies of TCE models.

These studies all regard EJVs or partial acquisitions as having option value since they offer explicit opportunities to buy out the partner or sell one's share. We note in Chapter 18 that many alliances do in fact end up in acquisition. A question that is not addressed is whether other cooperative strategies have option value. Contractual arrangements or other nonequity partnerships have no independent assets, so offer nothing to buy or sell. However, partnerships and other socially embedded cooperative ventures reduce uncertainty about the partner and also the partner's markets and technology and can certainly reduce the risk of acquiring the partner, if not guaranteeing the right to do so. On the other hand, any source of funds can buy a listed firm, and the options decision may relate much more to the reduction of uncertainty about the market's risks.

## 2.8 Increasing-returns theory

Economic theory has traditionally operated on the assumption that after a certain point there are diminishing returns to factor inputs. Such an assumption leads to the predictability of an ultimate equilibrium in markets and to the possibility of 'efficiency' in factor allocation, if contingent distortions can be eliminated from markets.

Economists such as Arthur (1989), however, have observed that increasingly, in knowledge-based industries in particular, the phenomenon of continuing increasing returns has manifested itself, a phenomenon of particular significance to the economic benefits of networks of alliances. In such circumstances companies able to get a large share of the market early on may lock in their consumers, with the result that these companies are able ultimately to dominate the market without decreasing returns setting in. The phenomenon of Microsoft is evidenced as an illustration of this characteristic. Its Windows product is regarded by technical experts as not necessarily the best product, but it is nevertheless the dominant one in the PC software market since it has enormous installed capacity and sunk costs, very low variable costs to produce, and an army of consumers trained in its use. In such conditions it would be very difficult indeed to dislodge it from its market dominance, and it is able to achieve increasing returns, perhaps until it corners the whole market. In an earlier case the QWERTY typewriter keyboard achieved a similar dominance although not for one company.

The existence of this characteristic of increasing-returns markets leads companies to develop dense technological networks, and to form alliances to achieve sufficient critical mass to be a major player in the market and to become first mover, lest they be preempted by rivals. As Arthur (1996: 106) says: 'if technological ecologies are now the basic units for strategy in the knowledge-based world players compete not by locking in a product on their own but by building webs—loose alliances of companies organized around a mini-ecology—that amplify positive feedback to the base technology'.

Bettis and Hitt (1995: 10) confirm this phenomenon of knowledge-based industries in particular. They claim that, 'In industries with a high knowledge content, as opposed to natural resource-based industries, it is uncommon for diminishing returns to occur; instead positive feedback is present where returns continue to increase. . . . The optimum scale may be the entire market and first mover advantages or an early lead in market share may be quickly magnified into market dominance.'

Achieving such a position is of course the key challenge, and this frequently leads to alliances: 'the increasing number of strategic alliances has changed the dynamics within and across industries. For example, alliances formed to develop new technology, such as research consortia . . . change the incentives and dynamics within an industry, whereas stakeholder alliances can change the dynamics across industries' (Bettis and Hitt 1995: 13).

In the new competitive landscape, therefore, companies form alliances first to develop new technology and secondly to fight off foreign competitors or at least to achieve parity in global markets. This applies to knowledge-based industries primarily, but may also extend elsewhere—perhaps, for example, to some service industries.

## 2.9 Summary

1. There is no generally accepted theory of cooperative strategy, but instead a number of 'lenses' through which it may be viewed, all of which give valuable insights.
2. Cooperative strategies between companies are carried out with the prime purpose of increasing the market power of the partners.
3. In terms of governance, alliances are set up when this form of organization minimizes the transaction costs involved.
4. Agency theory is not concerned with the motivation for an alliance, but with the behavior of the partners in one. Both are 'agents' of the other and as such systems must be set up to reduce the risk of self-serving opportunism taking place in the alliance.
5. The resource-based perspective suggests that partners set up alliances often in order to tap into each others specialized resources and strategic assets.
6. Transaction value theory holds that even if transaction costs are not minimized, so long as transaction value is maximized, the alliance is justified.
7. Alliances can be considered a real option to invest under conditions of uncertainty in a new market, a new technology or ultimately in an acquisition.
8. Increasing returns are the norm in knowledge-based industries, and the formation of a network of alliances enables companies to operate as significant players in such markets.

## 2.10 Questions for discussion

1. To what extent can a single dominant theory of cooperation be developed?
2. Is transaction costs or transaction value theory the key to appropriate corporate governance systems?
3. As in all strategy, the market theory is contrasted with the resource-based one. Is there any difference in cooperative strategy theory?
4. How can one put a value on a real option in this area?
5. Can increasing returns theory be extended outside knowledge-based industries?

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# 3 Managerial and organizational perspectives

## 3.1 What this chapter covers

This chapter describes the contributions of managerial and organizational theories to the understanding of cooperative strategy. It begins with strategic management theory (SMT), which draws attention to the motives for forming alliances, the selection of partners to achieve compatibility between their goals, and the need to achieve integration between partner cultures and systems. Game theory is then considered as a set of techniques that highlight the importance of understanding the consequences of cooperative and noncooperative behavior in a given situation, assuming rationality. The so-called Prisoners Dilemma is singled out as particularly indicative of the behavioral options in a relation between two partners. Organization theory's contribution comes through the resource dependency perspective and through a consideration of how to organize alliances. It also emphasizes the importance of trust in cooperative activity, without which alliances are likely to be short-lived (see Chapter 4).

## 3.2 Strategic-management theory

The perspective on cooperative strategy offered by SMT draws attention to the need for prospective partners to achieve a fit between their respective strategies, so that an alliance between them makes a positive contribution to the attainment of each party's objectives. SMT has also been concerned, though to a lesser degree, with the desirability of achieving another area of fit—namely, that between the organizational and national cultures which the partners bring to their cooperation. The burgeoning literature on strategic management contains a number of key, overlapping, themes that are relevant to cooperative strategy. These concern (*a*) the motives for forming alliances, (*b*) the selection of partners so as to achieve compatibility between their goals, and (*c*) the need to achieve integration between partner cultures and systems. Later chapters treat each one of these themes at greater length. Chapter 5 examines the motives behind cooperative strategy. Chapter 6 looks at partner selection. Some chapters in Part III, especially Chapters 14 and 15, consider how a cultural and operational fit can be developed through successful alliance management. In this last area, contributions from SMT join with those from organization theory.

Much of the strategic management work on alliances to date has concentrated on their antecedents rather than on their management. Thus analyses of reasons for setting up alliances, objectives for those alliances, and areas of possible conflict abound in the literature (Harrigan 1988). Tallman and Shenkar (1994), for example, suggest ways in which multinational enterprises might approach the issue of alliance formation as an alternative approach to acquisition or internal development. From a different tack, Contractor and Lorange (1988) identify a number of reasons for alliance formation that are by no means mutually exclusive. These range from risk reduction, through achievement of scale economies to coopting or blocking the competition. Faulkner (1995) classifies the motives for alliance formation into internal and external ones of which the main internal ones are, he claims:

1. Motives stemming from the resource dependency perspective, for example, need for specific assets or capabilities not currently possessed (see p. 34);
2. The minimization of transaction costs;
3. The need for speed to market not achievable by other means;
4. The spreading of financial risk.

He believes that the key external motives in the current international business situation are those surrounding the issues of globalization or regionalization; those concerned with international turbulence and uncertainty; and those concerned with the need for vast financial resources to cope with fast technological change and the shortening of product life cycles.

Logically following on from the strategic motives for alliance formation is the question of partner selection. Geringer (1991) examined previous research on the selection of international JV partners that he concluded was vague regarding selection criteria. As a clarification, he distinguished between two categories of selection criteria. 'Task-related' criteria which 'refer to those variables which are intimately related to the viability of a proposed venture's operations' (Geringer 1991: 45), and include features such as access to finance, managerial and employee competencies, site facilities, technology, marketing and distribution systems, and a favorable institutional environment (or a partner's ability to negotiate acceptable regulatory and public policy provisions). By contrast, 'partner-related' criteria refer to those variables that characterize the partners' national or corporate cultures, their size and structure, the degree of favorable past association between them, and compatibility and trust between their top management teams.

A number of strategic observations can be drawn from Geringer's work and that of others on partner selection. The relative importance of a given task-related criterion appears to depend on the partner's perception of how crucial the feature is for the cooperative venture's performance, how strong is the partner's ability to provide or gain access to the feature, and how difficult the partner thinks it will be in the future to compete in terms of the feature. If, for example, a company perceives technology leadership to be crucial for the venture's performance (and indeed its own), but that it cannot provide this on its own, it will logically give high priority to finding a partner with which an alliance will be capable of securing that leadership. Next, the selection criteria applied by partners to an alliance between firms from developed and less developed countries tend to differ. The former are generally oriented towards market access and accommodation to governmental regulations that may restrict access to firms investing directly in the country. Low-cost production and access to scarce materials are sometimes priority criteria for firms from developed countries. Such firms normally seek access to technology, know-how, managerial expertise, capital, and international markets.

The identification of partner-related criteria brings us to the third key theme within the SMT perspective. This has been expressed in terms of the need to secure a 'cultural fit' between cooperating partners in order that they can work together effectively and have a sound basis on which mutual confidence can develop (Bleeke and Ernst 1993; Faulkner 1995). According to Faulkner, the requirement is for the partners to have sufficient awareness and flexibility to be able to work together constructively; in other words, to be able to learn from each other's cultural differences and to be able to bring together their respective management systems, capitalizing on the strengths of each. Although this theme is receiving more attention within both the strategic-management literature and alliance practice, it is still underdeveloped and underrecognized. It raises the important question of how much autonomy a cooperative unit, such as a JV, should enjoy from its parent partners in order to have the freedom to develop a good cultural fit in terms of its own identity and way of operating (cf. Lyles and Reger 1993).

SMT emphasizes that firms enter into cooperative relations in order to achieve expansion and growth as well as to secure efficiencies of the kind identified by TCE. It draws attention to the external and contextual factors that encourage a cooperative strategy and develops a contingent view on the merits of a cooperative as opposed to a competitive strategy, and on the criteria for selecting a partner. This contingent view is more sophisticated and realistic than the universalistic rationales contained in the MPT and TCE perspectives. It also emphasizes the matching of partners rather than looking at cooperation simply from a single partner's point of view, as do MPT and TCE. A further contrast with these two major economic perspectives lies in the way that SMT brings the actor into play. Rather than positing that situational contingencies determine which cooperative strategies will be successful, SMT allows for the exercise of strategic choice by the actors who are deciding on firms' policies (Child 1997).

## 3.3 Game theory

Game theory is concerned with the prediction of outcomes from 'games', which are social situations involving two or more actors (players) whose interests are interconnected or interdependent (Zagare 1984: 7). The nature of a game might be sporting (as with poker), financial (as with bargaining over pay and other contracts), or military. Game theory is concerned with the strategies adopted by the players to a game and the effects these have on the game's outcome. Its insights therefore are of direct relevance to the understanding of cooperative strategy.

The types of game that can be played vary in complexity. Components of this variation include the number of players (2-person vs. *n*-person), their interests (conflict, coincide, or both), the information to which they have access (perfect vs. imperfect, complete vs.

incomplete), the number of times the game is played, and whether the players are allowed to communicate and make promises, commitments, or threats (Rapoport 1961).

Two-person games are the most elementary, and serve to highlight the dilemma that attends the choice between a competitive and a cooperative strategy. While game theory assumes that players are self-interested, it does not go on to the further assumption that competitive behavior necessarily follows. The dilemma is that, while cooperation will maximize joint interest, it does not maximize self-interest—at least for a particular transaction at a particular moment of time. In addition, if one player cooperates while the other defects from the cooperation, the latter will gain at the expense of the former. If neither party cooperates, they will both lose though not to the extent of the loss incurred by the nondefecting party when the other reneges.

These possibilities are contained in the so-called 'prisoner's-dilemma' game, which has two versions relevant to the choice between competitive and cooperative strategies. The traditional version describes situations in which players are logically condemned to defect. This derives from a model first developed in 1951 by Merrill Flood of the Rand Corporation and later termed the prisoner's dilemma by Albert Tucker. It addresses the issue of how we individually balance our innate inclination to act selfishly against the collective rationality of individual sacrifice for the sake of the common good. Casti (1992: 198) illustrates the difficulty effectively:

In Puccini's opera Tosca, Tosca's lover has been condemned to death, and the police chief Scarpia offers Tosca a deal. If Tosca will bestow her sexual favours on him, Scarpia will spare her lover's life by instructing the firing squad to load their rifles with blanks. Here both Tosca and Scarpia face the choice of either keeping their part of the bargain or double-crossing the other. Acting on the basis of what is best for them as individuals both Tosca and Scarpia try a double-cross. Tosca stabs Scarpia as he is about to embrace her, while it turns out that Scarpia has not given the order to the firing squad to use blanks. The dilemma is that this outcome, undesirable for both parties, could have been avoided it they had trusted each other and acted not as selfish individuals, but rather in their mutual interest.

Analytically there are two parties and both have the options of cooperating or defecting. If the maximum value to each of them is 3 (a positive benefit with no compromise involved) and the minimum value 0, then the possible outcomes and values for A (and B) are as shown below:

- A defects and B cooperates: A scores 3 (and B scores 0; total 3). Tosca gets all she wants without making any sacrifices. This would have happened if Tosca had killed Scarpia, and Scarpia had loaded the rifles with blanks thus enabling Tosca's lover to escape.
- A cooperates and B cooperates: A scores 2 (and B scores 2; total 4). Tosca, although saving her lover's life, has to submit sexually to Scarpia in order to do so, which it is presumed represents a sacrifice for her. Similarly Scarpia's compromise involves not killing Tosca's lover.
- A defects and B defects: A scores 1 (and B scores 1; total 2). This is what happened. At least Tosca has killed the evil Scarpia, but he in turn has killed her lover. Not a successful outcome for Tosca or Scarpia, however, but marginally better for her than the fourth possibility.

- A cooperates and B defects: A scores 0 (and B scores 3; total 3). This is the worst outcome from Tosca's viewpoint. She has surrendered herself to Scarpia, but he has still executed her lover. This is the 'sucker's pay-off', and to be avoided if possible at all costs.

The dilemma is that, since Tosca (A) does not know what Scarpia (B) will do, she is likely rationally to defect in order to avoid the sucker's pay-off. Thus she may score 3 if Scarpia is as good as his word and she can make him the sucker. She will at least score 1. However, if both cooperate they will each score 2, which is the best joint score available. Yet in the absence of trust it is unlikely to be achieved.

In the situation of a strategic alliance, the optimal joint score can be achieved only through genuine trusting cooperation; yet this may be difficult to achieve if both parties in the alliance are overly concerned not to be the sucker, and are thus reluctant to release their commercial secrets, for fear that their partner will defect with them. This was the problem that Axelrod (1984) set out to examine through an interesting set of experiments. The issues he addressed were:

1. How can cooperation get started in a world of egoists?
2. Can individuals employing cooperative strategies survive better than their uncooperative rivals?
3. Which cooperative strategies will do best?

Axelrod invited a number of academics to participate in a contest pitting different strategies against one another in a computer tournament. Each participant was to supply the proposed best strategy for playing a sequence of prisoner's-dilemma interactions in a round-robin tournament. The winning strategy was the simplest—namely, Anatol Rapoport's strategy of tit-for-tat. It had two rules:

1. cooperate on the first encounter, and
2. hereafter do what your opponent did on the previous round.

Such a strategy was a forgiving one, which implied a willingness both to initiate and to reciprocate cooperation. If both partners did indeed cooperate on the first round, then cooperation would continue. However, if only one cooperated on the first round and the other defected thus creating a sucker in the first round, then the cooperator would defect in the second round to show the defector the error of its ways and the penalty for defection. The results were confirmed in a second tournament. The conclusions were that to be cooperative and forgiving was the key, and to retaliate when appropriate but without being vindictive. As Axelrod (1984: 112) summed up:

> Tit-for-tat won the tournaments not by beating the other player but by eliciting behavior from the other player that allowed both to do well.... So in a non-zero sum world, you do not have to do better than the other player to do well for yourself. This is especially true when you are interacting with many different players.... The other's success is virtually a prerequisite for doing well yourself.

This second version of the prisoner's-dilemma game provides for the essence of co-operative strategy. Applied to strategic alliances this series of experiments suggests a number of things:

1. The rational strategy of defection (competition) applies on the assumption of a zero-sum game, and a nonrepeatable experience. That is, it applies if you are in business only for a single trade, such as buying a souvenir in a bazaar in Morocco. In this situation, defection (i.e. bargaining as hard as you can) is a rational strategy for you to pursue.
2. As soon as the game becomes non-zero-sum, possibly because cooperation is starting to provide economies, and/or it is known that the game will be played over an extended time period, the strategy of defection is likely to become suboptimal. To cooperate and keep your bargain is a better strategy for both players. If you do not, it will at the very least harm your reputation. You will become known as a player not to be trusted.
3. In these circumstances, forgiving cooperative strategies are likely to prove the most effective.

For example, a partner who defects (say, steals secrets) in an alliance will find his gains short-lived as the alliance founders, and the existence of available future partners becomes somewhat limited, because his reputation for defection goes before him. A good cooperator, however, will develop the opposite reputation, and will experience attractive partnership propositions.

Although the short-term dominant strategy can be shown as defection in a one-shot prisoner's-dilemma game, this does not apply in a multishot game with an indeterminate end. Nor does it apply if the penalty for defection is made very high. Further, it does not apply if the partners value working together and care about their reputation in the wider business community. A strategic-alliance partner who is seen to defect would find it very difficult to attract future partners.

The trouble with tit-for-tat is that in the real world the first defection often leads to breakdown, and also as a strategy it is powerless against the persistent defector. Ridley (1996) suggests two alternative strategies that in real life have been found to be more effective than tit-for-tat. They are Pavlov and Firm-but-Fair. Pavlov posits players who, in roulette terms, stick to red if they win on red, and if they lose try black next time. Ridley claims this to be the basis of both dog-training and child-rearing. We are trained to continue to do things that are rewarded and to stop doing things that are punished. However, Pavlov is also powerless against continual defectors. In Firm-but-Fair, actors act successively and can communicate with each other, unlike in the strict prisoner's-dilemma model. This leads them to cooperate with cooperators, return to cooperating after mutual defection, and punish a sucker by further defection, but it assumes that they continue to cooperate after being a sucker in the previous round, which neither tit-for-tat nor Pavlov do. Thus the motivation to cooperate and to continue to cooperate in an alliance is in game-theory terms very strong if the alliance is set up in the right way.

Iterated versions of the prisoner's-dilemma game have in these ways been used to analyze how cooperation evolves when the players have a possibility of meeting again and therefore have a stake in their future interaction. Axelrod (1984) refers to this as the future casting a shadow over the present situation. When this is the case, Axelrod argues that cooperation as a social process can develop in three stages. First, it may commence, even in a context where unconditional defection is the norm, with small clusters of individuals who base their cooperation on reciprocity and have a sufficient proportion of their interactions together. Second, a strategy based on reciprocity can thrive alongside other strategies. Third, once firmly established and accepted on the basis of reciprocity, cooperation can protect itself from invasion by less friendly strategies, such as tit-for-tat, so long as the collaborators retaliate in response to a first defection. However, while this approach works well in computer simulations, it is rarely found in real life, where defection generally leads to the break-up of the collaboration as trust dissipates.

Iterated games also suggest that the probability of cooperation may be improved initially by providing mutual hostages and then progressively reinforced by the benefits it is seen to provide. This is an important insight which directly parallels the conclusion that may be drawn from theories about the ways in which trust between partners can develop over time through continued interaction between them (see Chapter 4). Indeed, Gulati et al. (1994) stress the significance of partners making unilateral commitments. They conclude from research on seventeen companies engaged in alliances that one shortcoming of the prisoner's-dilemma framework lies in the way it underestimates the importance of partners acting unilaterally to make commitments that enhance the possibility that all the partners will cooperate. They conclude that such unilateral commitments can be vital to the success of alliances.

Parkhe (1993: 799) summarizes the process whereby cooperation is reinforced through iterations, under conditions postulated by game theory:

> Experimental evidence suggests that although noncooperation emerges as the dominant strategy in single-play situations, under iterated conditions the incidence of cooperation rises substantially. . . . Similarly, in strategic alliances, cooperation is maintained as each firm compares the immediate gain from cheating with the possible sacrifice of future gains that may result from violating an agreement. . . . The assumption here seems intuitively reasonable: broken promises in the present will decrease the likelihood of cooperation in the future. By the same token, cooperation in the current move can be matched by cooperation in the next move, and a defection can be met with a retaliatory defection. Thus, iteration improves the prospects for cooperation by encouraging strategies of reciprocity.

Nalebuff and Brandenburger (1996) draw from game theory the message that companies need to weigh up the consequences of cooperative and competitive behavior. They warn against aggressive strategies that can backfire, citing as an example the fact that the US airline industry lost more money in its price wars of 1990–3 than it had previously made in all the years since the Wright brothers. Nalebuff and Brandenburger argue that game theory is a way of thinking—a tool for analysis—that is well suited to assessing the likely consequences of competitive and cooperative behaviors in conditions where the benefits to one player depend on what the others do, and where in a complex world there are many interdependent factors so that no decision can be made in isolation from a host of other decisions. The central tenet of their book is that business has to recognize the duality between cooperation and competition—which they call 'coopetition'. Luo (2004) reviews the ways that coopetition is today being applied to international business. He defines coopetition as simultaneous competition and cooperation between global rivals, and claims that it is 'an emerging landscape' of global business. It is, however, a way of thinking that may be more novel for Western managers than for their counterparts in regions such as East Asia who have long been familiar with the practice of cooperating through business networks (Biggart and Hamilton 1992).

Kay (1993: 152–3) distinguishes between two categories of strategic alliance—the 'common-objective' alliance and the 'mutually beneficial-exchange' alliance. The former is typically one in which the partners possess distinctive capabilities which complement each other. Examples are the previous cooperation between Rover and Honda and the many alliances between small biotechnology firms and large pharmaceutical firms for the production and sale of biotechnology-based ethical drugs. The latter is an alliance in which each partner possesses expertise, information, or skill that is of value to the other, an example being General Motors' cooperation with Toyota. In this alliance, GM learned about lean production manufacturing, while Toyota benefited from access to the American market. Applying the logic of game theory, Kay concludes that, in a common-objective alliance, cooperation is a dominant strategy for both partners—it pays both partners to put the maximum effort into attaining the common objective. In the case of a mutually beneficial-exchange alliance, however, the dominant strategy for both partners is to hold back—in other words, to get as much as possible while giving as little as possible. This is the prisoner's-dilemma situation, in which self-interest is not maximized by cooperation even though joint interest may be. The longer the alliance holds, the more likely it is that a recognition of the mutual benefit from cooperation will prevail, but paradoxically the initial pursuit of self-interest is likely to bring an alliance to an early demise.

Game theory, then, makes a valuable contribution to the analysis of cooperative strategy by pointing to situations in which this strategy may be rewarding and also the conditions under which it may be undermined. In its present forms, game theory relies on a number of simplifying assumptions that distance it from reality, without, however, necessarily undermining its essential insight. Among the features of reality which cannot readily be encompassed by the game-theory framework are the personalities of the players, their social ties, verbal communication between the players (and the emotional and norm-building consequences of such communication), uncertainty about what the other player actually did at previous points in the game, and the social conventions and institutional rules in which the players and their interactions are embedded. Game theory also reduces firms to single actors and has difficulties in coping with the differentiation of roles, perceptions, and interests within them. Nevertheless, it continues to have tremendous potential for advancing our understanding of the intrinsic nature of business cooperation.

## 3.4 Social network theory

The relevance of social network theory for cooperative strategy arises from the fact that economic actions are influenced by the social context in which they are embedded. This context includes the position of decision makers and their firms within social networks.

Although there is a great deal of confusion as to quite what a network perspective entails, social networks can broadly be defined as persistent and structured sets of players (persons or organizations) who cooperate on the basis of implicit and open-ended contracts. Such contracts are socially rather than legally binding. The perspective maintains that the actions of individuals and organizations can be explained to a large extent by their position in a social network that is itself constantly being maintained by the actions of those individuals and organizations (Nohria and Eccles 1992).

Strategic alliances are often located within social networks, and there is evidence indicating that this has important consequences. For example, the social relationships that are established through an alliance can assist both the operation of those alliances as well as the formation of new ones between the same partners. The existence of social networks of prior ties often influences the choice of partners for new alliances. The firms, and their leaders, that become partners are likely to be reassured about the risks entailed in so doing by the fact that there are already strong social bonds between them governing their attitudes and behavior (Gulati 1998). It has been found that prior alliances breed trust between partner firms and allow cautious contracting to give way to looser, more flexible practices (Gulati 1995). The cultural values that lend coherence and identity to social networks may also influence the ways in which alliances are constituted and how they evolve. An extended form of alliance social network can be seen in 'business ecosystems' in which key firms act as leaders and integrators of value-chain networks between partners. Dell Computers provides a well-recognized example that is discussed further in Chapter 9.

The social network perspective contributes in several ways to our understanding of cooperative strategy. It points to the fact that networks can be valuable sources of information for new alliance opportunities. Membership of established social networks can reduce the costs of coordination between partners and of safeguarding against appropriation of proprietary assets such as technology. Prior ties help to assure the partners that they can run their alliances with more flexible organizational arrangements and a less costly managerial structure. By enhancing trust between partners and their willingness to cooperate, social networks can enhance alliance survival and successful evolution. The main caveat to these benefits lies in the risk that a firm might become too locked into membership of a social network and as a result overlook or turn down opportunities for alliances with firms outside the network. Firms might, for example, be overcautious about forming potentially beneficial alliances with companies from outside their country or culture.

## 3.5 Organization theory

Organization theory embraces a range of perspectives that offer insights on three main aspects of cooperative strategy. First, there is the significance of resource provision and scarcity in cooperative strategies and relationships. The resource-dependence perspective (RDP) is of central importance here, and can inform both the general issue of why interorganizational cooperation is sought as well as the more specific question of how the investments partners make in alliances bear upon the control they can exercise over the management of the alliances. Second, there are the ways in which alliances can be appropriately organized. This issue is informed by network analysis and work on transnational business organization. The third aspect concerns the nature of trust within interorganizational cooperation, on which there is a growing body of recent research. The question of trust is so fundamental to cooperation between organizations that it is discussed separately and at length in Chapter 4.

### 3.5.1 Resource-dependence perspective

The RDP is concerned with the arrangements that are negotiated between organization managers and the external stakeholders, or organizational partners, who contribute necessary resources in the expectation of receiving valued returns. With its focus on needed resources, this perspective contributes to our understanding of why firms, or other organizations, undertake cooperative strategies. It raises as a strategic issue the problem organizations face of how to deal with uncertainties about their supplies of resources and human competencies. It indicates that, when resources and competencies are not readily or sufficiently available to firms, they are more likely to establish ties with other organizations.

According to Pfeffer and Salancik (1978), resource scarcity prompts organizations to engage in interorganizational relationships in an attempt to exert power, influence, or control over organizations that possess the required resources. Pfeffer and Salancik tend to emphasize the conflictual and coercive side of relations between organizations. Resource scarcity may, however, also encourage cooperation rather than competition, so giving rise to relationships based on mutual support rather than on domination. This is likely when the potential partners to an exchange anticipate that the benefits of forming a cooperative interorganizational relationship will exceed its disadvantages, including the cost of managing the linkage and the diminution of decision-making latitude.

Consistent with this attention to resource scarcity is the view that emphasizes the competitive importance of a firm possessing a portfolio of core competencies and value-creating disciplines (Hamel and Prahalad 1994). Similarly, Hall (1992, 1993) has been concerned with identifying the intangible sources of sustainable competitive advantage associated with the possession of relevant advantages in capability over competitive rivals. These intangible resources encompass assets such as patents, trademarks and data, and human competencies such as know-how and learning capabilities. The implication of this 'resource-based' view is similar to the resource-dependence argument—namely, that a strong reason for organizations to collaborate with others lies in their recognition that they lack critical competencies, which they cannot develop readily, and/or sufficiently rapidly, on their own.

The resource-dependence perspective also contributes to an understanding of the relation between resource provision and control within strategic alliances. The ability of business investors to exercise control over the firms in which they have an ownership stake is an issue of long-standing concern (cf. Berle and Means 1932). It assumes a new form, however, in those types of cooperation in which the partners take an equity stake, notably EJVs. Unless they are simply portfolio investors adopting the role of sleeping partners, the joint-venture owners will normally contribute much more than just equity capital. In establishing JVs to exploit complementarities between themselves, the owners provide skills and knowledge. These are assets in the possession of partner firms. They have intrinsic value and amount to ownership inputs with property rights. They confer powers of control over a JV both through the formal terms of any contracts by which they are provided, and through the less formal influence that derives from the partner's possession of scarce expertise and resources (cf. French and Raven 1960; Child et al. 1997). Since an owning company faces the problem of protecting the use and integrity of its investments when collaborating with a joint-venture partner, it has a motive for seeking a certain level of control (Hamel 1991).

In treating the relation between resource provision and control, the RDP builds upon Emerson's (1962) observation that dependency in a social relation is the reverse of power. Pfeffer and Salancik (1978) developed this notion to argue that the ability of external parties to command resources that are vital for the operations of an organization gives those parties power over it. In the case of a JV, this means that a parent firm which contributes a resource necessary for the venture's success, and that the other parent cannot easily provide, will gain power relative to the partner and relatively greater control over the JV. It also implies that a parent's control will be focused on those activities of the JV to which it contributes resources.

Some have suggested that the implications of resource dependence for JV control may be mediated by the bargaining powers of prospective partners (Fagre and Wells 1982; Lecraw 1984). They posit that prospective partners can negotiate for a level of JV control, 'given the assets that they command and perhaps general trends that may or may not be currently in their favor. Equity ownership is seen as an outcome of negotiation, a representation of relative power between participating interests' (Blodgett 1991: 64). While much of the bargaining power available to prospective partners is likely to arise from their command of significant resources in the first place as the quotation admits, this perspective allows for an element of negotiated indeterminacy in the extent to which the command of resources leads to control.

Reference to bargaining power thus warns against an assumption that the impact of resource provision on control in alliances is entirely deterministic. Pfeffer and Salancik's own analysis allows for the ability of firms to manage and avoid dependence. Similarly, the nondominant partners of JVs may be able to reduce their resource dependency over time—for example, through the superior learning process that Hamel (1991) has documented. There are also reasons to expect that even resource-dominant parent companies may choose to exercise their control over JVs selectively, depending on their cost/benefit assessment of assuming responsibility for the various areas of JV activity rather than leaving this either to their partners or to the venture's own management. Such an assessment would compare the strategic importance of securing control over different activities against the costs involved, and it would take into account the net benefit of adopting alternative control mechanisms as well.

The resource-dependence theory, concerned with the exercise of power, contributes a political perspective. This can be applied both to the relations between partner organizations and to the impact on the internal dynamics of an alliance of dependence on partners or other 'external' parties. While resource dependence's emphasis on the balance between partner or other stakeholder contributions and returns is broadly consistent with the focus of game theory, the processes it uncovers are far more complex and evolutionary than is readily incorporated into game theory. There are dynamics both around the interaction of organizational members with external networks, and around coalitions within the firms themselves. In this respect, the RDP is closely related to strategic-choice analysis, which also draws attention to the intra- and interorganizational political dynamics overlooked by many other perspectives (Child 1997).

This perspective is complementary to the 'resource-based' perspective described in Chapter 2, which makes a qualitative distinction between human and other types of resource, in stressing the vital contribution that the former makes to a company's performance (Hamel and Prahalad 1994). The resource-based perspective breaks with the product/market paradigm followed by market-power theory and many students of strategic management. It highlights the importance of human competence requirements as a stimulus to embracing a cooperative strategy, as well as to the significance of managing alliances in such a way as to secure motivation and synergy among the staff who are brought together from the previously separate partner organizations. However, as an essentially economic perspective, the resource-based model does not consider the motivations of actors in alliances in the same way that an organizational perspective such as resource dependency does.

### 3.5.2 Organizational perspectives

The emergence of strategic alliances presents managers with the practical requirement of how best to organize these entities. They have not as yet received a great deal of guidance from organization theorists, whose conventional assumptions are challenged by the 'hybrid' nature of strategic alliances. Moreover, as Borys and Jemison (1989) point out, the varied forms of alliance make them particularly difficult to analyze. The organizational requirements of alliances on which most attention has so far been directed are (*a*) the relative importance of structure and process in their management, (*b*) their network (or quasi-network) character, and (*c*) issues of control, autonomy, and learning. Later chapters discuss these topics in more detail, and they are introduced only briefly at this point.

The question of how theoretically and practically useful it is to focus on the structure rather than the process of strategic alliances was first raised in respect of decentralized multinational corporations (DMNCs). Doz and Prahalad (1993: 26) have argued that:

> Except in advocating a matrix organization, which is another way to acknowledge structural indeterminacy, a structural theory of DMNCs had little to offer. One needs a theory that transcends the structural dimensions and focuses on underlying processes. Issues of information and control become essential. More than the formal structure, the informal flow of information matters. So do the processes of influence and power, such as how the trade-offs among multiple stakeholders and multiple perspectives are made.

This argument applies even more to strategic alliances which, being generally shorter-lived and subject to more frequent reconfiguration than multinationals, can rely even less on formal structures. While formal channels for reporting back to parent or partner companies on financial, operational, and technical matters are absolutely necessary, there is a particular need in alliances for effective informal information exchange. This is both to promote the bonding and trust which will lead to a better cultural fit, and to ensure that the alliance is sufficiently adaptive to its environment. In other words, information flow is essential to achieving cultural fit and learning within the alliance. Unless an alliance is managed in a completely asymmetric manner, with one partner dominating all executive functions, it has to rely upon open and effective information flows between the partners, the staff they appoint to their cooperative ventures, and other staff who are recruited specifically for the alliance. There is no other way for it to be organized than as a pluralistic enterprise.

At the same time, however, we are reminded by resource-dependence theory that the processes of influence and power are also inherent in an alliance. Alliance partners may even compete for control over areas such as the management of its technology either to safeguard proprietary knowledge or to acquire such knowledge. The founding of alliances on the logic of exploiting complementarities between the partners may in any case make it sensible for each of them to assume responsibility for certain of its activities and decisions. The alliance must also perform according to certain goals and standards, which in turn require monitoring. These considerations bring the question of control into prominence. The challenge is how to organize an alliance and its links to the partners in such a way as to define their respective roles and, having done so, to build in the required degree of control over the alliance's behavior and performance.

The organization of cooperative activities can assume many forms. One form is the alliance that is dominated by one partner and structured more or less on the hierarchical lines of a so-called 'conventional' organization. Killing (1983) in his study of equity JVs found that this 'dominant'-partner model was associated with superior economic performance, and he therefore recommended its adoption wherever possible. It does not, however, represent a truly cooperative strategy and may forgo some contributions that the nondominant partner could otherwise offer. At the other end of the spectrum is the network model, which views the collaborating partners as linked together by a variety of relationships (Nohria and Eccles 1992). This model has been applied to organizations in order to convey an understanding of the connectivity and communication between its members, which cannot be captured by organization charts or formal role definitions. In the case of cooperative alliances, the term 'network' can be used to depict a particular organizational form that is characterized by a high sense of mutual interest, active participation by all partners, and open communications.

In this latter sense, the network approach in (inter-) organizational theory provides valuable insights, especially when it is combined with those from other transactional perspectives such as TCE and resource dependence. This combination of perspectives illustrates how firms create and manage alliances among themselves as strategic responses to competitive uncertainties. The biotechnology industry provides a good example. Barley et al. (1992: 317) note that 'the particular constraints and opportunities surrounding commercial biotechnology appear to have compelled organizations to form an elaborate web of formal alliances'. As a result, small firms have had to sacrifice some degree of autonomy in order to gain access to markets with high entry barriers. Powell et al. (1996) argue, with reference to the same industry, that its complex and expanding knowledge base, with widely dispersed expertise, causes the locus of innovation to be found in networks of learning rather than in individual firms. The need for learning has, in other words, promoted cooperative strategies in this industry.

Given that many strategic alliances are established in order to secure advantages of learning and knowledge transfer, more attention is now being paid to how the organization of alliances can assist the learning process (Inkpen 2002). Organizing alliances so as to reconcile their needs for learning and control is one of the most important requirements for a truly cooperative strategy to be implemented successfully. These issues are considered in Chapters 11 and 13, but, one approach that has emerged in response to this challenge is a variant of what Peters and Waterman (1982) called 'simultaneous tight–loose coupling'. This operates clearly prescribed standards for achievement in the core functions of accounting, production, quality, and technological integrity. The performance of the alliance is closely monitored in these areas on a basis agreed between the partners. This constitutes the zone of tight coupling, in which control predominates and learning is either incremental or is planned as with technology transfer. By contrast, the zone of loose coupling tends to be found in the areas of business development, marketing, human-resource management, and external relations. Here, the partners' knowledge is less secure and/or less relevant, and potential 'partner-related' complementarities need to be worked out as well. Learning is therefore at a premium, and it becomes appropriate to encourage flexible roles, local initiative, and an unfettered circulation of information—in other words, a loose-coupling approach. It is, clearly, not a straightforward matter to organize an alliance with different levels and types of coupling running together. It demands both a high degree of understanding from the partners and considerable skill on the part of the alliance's chief executive (Schaan and Beamish 1988).

## 3.6 Summary

The key messages that emerge from this chapter are:

1. Strategic management theory:
   - emphasizes the need to be clear about the motives for adopting a cooperative strategy.
   - The selection of a suitable partner is a key part of success.
   - Both strategic fit and sensitivity to the need for cultural fit are key to alliance success.
2. Game theory provides valuable insights into the possible attitudes of one's partner in cooperation:
   - Cooperation and competition need to be consciously balanced in alliances.
   - Highly self-interested behavior in business relations tends to be self-defeating.
   - 'Firm-but-fair' principles tend to be self-strengthening in alliances.
3. Organization theory:
   - In alliances formal equity dominance is not sufficient for control, and can be counterproductive.

- Alliances are a hybrid of hierarchies and networks and therefore have to develop their own special rules of organization.
- There is an inevitable tension between the control and learning motives of partners.
- Trust is key to the success of alliances.

## 3.7 Questions for discussion

1. How can the establishment of cultural compatibility be achieved?
2. What situation of competition versus cooperation between partners is most dangerous for the future of an alliance?
3. Is the extent that one partner has control in a JV likely to impact on that venture's performance?
4. Is altruism necessary for an alliance to succeed, or is enlightened self-interest wiser?
5. How might game theory models be further developed to help in the management of alliances?

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# 4 Trust in cooperative strategies

## 4.1 What this chapter covers

Trust is an essential component in cooperation, and its value is widely appreciated by the managers of strategic alliances. Yet it remains a complex, even elusive, phenomenon. This chapter notes that trust features in alliance relations at three levels: between partners, between groups within an alliance and between individuals. It goes on to examine the foundations for trust in an alliance that can be provided by a clear calculus of costs and benefits, by the development of mutual understanding, and by the emergence of friendship and bonding between people. These insights help us to understand the nature of cooperative relationships. They can be applied to the process of strategic alliance development, and the chapter closes with a discussion of practical ways by which trust can be enhanced in alliances.

## 4.2 Significance of trust

Cooperation between organizations creates a mutual dependence between them. This arrangement requires trust to succeed. Although there are many definitions of trust, they tend to agree that it refers to the willingness of one party to relate with another in the belief that the other's actions will be beneficial rather than detrimental to the first party, even though this cannot be guaranteed (cf. Gambetta 1988; McAllister 1995; Kramer and Tyler 1996; Lane and Bachmann 1998). In the world of business cooperation, trust means having sufficient confidence in a partner to commit valuable know-how or other resources to transactions with it despite the fact that, in so doing, there is a risk the partner will take advantage of this commitment.

Firms incur a number of risks when they enter into strategic alliances. One is the risk that their partner(s) will act opportunistically; in other words take advantage of them if and when the opportunity arises. When forming an alliance, it is difficult to distinguish between a partner who will behave opportunistically and one who will not. The reputation of the prospect partner firm for reliable behavior can therefore be quite a significant factor in deciding whether to proceed further. Another type of risk concerns the possible inability of a partner firm to fulfill its part of the alliance bargain. The partner may intend to honor its side of the agreement, but not have the ability to do so. It is therefore important when an alliance is formed for each partner to assess the other's competence, and then decide how tasks are to be jointly performed. A third type of risk arises when partners sink specific assets into capital-based alliances such as EJVs. JVs between partners in developed and developing countries usually involve a greater investment of specific assets by the developed country partner(s) than by the developing country host partner(s), and in this way the former bears the greater risk.

One of the hybrid characteristics of alliances arises from the paradox that they often combine elements of cooperation and competition, or at least the attempt to formulate common goals on the basis of not wholly complementary objectives (cf. Hamel 1991). The combination of mutual reliance between alliance partners with residual or potential elements of competition or conflict between them can set up a game-theoretic dynamic that adds to the risk and precariousness of the cooperation. Trust between the partners is required to help overcome this threat, yet at the same time the source of the threat inhibits the development of trust. The reality of this dilemma would appear to be borne out by surveys that suggest that between 40 and 50 percent of strategic alliances fail within five years (Bleeke and Ernst 1993). These percentages are, however, inflated by the fact that some alliance terminations should not be judged to be 'failures'; for instance, when the partners agree to part amicably or when one partner agrees to its share being bought out by the other.

Most managers involved in alliances are very aware of the significance of trust, though they also realize it is not an easy thing either to create or to preserve (see Box 4.1). The fundamental necessity for trust in alliances has also been recognized in the literature on the subject (e.g. Faulkner 1995; Parkhe 1998; Child 2001; Currall and Inkpen 2002). As Chapter 11 discusses, trust is likely to moderate the relationship between control and confidence in partner cooperation. That is, trust between partners and their respective staffs assists the operation and acceptance of control, especially that of an informal nature brought about through close social interaction. In addition, trust is complimentary to the social networks and social exchange that can importantly facilitate alliance formation and operation (Das and Teng 2002). As Blau noted (1964: 99), 'trust is essential for stable social relations'. Trust between their members strengthens social networks. Equally, the presence of such networks provides assurances and guarantees against opportunistic behavior and therefore provides beneficial conditions for trust to develop between new alliance partners. Creed and Miles (1996: 30) comment, 'both across the firms within a network and within the various network firms, there is little choice but to consider trust building and maintenance to be as essential as control system building and maintenance are viewed in the functional form'. Nonetheless, despite being one of the most crucial concepts in management theory and practice, trust also remains one of the least understood.

Increased trust between alliance partners promises an economic pay-off for each. If they can develop mutual trust, this should reduce the negative effects of bounded rationality, specific investment in the alliance, and the opportunism that would otherwise arise, and so reduce transaction costs (Chiles and McMackin 1996). In other words, trust between partners should make them more willing to share information and so better inform their actions and decisions (reduce bounded rationality). Mutual trust should make it safer for the partners to invest assets in their alliance which cannot readily be used elsewhere (asset specificity) and should reduce the temptation for either partner to

**Box 4.1**

This is an extract from a conversation between two senior executives of a leading UK software and IT systems services company that is involved in a wide range of strategic alliances.

A. Trust is right up there on top of my list of factors that make cooperation work. No partnership will work without trust and it is one of the most difficult things to achieve.

B. I think it has all sorts of dimensions to it. But essentially the way I think I gained the trust of [one of the company's partners] . . . was that I could make our company do what it said it would do. . . . I could deliver this and that's when they started to trust me.

A. What was interesting was that, when I went in to see them, I asked them about their perceptions of our competencies and capabilities. And if it wasn't the first [thing they mentioned], it was the second, it was about partnering. Which was a quite staggering thing, to me, for them to have said. I mean, because we had to struggle incredibly hard to establish a true trust relationship with them.

*Source*: John Child, personal research.

take advantage of the other (opportunism) because of the goodwill it represents. If trust can introduce these positive features into a partnership, it will render the cooperation more genuine, reduce the need to spend time and effort checking up on the other partner, and help to direct the partners' attention and energies towards longer-term goals of mutual benefit. This is why so many alliance managers consider trust to be essential.

As the conversation reported in Box 4.1 indicates, it is not easy to establish trust between people representing different companies. As we shall see, the process has to develop through a number of stages over time. It becomes a special challenge for international strategic alliances (ISAs), because these cross the boundaries of the cultural and institutional systems that support trust through the sharing of a common social identity, norms of conduct and institutional safeguards such as the law. The fact that partners from different countries as a result follow different assumptions of 'what can be taken for granted' places particular difficulties in the way of creating trust-based relationships between them, over and above the tensions which might be expected to arise within strategic alliances in general.

In this chapter, we first note that trust in alliances is actually a multilevel phenomenon, a feature that has a number of practical implications. We then consider different insights into trust which help us to understand the nature of cooperative relationships. These insights can be applied to the process of strategic alliance development. This in turn makes it possible to examine ways in which trust can be enhanced in alliances. Trust is a theme that runs throughout this book and many of the points introduced here are developed further in later chapters.

## 4.3 A Multilevel phenomenon

It is easy to talk about trust between alliance partners as though this concerns the relations between organizations, when it may actually depend greatly on the quality of relations between groups and individuals. Currall and Inkpen (2002) argue that trust has to be thought of as occurring at three levels within an alliance. One level is that of the partner company; another is at the level of groups such as a group of partner managers; the third level is that of the individual. The importance of making these distinctions can be seen when we consider the various arrangements that may help promote trust within an alliance. For instance, a formal agreement, such as a JV contract, can provide a basis for trust, based on the assurances and commitments it contains. However, such an agreement may not be sufficient if the groups and individuals who have to work together within the JV do not trust each other. For if trust is lacking at their level, they may well breach the terms of the formal interorganizational agreement in order to secure an advantage and/or to protect what they see as their own interests. Chapter 10 will indicate how trust between partner firms, as organizations, can depend greatly upon how much they trust the general manager of a JV. Equally, the development of interpersonal trust between the managers within the partner organizations who are directly responsible for coordinating and monitoring the alliance can have a very significant effect on promoting trust at a group level, such as between collaborating departments in the two partner companies, as well as at the organizational level represented by boards of directors. This is well illustrated by the way the alliance between the Royal Bank of Scotland and Banco Santander developed, which is described in Chapters 11 and 13. It is therefore important that the formal provisions, such as contracts, to foster an alliance relationship are complemented by efforts to ensure that informal and interpersonal relations proceed on a basis of trust as well. This implies that care needs to be taken to select suitable people and to offer them appropriate briefing and training. As just noted, this becomes even more critical in the case of an international strategic alliance.

## 4.4 Trust and cooperation

Trust is risky, virtually by definition, because, without some uncertainty regarding the outcome of the relationship or exchange, it would not have to come into play. The trustor's expectations about the future behavior of the trustee may turn out to be incorrect, possibly owing to unfamiliarity with the trustee or the absence of social and legal mechanisms to contain the risk (Lane and Bachmann 1996: 368). This conditional nature of trust has given rise to enquiry into the grounds on which trust might develop and the foundations on which it can rest.

This enquiry has produced three insights that are particularly relevant to an understanding of cooperative relationships. The first is contained in the distinction between calculation, understanding, and personal identification as bases for trust. The second is an appreciation that cooperative relations can develop over time and that this may be associated with the deepening of trust based on an evolution of its foundations. The third is a recognition that trust is socially constituted, in that it tends to be strengthened by cultural affinity between people and can be supported by institutional norms and sanctions. The first two of these insights contribute to an understanding of cooperation between alliance partners in general, including those engaged in purely domestic alliances, while the third is of particular importance for the case of international alliances.

### 4.4.1 Bases of trust

Lane (1998) identifies three perspectives on the basis of trust, which draw attention respectively to the role of calculation, understanding and personal identification. The first is calculative trust—namely, that 'trusting involves expectations about another, based on calculations which weigh the cost and benefits of certain courses of action to either the trustor or the trustee' (Lane 1998: 5). Lewicki and Bunker (1996) argue that this form of trust is based on the assurance that other people will do as they say because the deterrent for violation is greater than the gains, and/or the rewards from preserving trust outweigh any from breaking it. 'In this view, trust is an on-going, market-oriented, economic calculation whose value is derived by determining the outcomes resulting from creating and sustaining the relationship relative to the costs of maintaining or severing it' (Lewicki and Bunker 1996: 120). Trust based on calculation clearly depends on an availability of relevant information, and in practice there may be significant limits to this. Indeed, some critics of the calculative view of trust have argued that it is when relationships or transactions are initiated under conditions of information uncertainty that trust in the proper sense comes into play.

Trust based upon calculation is likely to apply particularly to relationships that are new and hence can only proceed on the basis of institutionalized protection (incorporating deterrence) or the reputation of the partner. It may also be the only form of trust that can apply to arm's-length and hence, impersonal economic exchanges. However, if those exchanges become recurrent, such as with repeat mail-order business, then another form of trust may also emerge. This is based on increased mutual knowledge among the partners, which nurtures the realization that they share relevant expectations. As we note below, calculation-based trust is very relevant to the formation phase of strategic alliances, though its withdrawal can also undermine the mutual confidence of partners who have developed other bases for trust as well.

A second potential basis for trust lies in the sharing of cognitions, including common ways of thinking, between the parties concerned. This sharing of cognitions provides a basis for understanding the thinking of a partner and for predicting that person's actions. Clearly, some cognitive sharing is necessary for a calculative basis of trust to come into play, but common cognitions provide the further reassurance that one can now reasonably predict other persons on the basis of shared expectations. One can normally only be sure of sharing ways of thinking with others by getting to know them well enough, and an aspect of cognitive trust is what Lewicki and Bunker have termed 'knowledge-based trust'. Knowledge-based trust 'is grounded in the other's predictability—knowing the other sufficiently well so that the other's behavior can be anticipated. Knowledge-based trust relies on information rather than deterrence' (Lewicki and Bunker 1996: 121). The assumption of rationality contained in the calculative view of trust is relaxed somewhat in cognitive trust, because the trust here is founded upon both the security and the comfort that the partner is well understood and is known to share important assumptions with you. The CFM alliance established by General Electric and SNECMA for manufacturing jet engines, for instance, began as a calculated effort by two relatively weak firms to enter a lucrative market, but has persisted for over twenty-five years, despite the ability of both partners to do the work alone, as developing understandings between the partners have made this a comfortable solution for this business.

A third view of trust is that it is based on people sharing a personal identity. This means they hold common values, including a common concept of moral obligation. As Lane points out, common values and norms of obligation can develop in a long-standing relationship where trust was originally created in an incremental manner. This kind of trust is likely to find a parallel at the more interpersonal level, in what Lewicki and Bunker (1996) call 'identification-based trust'. Identification-based 'trust exists because the parties effectively understand and appreciate the other's wants; this mutual understanding is developed to the point that each can effectively act for the other' (Lewicki and Bunker 1996: 122). If friendship develops within a long-term relationship, the emotional bond thereby introduced is likely to provide a mainstay for identification-based trust, because it enables a person to 'feel' as well as to 'think' like the other (1996: 123). When people come to like each other, they are encouraged to place themselves voluntarily within the powers of another—this is what Brenkert (1998) calls 'the voluntarist view' of trust. Trust which is based on people identifying with, and liking, each other therefore derives from what we may call '*bonding*' between them.

Running somewhat parallel to this threefold distinction between trust based on calculation, understanding, and bonding is the broader distinction, made by McAllister (1995) among others, between what he calls 'cognition-based' and 'affect-based' trust. Trust that is cognition-based rests upon the knowledge people have of others and the evidence of their trustworthiness: 'available knowledge and "good reasons" serve as foundations for trust decisions' (McAllister 1995: 26). McAllister points out that previous organizational researchers have assumed competence, responsibility, reliability and dependability to be important sources of cognition-based trust. Brenkert (1998) identifies a 'predictability view', which holds that trust denotes the extent to which one can predict that the person being trusted will act in good faith. While Brenkart argues that such prediction rests on 'a belief that one person has about another', this is consistent with the concept of cognition-based trust because the belief almost certainly rests on a degree of knowledge about the other person which is taken to constitute 'good reasons' for trust, however limited and imperfect that knowledge might be.

By contrast, affect-based trust, according to McAllister (1995: 26), is founded on the emotional bonds between people. These bonds express a genuine concern for the welfare of partners, a feeling that the relationships have intrinsic virtue, and a belief that these sentiments are reciprocated. In other words, they incorporate an identification with the other person's wishes and intentions. Affect-based trust is clearly a form that is most likely to develop and deepen through fairly intensive relating between people on a person-to-person basis over quite a long period of time. As such, it is facilitated by the ability to communicate well and to avoid, or quickly clear up, misunderstandings.

So mutual knowledge and the sharing of information between the people concerned remain essential conditions. Cultural and associated language differences tend to impede communication and easy understanding, and may therefore stand in the way of affect-based trust. Perceived conflicts of interest will also make it hard to develop or maintain this kind of trust. In strategic alliances, affect-based trust and cooperation will therefore be difficult to achieve, and if they emerge at all this is only likely after the alliance has been operating successfully, and up to the partners' expectations, over a period of some years.

The distinction between cognition and affect in trust-based cooperative relationships suggests that these are likely to form initially on the basis of essentially cognitive considerations, including calculation, but that as the relationship matures it may increasingly involve the development of friendship ties.

### 4.4.2 Development of trust-based relations

The second insight, which it is appropriate to apply to strategic alliances, is that cooperative relations can develop over time, supported by a corresponding evolution of trust. As Smith et al. (1995) note, several writers have suggested that cooperative relationships develop through a number of stages. There are feedback loops in this process whereby the partners evaluate their experience and decide whether to continue to cooperate and, if so, in what form (Ring and Van de Ven 1994). The distinction between trust based on calculation, understanding, and identification opens a window on the way that the evolution of trust is integral to this dynamic process of evolving cooperation.

In this vein, Lewicki and Bunker (1996: 124) propose a model of 'the stagewise evolution of trust' in which 'trust develops gradually as the parties move from one stage to another'. They argue that trust first develops on the basis of calculation. This is the stage at which people are prepared to take some risk in entering into dependence on others because they are aware of some institutional safeguards or deterrents against reneging. For some relationships, trust may remain of this kind and at this level, as in repeated but arm's-length market transactions between people. Lewicki and Bunker suggest that many business and legal relationships begin and end in calculative trust. Calculative trust approximates to the stage at which people in different organizations decide, often somewhat guardedly, that 'OK, I am prepared to work with you'.

If initial cooperative activities serve to confirm the validity of the calculative trust and thus encourage repeated interaction and transaction, then the parties will also begin to develop a knowledge base about each other. In other words, a process of 'getting to know you' is now under way. The conditions are generated for a transition to trust based on mutual understanding. This is the stage in a relationship at which a person feels comfortable with a partner in the knowledge that he or she has proved to be consistent and reliable, and that the partner shares important expectations about the relationship. As a result, the partner is proving to be predictable. In this way, the parties' experience of a calculative trust relationship (i.e. feedback) is critical for their willingness to undergo the shift to cognitive trust. If the feedback is negative, and trust is broken, they will probably move to terminate the relationship. Even short of fracture, if the experience of relating on a calculative basis is not strongly positive, or if the relationship is heavily regulated, or if the interdependence of the partners is heavily bounded, they will have little cause to develop cognitive (knowledge-based) trust.

A further transition may come when normative trust builds on the depth of knowledge that the parties have acquired of each other and on the mutual confidence they have developed. These outcomes from the relationship may encourage the parties to identify with each other's goals and interests. A certain amount of mutual liking will probably now enter into the relationship, so that this stage is typically one at which the partners have become friends. It is the stage of 'getting to like you'. Lewicki and Bunker believe, however, that, whereas stable cognitive ('knowledge-based') trust characterizes many relationships, trust based on personal identification may be less common especially in business or work transactions where some difference of interest is usually inherent in the relationship. This may have some benefit in business arrangements where selection of perhaps less competent partners based on personal relationships can be hazardous—hence the oft-repeated folk wisdom of avoiding doing business with family members!

Certain specifics of Lewicki and Bunker's evolutionary model may require modification. It does not, for instance, appear to allow for the possibility that, in the absence of effective external institutional guarantees, it may be necessary to develop a degree of knowledge about the partner to generate even the minimal level of trust necessary for cooperation to be established. Otherwise an adequate foundation for calculating potential benefits, risks, and so forth will not exist. Nevertheless, despite such detailed qualification, the evolutionary model of trust can contribute very significantly to an analysis of alliance formation and development.

### 4.4.3 Social constitution of trust

The third insight is a recognition that trust is socially constituted, in that it is necessarily realized, and strengthened, by social interaction, cultural affinity between people, and the support of institutional norms and sanctions. Zucker (1986) argues that trust is socially produced through three main modes, of which the latter two have their bases in socially constituted entities. The first mode is one in which trust develops on the basis of the experience of past exchange or the expectations attached to future exchange. Production of trust in this mode arises through the mutual reinforcement of investments in trust and the quality of the cooperation associated with it, and is consistent with the process of developing and deepening trust-based relations that we have already discussed. The second mode is based on the sharing of common characteristics, such as ethnicity and culture. The third mode is one in which formal institutional mechanisms provide codes (as in medicine) or guarantees (as in financial markets supervision) that transactions will take place as promised.

Regarding the second of Zucker's modes, cooperation is likely to be easier between people who have the same cultural norms. There are a number of reasons for this. People are more likely to trust those who share the same values, because this establishes a common cognitive frame and promotes a sense of common social identity that has a strong emotional element. Differences between cultures in language, symbolism, and meaning can make it very difficult to find a common cognitive basis from which trust can first develop.

It will also be easier for trust-based relationships to develop if the risks involved are reduced by institutional mechanisms—the third mode Zucker identifies. These mechanisms include an effective law to enforce contracts, efficient supervision by government agencies, and a strongly developed moral opprobrium for any violation of the social norms applying to trust. The presence of social and cultural norms which attach a value to trust, define the circumstances under which it should be honored, and justify sanctions for violation indicate the extent to which trust is a socially constituted phenomenon (cf. Lane and Bachmann 1996).

While the social constitution of trust can support cooperation within the boundaries of a given social unit, such as a nation and to a lesser degree an organization, it clearly presents problems for relationships that cross these boundaries. Those in a domestic strategic alliance cross the boundaries of organizations as social units, whereas those in an international strategic alliance cross both national and organizational boundaries. The development of trust-based cooperative relationships within ISAs is therefore a major challenge, especially in the case of alliances between partners from a developed and a developing society. In this case, the partners involved do not share common cultural characteristics and they cannot rely upon the same system of institutional support, except to the extent that international trade law and arbitration procedures have effect. This means that the development of trust in ISAs will depend heavily upon the process mode of its production—namely, the way that their relationships are established and managed.

## 4.5 Trust and alliance development

There is considerable agreement among writers on strategic alliances that their development can be broadly divided into three phases: formation, implementation, and evolution (Lorange and Roos 1992). Formation is the phase during which the future partners conceive an interest in the possibility of forming an alliance, select potential partners, and negotiate an agreement (usually a contract). Implementation is the phase during which the alliance is established as a productive venture and people are appointed or seconded by the partners, systems installed, and operations commenced. Evolution refers to the ways in which the alliance develops further following its establishment. There is a potential for trust to evolve in step with these three phases of alliance development on the basis initially of calculation, then understanding, and finally bonding.

### 4.5.1 Formation and calculation

Trust based on calculation appears at first sight to be a contradiction in terms. However, if trust rests on a belief that another party's action will be beneficial and reliable rather than the opposite, then calculation can clearly enter into it. A calculation that partners have the ability, competence and motivation to deliver on their promises, and that there are sufficient deterrents based on law and reputation for them not to let you down, is a vital condition for being prepared to cooperate with relative strangers.

Early in the formation process, the future partners will have come to the conclusion that they favor an alliance out of a range of possible alternatives. For example, if one partner's purpose is to enter a new market, it has a range of possibilities for accomplishing this objective: these include exporting into the market using local agents, licensing technology to a local producer, forming an alliance with a local firm (in the form of a collaboration, EJV, or merger), and setting up a wholly owned subsidiary (Root 1994). The choice between these alternatives is likely to be informed by the partner's strategic intentions and previous experience of managing different forms of market entry. It will rest almost entirely on calculation concerning the relative costs and benefits of each alternative. At this stage, the calculation has to rely primarily upon business intelligence.

If it is decided to explore the possibilities of forming an alliance, the selection of a partner is also likely to be based importantly upon calculation. During this phase, potential partners are identified and their mutual interest grows sufficiently for them to start exchanging information directly rather than using business intelligence. In principle, the potential partners try to find out as much as they can about each other and then compare the information obtained against a range of selection criteria in order to assess the degree of strategic fit between themselves (Geringer 1991; Faulkner 1995). Strategic fit is discussed further in Chapter 6.

In reality, however, information about prospective partners will be limited, especially that relating to their internal cultures, competencies, and values. This means that judgements will have to be made on the basis of the partners' reputations, including those for trustworthiness. This 'information stage', during which the prospective partners try to find out as much as possible about each other, will normally precede their entry into negotiations on a contract. In learning about the other, the partners are also embarking on the processes of 'getting to know' each other.

While the information stage of alliance formation is ostensibly aimed at establishing the nature and degree of 'strategic fit' between potential partners, in the case of a putative international strategic alliance the nature of cultural differences between them will also become evident. Cultural differences could inhibit the development of mutual understanding and trust, and jeopardize the process of moving towards a formal agreement. This is a quite realistic possibility when alliances are being discussed between partners from societies that are culturally and institutionally disparate. Particularly at the stage of forming an international alliance, it is not possible to treat strategic fit and cultural fit separately and sequentially, because the exchange of information during this phase depends on an initial development of trust which, in turn, depends on how the relations between the partners are affected by their cultural distance (Möllering 2003). Once the calculative basis for the alliance has been agreed, it may become more feasible to work systematically towards a resolution of the operational problems that continue to result from the cultural differences between the partners (Child 1994).

The process of information-gathering, if sustained, will move into one of negotiation. Negotiation hammers out a calculative framework for the 'strategic fit' and the mix of commitments and safeguards embodied in an alliance contract. It also provides an opportunity for the parties to establish a level of comfort for future cooperation based on a deepening of their mutual knowledge. In other words, in so far as the agreement to cooperate is one to establish a mutual dependency between the partners, but where considerable uncertainty remains, it is an act of trust based primarily upon calculation. While the calculus will take account of legal and other institutional safeguards, it is also likely to be informed by the direct knowledge the partners have gathered about one another.

Smitka (1994: 93) uses the term ‘contracting’ to refer to the negotiation of, and agreement upon, mutual obligations between potential partners, or ‘the framing of the environment for transactions’. The value of this term lies in the way it directs attention to the process of negotiating and agreeing the terms of an alliance relationship. Nor is it assumed that the outcome is all captured in the terms of a formal contract per se, which is signed at a particular point in time and supposed to define the relationship thereafter. In other words, ‘contracting’ may well continue after a formal alliance contract is signed and, as we shall see in the case of Sino–foreign alliances, the expectations of Western and non-Western partners can differ considerably on this point. Different expectations on this issue constitute one of the most significant threats to trust between the partners, because from the Western perspective they can readily be interpreted as signs of the other partner’s bad faith on the fundamentals of the alliance.

### 4.5.2 Implementation and mutual understanding

Following the establishment of a strategic alliance, with the allocation of capital and other resources to it, there is a phase of implementation during which it is commissioned as a productive venture. During implementation, people are appointed, technology and systems installed, and operations commenced. Implementation is of crucial importance for the quality of cooperative relations within the alliance. The people appointed to work together may or may not possess the necessary technical competencies for the alliance to succeed, and this is equally the case with their cultural competencies. If these competencies are lacking and, as a result, the alliance founders, the underlying calculus for the alliance can no longer remain valid.

It is therefore essential to maintain the basis of calculation that initially made the partners willing to enter into a cooperative relationship, with the investment and risk that this involved. However, once the alliance is in the process of being implemented, the people working together from the partner organizations have the opportunity of getting to know each other more intensively than before. The growing ability of each partner’s staff to understand and predict the thinking and actions of the other’s can provide a further basis for trust between them. This mutual understanding should reduce the sense of uncertainty which partners experience about each other.

The systems that are installed during the implementation phase, particularly those for control and information reporting, are for this reason very significant. The ways they are designed and operated can determine the quality of knowledge that is available to each partner. For example, if one partner’s systems for accounting, marketing, operational, and technical information reporting are installed in a JV, this adds to the quality of the knowledge available to that partner, but not necessarily to the other. The first partner enjoys a potential for trust to mature, which may be denied to the other. Similarly, if the personnel appointed to work together within the alliance are insensitive to each other’s cultures, the likelihood of their achieving a close cooperative relationship on an integrated basis will be diminished and the most that can be achieved may be a suboptimal segregation between spheres of activity and influence (cf. Child and Markóczy 1993; Tung 1993). In order for mutual understanding to develop between the partners, it is also clearly necessary to find ways of resolving the conflicts that are likely to arise in the course of their working together.

### 4.5.3 Evolution and bonding

If difficulties such as these can be avoided or overcome, and if the alliance proves to be an economic success, it is likely to mature into an organization with an increasing sense of its own identity and culture. Unless the alliance is established for a one-off or temporary purpose only, or as a stepping-stone for one partner to absorb the other, the partners may well not place any time limit upon its potential life. The very success of an alliance will tend to encourage the partner/parent companies to grant it an increasing measure of autonomy, and also provide the management of the alliance with the legitimacy to take its own decisions (Lyles and Reger 1993).

This evolutionary process permits stable, ongoing relationships to develop, relationships both between people in the partner organizations who have a responsibility for (or interest in) the alliance and between people working on an everyday basis in the alliance's own organization. They are in a position to accumulate knowledge about each other, and this tends to reinforce the relationship. Moreover, the success of the alliance in meeting partner interests means that calculative factors should not threaten their relationships. As relationships develop over time within the context of a successful collaboration, so there is a natural tendency for those concerned to identify increasingly with one another's interests as well as for emotional ties to grow. In this way, bonding can form between partners, which Faulkner (1995) has identified as being, in turn, a significant foundation for alliance success. Thus a virtuous cycle may be established, which reinforces both trust and the cooperation that it nurtures. This cycle can, of course, be broken and reversed, as we note shortly.

Figure 4.1 summarizes the coincidence between strategic-alliance development and the evolution of trust-based relationships, which has been analyzed in this section.

It is important to make two further observations in connection with this analysis. The first recalls the multilevel nature of trust in alliances. For, in reality there will be only

| | | | |
|---|---|---|---|
| Phase of alliance development over time | FORMATION → | IMPLEMENTATION → | EVOLUTION |
| Key element in trust development | CALCULATION | MUTUAL UNDERSTANDING | BONDING |
| | 'Being prepared to work with you' | 'Getting to know about you' | 'Coming to identify with you as a person' |

**Figure 4.1** Phases of alliance development and the evolution of trust.

certain individuals relating with each other across the boundaries of cooperating organizations. Their role in promoting trust between the partner organizations is therefore a key one, and the trust that can be said to exist between the organizations will to a large extent come down to the quality of mutual trust which exists between those individuals. This reminds us that trust is actually an interpersonal phenomenon, upon which the quality of interorganizational relations is founded. The organizational members upon whom interorganizational cooperation depends can perhaps be best labeled their 'trust guardians'. The contribution that these trust guardians make to interorganizational cooperation will depend on (*a*) the mutual trust they have developed, (*b*) the influence they enjoy within their respective organizations, and (*c*) how many there are of them in each organization.

It follows that if there is a frequent turnover of the personnel allocated by the partners to an alliance, the opportunities for developing trust-based cooperation between them will be diminished. Overseas tours of duty for the personnel of a foreign ISA partner are often limited in duration, especially when the other partner is located in a developing country with 'hardship' conditions attached. We shall see that this is a factor inhibiting the development of trust in Sino-foreign JVs, especially within the context of a local culture that attaches high value to transactions based upon personal relationships.

The second observation concerns the vulnerability of trust-based cooperation within strategic alliances. As noted earlier, alliances between firms are based on cooperation between partners whose interests do not usually wholly coincide and who, in the case of horizontal alliances, could become competitors at a future point in time. The multistage model of trust evolution points to the danger of collapse in an alliance relationship at any stage of its development if the previous bases of trust are withdrawn. In business relationships, given the financial expectations of owners and external stakeholders, bonding cannot sustain trust if one or both of the partners conclude that the calculative or predictive basis of their cooperation has disappeared. Equally, if a problem arises in the basis for a higher level of trust development, such as the emergence of a personal antipathy, it may prove necessary to return to the initial foundations for the relationship in order to rebuild it. For instance, if a personal dislike arises between two interorganizational trust guardians, it may still be possible to rescue the relationship between the organizations themselves through their leaders recognizing that it continues to retain a basis in mutual economic benefit. A hierarchy of foundations for trust and cooperation is, in effect, being posited here with calculation at the base, prediction in the middle, and bonding at the apex.

The fragility of trust in business relationships draws attention to the interdependence between trust and the availability of legal redress, or other institutional support, should cheating occur. The relation between trust and law is, however, still being debated. Does a well-developed legal system offering effective recourse to the courts complement trust-based relations, in providing a baseline support that makes people more prepared to risk offering trust and so set its development in motion? Or is the role of law primarily to act as an alternative framework to trust-based relations for governing the conduct of transactions (Lane and Bachmann 1996; Arrighetti et al. 1997; Deakin and Michie 1997). There is certainly a widespread fear that trust is in decline in business relations and that this is reflected in the growing incidence of disputes being taken to law. This is evident even in countries like China where business people have traditionally relied on the security provided by special trust-based relationships in an otherwise extremely highly risky environment.

### 4.5.4 Co-evolution of trust in alliances with control and learning

Inkpen and Currall (2004) explore the relationship between trust, control and learning within joint ventures, as they develop over time. The analysis these authors offer is broadly consistent with that we have just presented, but they also take account of the likely effects of control and learning. They argue that the presence of clearly defined collaborative objectives will foster the initial development of trust between JV partners. The greater the initial level of trust between partners, the more they can rely on informal social control and the lower will be the initial costs of monitoring and controlling the JV. If a heavy reliance on formal controls can be avoided, this in turn is likely to foster the development of trust.

Once a JV has been formed and initial conditions support continued collaboration, then the learning process becomes central to the way the alliance and the quality of trust within it evolve (See Doz 1996 and Chapter 18). Repeated interactions between the JV partners and their staffs that are viewed as successful will enhance their mutual trust. As the partners learn more about each other, the more likely they are to reduce their emphasis on formal JV controls and, as already argued, this should also enhance mutual trust. If trust develops over time, it should come to serve as a stabilizing influence on relations between the partners, helping them to cope with shifts in bargaining power and other crises. This brings clear benefits: 'As the fear of opportunism fades because of the development of mutual trust, there should be a reduction in coordination and monitoring costs. Thus, trust has efficiency implications; trust reduces the probability of loss and enables partners to move forward even though uncertainty in the relationship may remain' (Inkpen and Currall 2004: 596). While these benefits of trust are certainly worth striving for, a caution should be borne in mind. Trust is a fragile phenomenon and is easily broken. It can take a lot of time and effort to build upon, but can be destroyed by a single act of perceived betrayal.

What then are the measures that can help build and preserve trust in alliances?

## 4.6 Developing trust

The fact that trust in the relations between organizations develops through several stages, and rests upon a number of different foundations, helps us to identify the kind of policies and practical measures which can be taken to develop and promote it.

### 4.6.1 A basis for mutual benefit

It is clearly vital, when establishing an alliance, to maintain clarity and realism in the commitments that partners promise to make to each other. There are four aspects to this. First, the commitments must be realistic and therefore subject to careful calculation and scrutiny; the partners must be seen to be able to honor those commitments. Second, the commitments offered by each partner must together add up to a viable strategic fit. Third, at this early stage, before any significant trust has been established, it is important to research the legal and other institutional safeguards which are available in the event of the other partner reneging on its promised commitments. Last, but not least, an agreement between the partners should be committed to writing, in detail and with the minimum of ambiguity.

All this may appear, paradoxically, to be adopting an untrusting approach. Its relevance lies in the fact that the first basis for developing successful and trusting cooperation between partners is one of calculation. If the calculation is wrong in the first place, the partnership is immediately hostage to blame and recrimination. It is therefore a false economy to rush the process of selecting a partner and negotiating the terms of the agreement. Many potential alliances are with prospective partners whose ability to deliver market access or specific competencies are not well known. This is especially likely with partners from developing countries. In such cases, it is imperative to undertake a thorough appraisal of the prospective partner and the context in which it operates, and not to rely on what the other party itself gives by way of estimates or assurances. It is tempting for a potential partner to promise more than it can realistically deliver when it is keen to achieve the cooperation of another company whose assistance it considers to be a strategic priority.

### 4.6.2 Predictability and conflict resolution

Conflicts are bound to arise between alliance partners, even if there is very little inherent competition between their underlying business interests. They arise frequently between the units within a single organization and are therefore all the more likely to occur in the cooperation between people from different organizations. There is likely to be a mixture of disputes over 'hard' financial or technological issues and frictions of a 'softer' cultural and interpersonal nature. In each case, it is important to have mechanisms for resolving such conflicts in place from the very outset of the alliance's existence.

Mechanisms for mitigating 'hard' disputes are consistent with the provision of information among alliance members and hence the development of trust based on knowledge and predictability. One example is the arrangement for regular and frequent meetings between the managers and staff seconded or appointed to the alliance by the partners. These meetings should establish the facts of any matters at issue and record the discussion and any solutions proposed. The records of such meetings provide a basis on which problems can be addressed at a higher level between the partners, if a resolution is not forthcoming within the alliance organization itself. An important aim of meetings and other formal conflict-resolution mechanisms is to ensure that relatively 'hard' disputes do not get turned into, or mixed in with, interpersonal antipathies. The intention is to depersonalize the issues as far as possible.

Another important approach towards reducing the incidence of 'hard' disputes is to invest in a formal specification of rules and guidelines that make matters such as correct financial procedures and the protection of technology clear to the people working within the alliance. It will probably require an investment of time by senior partner managers to agree on this formalization, at a very early stage of the alliance, even before it comes into operation.

Formalization also plays a role in encouraging the sharing of information among the members of an alliance, within any bounds of confidentiality and intellectual property-right-protection that have been agreed in the terms of the cooperation. While formal measures cannot guarantee the amount and quality of information-sharing, procedures such as password access to computer networks, the circulation of well-documented material before meetings, and the regular dissemination of data on the alliance's performance can be of considerable assistance. The sharing of information should, over time, contribute to a breaking-down of barriers between people who have come from the partners to work together. In so doing, it will help to generate the mutual confidence that takes trust forward beyond a basis of calculation onto one of shared understanding and predictability.

Approaches to reducing conflicts of a 'softer' interpersonal nature within a cooperative relationship will be less formal, but nevertheless also need to be organized. The building of sensitivity about how people coming from the partners' organizations perceive each other is central to this effort. There are well-known techniques which Western organizational development consultants have devised for achieving this, and which generally work within that cultural milieu. Other approaches will, however, be necessary for cross-cultural alliances, requiring not the quick 'confrontations' favored in the USA but a more patient and less personally exposing process of mutual discussion and socializing.

The organizational 'politics of envy' and problems arising from perceived discrimination in the treatment of staff from the alliance partners, have to be tackled systematically as well. For example, serious interpersonal problems can arise within foreign JVs established in developing countries over the often quite enormous disparities in pay between foreign and local managers. Local resentment over high expatriate compensation may be eased somewhat by charging this to the foreign partner directly rather than having it as a direct charge on the alliance. However, a more effective solution lies in making the basis for compensation quite clear to all concerned in terms of qualification, performance, market factors, and so forth. This helps to demonstrate the rationale for the compensation system, and also indicates potential channels for betterment that are open to local managers and staff.

It is evident that measures such as these taken to reduce interpersonal conflicts within alliances will, if successful, also help to remove barriers to establishing personal friendships between partners' personnel. Personal friendship is conducive to the third major basis for trust—namely, mutual bonding.

### 4.6.3 Mutual bonding

There are several practices that facilitate the development of bonding between the people directly involved in cooperation between different organizations. It is extremely important that friendly personal contact is regularly maintained between the leaders of the cooperating organizations. This contact should be visible to all those working under them. This means planning for personal visits between partner chief executives at least once a year, and giving these full publicity. Apart from the intrinsic merit such visits have in ironing out any differences of view between the partners and laying down broad plans for the future, they very importantly set an example and establish a climate of cooperation for the people working further down the alliance. We shall see, later in this book, how visible top-level commitment to cooperation impacts on its success in achieving goals such as mutual learning (Chapter 13).

Careful consideration should be given to the length of appointment or secondment of personnel to an alliance. If this is short, say three years or under, the chances of achieving mutual bonding are reduced. Not only is there personal unfamiliarity to overcome, but, if a language has to be learnt or improved, this clearly takes time as well. Personnel on longer-term appointments are also more likely to invest in establishing relationships within the alliance, for they see it as a more significant part of their overall career path. Western, and especially American, companies tend to attach people to alliances on contracts of four years maximum, whereas Japanese companies tend to attach their people for up to twice as long. Partners in countries where relationship is a requirement for business cooperation commonly complain that personnel assignments to their alliances are too short for any bonding to occur.

The careful selection of people who are to work in an alliance will also assist the prospects of mutual bonding. They should be selected not merely on the basis of technical competence, important though this is, but also on an assessment of their ability to form good relationships with people from other organizational and national cultures. Track records can tell a lot in this respect. Some global companies have, for this reason, now created opportunities for successful alliance and expatriate managers to be able to remain in interorganizational and international assignments without detriment to their long-term advancement within the home corporation. People with open-minded and prejudice-free personalities are likely to be more successful at personal bonding within alliances. These characteristics can be assessed through careful observation and, if appropriate, through systematic personality tests.

The development of personal friendship, and hence normative trust, is further helped by policies intended to avoid the ghetto situations which can easily arise with international alliances where at least one partner's personnel are located in an unfamiliar environment. A ghetto can arise because separate housing of superior quality has to be provided for expatriates, and it can be heavily reinforced if the local language imposes a significant social barrier for the staff and their families. It is important for the alliance to encourage as much socializing between the partners' personnel as possible. Activities such as sports and social events, charitable and sponsorship activities in the local community, and alliance open days, can do a lot to break down social barriers. They help to bring about an acceptance of the alliance within its local community, and a strengthening of its external identity. At the same time they are collective events that help to build up an internal identity within the alliance itself.

It is, of course, not possible to legislate for the development of personal friendship among those working together in a strategic alliance. There is inevitably an element of unpredictability in interpersonal dynamics. Nevertheless, policies such as those just outlined can help a great deal, especially in circumstances where there are no serious commercial or financial differences driving a wedge between the partners. And, once established, personal bonding and a sense of mutual identity between alliance partners can reinforce their determination to solve business problems, if and when they arise.

## 4.7 Conclusion

Cooperation between organizations creates mutual dependence and requires trust in order to succeed. This comes down to trust between the individuals who are involved in the alliance. Uncertainty about partners' motives, and a lack of detailed knowledge about how they operate, requires that a basis for trust be found for cooperation to get under way in the first place.

We have suggested that there are identifiable stages in the evolution of trust. Calculation, then understanding, and then bonding progressively provide the foundations on which trust can develop. Trust is seen to develop gradually as the partners move from one stage to the next. This is consistent with the view that trust can be strengthened by the partners building up the number of positive exchanges between themselves. As the partners become increasingly aware of the mutual investment they have made in their relationship, the benefits they are deriving from it, and the costs of reneging, they have more incentive to carry it forward. In this sense, the trust between them will benefit from the 'shadow of the future' (Axelrod 1984). The view of trust as an evolving process provides valuable clues about the way in which cooperative relationships can be developed both within and between organizations.

While alliances between firms do sometimes arise on the basis of already-existing personal friendships, they usually start off on impersonal terms. In other words, the partners have to calculate that, under conditions of limited knowledge, the potential benefits of cooperation outweigh the risk of partners' reneging on their commitments. Once an alliance is being implemented, the growing body of shared information and mutual knowledge should enhance trust between the partners, because it increases their ability to understand each other better and hence predict each other's actions. Eventually, the experience of working together may produce a sense of shared identity and personal friendship. In short, the partners develop trust through the repeated experience of working together, making joint decisions and other contacts which generate familiarity and then bonding.

The conclusion that trust between partners can develop over time through continued interaction and learning between them, from an initial basis that is purely calculative, is consistent with the experimental findings from iterated games—namely, that the probability of cooperation may be improved initially by providing mutual hostages and then progressively reinforced by the benefits it is seen to provide. As Chapter 3 noted, the experimental evidence suggests that, although non-cooperation emerges as the dominant strategy in single-play (i.e. initial) situations, under iterated conditions the incidence of cooperation rises substantially.

The potential advantages of promoting trust between partners and their employees are considerable, for they offer an opportunity to relieve (though not necessarily resolve) the dilemmas of control, integration, and learning which are inherent in organizing alliances. So far as control is concerned, trust can avoid the managerial costs of second-guessing the other partner's intentions and ways of doing things. It is likely to facilitate agreement on common control and information systems. Trust will break down some of the more intractable barriers to integration between the partners and their personnel, barriers that are usually far more difficult to deal with than, say, differences in technical skills or language. The development of trust should also promote the conditions necessary for a cooperative strategy to achieve its learning objectives, by making its members more willing to share information and ideas.

These insights are fundamental to an understanding of cooperative strategy, its rationale, and its management. They also help to identify the policies and practices that can be taken to promote trust as a condition for effective cooperation. Some policies are geared towards creating a clear calculus for mutual benefit; others are aimed at enhancing shared information, especially to resolve conflicts and to open up communication; while yet others assist the growth of mutual bonding.

## 4.8 Summary

The key points arising from this chapter are:

1. Cooperation between organizations creates mutual dependence and requires trust in order to succeed.
2. There are identifiable stages in the evolution of trust. Calculation, then understanding, and then bonding progressively provide the foundations on which trust can develop. Trust is seen to develop gradually as the partners move from one stage to the next.
3. Trust can be strengthened by the partners building up the number of positive exchanges between themselves. As the partners become increasingly aware of the mutual investment they have made in their relationship, the benefits they are deriving from it, and the costs of reneging, they have more incentive to carry it forward.
4. This view of trust as an evolving process provides valuable clues about the way in which policies can be devised to foster cooperative trust-based relationships both within and between organizations.
5. Some of these policies are geared towards creating a clear calculus for mutual benefit; others are aimed at enhancing shared information, especially to resolve conflicts and to open up communication; while yet others assist the growth of mutual bonding.

## 4.9 Questions for discussion

1. What is trust and how can it manifest itself in a strategic alliance?
2. Why is trust so important for a cooperative strategy?

3. Do you think that trust can play any part in an alliance between competing firms?
4. As alliance partners learn more about each other, under what conditions is this likely to increase the trust between them?
5. On what basis can one expect trust within an alliance to develop as it evolves over time?
6. There is a range of policies aimed at fostering trust-based cooperative relationships. Do you think these normally have to be introduced in any particular sequence?

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# PART II ESTABLISHING COOPERATION

Part II deals with the process of establishing cooperative ventures, with a particular focus on those aspects of cooperation that precede the actual business of working together. This is the area that has so far attracted the greatest amount of attention in the literature, and also amongst practitioners.

Cooperative strategies are processes that result in the formation of various types of cooperative arrangements, whether extended contracts, alliances, partnerships, or EJVs. These arrangements may be stand-alone or form part of wider networks. The organizations that result are likewise part of an ongoing process, as their strategies, structures, objectives, routines for activity, and so forth evolve over time. This is an aspect of all organizations, but is particularly at issue for cooperative ventures, which must deal constantly with the pressures from two or more parent organizations as well as their own competitive environments. The chapters in Part II address the processes of forming and designing cooperative ventures or alliances from both conceptual and practical perspectives.

Cooperative ventures involve complex transactions between two or more organizations with multiple goals and objectives, and therefore take time to develop. Several scholars have attempted to stylize and provide structure to describe the development of alliances by imposing a series of stages on what is actually an idiosyncratic and concurrent process. Different models propose different stages in the alliance formation process, depending on their focus and interpretation of events and their theoretical concerns, but the various models can often be related. For instance, Zajac and Olsen (1993) proposed a three-stage model: an 'initializing stage' in which an alliance is assembled, a 'processing stage' in which the value creating activity takes place, and a 'reconfiguring stage' in which the alliance is assessed and either ended or redefined to maximize value. Tallman (2000) splits the precontract period into a stage of analysis and search for a partner and a postselection stage of negotiation and bargaining, while retaining the postsigning third stage of managing the alliance. He considers the issue of alliance failure as ending the period of value extraction rather than as a separate step in the process. Tallman and Shenkar (1994), on the other hand, propose a three-part decision process in the cooperative venture decision. The first decision is that of the basic organizational form, at which point cooperation is chosen (whether as a first choice or a best second alternative) over competition or acquisition for the transaction. The second decision is the general type of cooperative form, whether a shared equity form or a strictly contractual alliance. In the third decision stage, the specific details of the arrangement must be determined, whether contractual or equity based. Tallman and Shenkar note that a partner must be determined before the second decision, since specific capabilities and assets are likely to be considered in this decision. Thus, the first decision is part of Tallman's first stage of search and the latter two decisions are part of the negotiation over terms.

Tallman (2000) ties his three stages to specific transactional characteristics that change at the points in time that separate the three stages. Since this model has ties to several of the theoretical perspectives described in previous chapters, we will use it as an outline for our discussion of the cooperative strategy process.

The first, or analysis and search, stage is characterized by nonspecific investments in market analysis, decisions about organizational form, evaluation of large numbers of potential acquisition and/or alliance candidates, courting of potential partners, and so forth. The firm should be developing an understanding of its proposed and actual markets at this time, as well as an understanding of its own assets, capabilities, and motivations. Only when these issues are fairly well understood can the choice of cooperation versus acquisition versus startup be made—so Tallman and Shenkar's first decision should occur sometime during this first stage of the alliance process. At the same time, competitor analysis, preliminary discussions and negotiations, consultants, relationships, reputations, and other directly and indirectly related sources of information can be used to narrow the choice of partners. It is during this stage that the issue of motivation for cooperative strategies should be considered explicitly, an issue to be developed in detail below. It is also the case that most partner relationships begin with both partners involved in searches for means of maximizing transaction values that result in decisions to follow cooperative strategies (Zajac and Olsen 1993). When these parallel processes intersect, two firms eventually conclude that they can get the best value with each other.

The second stage of the alliance process begins with the selection of the specific partner or partners. This point represents the 'fundamental transformation' of a transaction, according to transaction cost economics (Williamson, 1975), because the number of possible partners drops from many to one and the character of the transaction changes drastically. Before the choice of a specified partner or partners, the alliance-seeking firm (actually both potential partners in cases where the search is two-sided) has a variety of options and has made minimal commitments or investments in any prospect. Therefore, it can easily step away from any potential partner should the expected value of the prospective alliance fall, the apparent value of the partner's resource seem questionable, the reputation of the partner turn out to be questionable, or any other aspect of the potential deal seem risky, and seek another partner. The lack of transaction-specific investment at this point makes abandoning any particular prospect relatively inexpensive, in both real and opportunity cost terms.

Once a company has developed the political will to attempt to solve some of its problems through seeking an alliance partner, it has to address a number of issues. It must identify the sort of partner it wants, and form a clear view about what each of them is likely to bring to the relationship. Then, it must work with its proposed partner to agree how these respective contributions can be valued in a fashion that is fair to both partners, taking note of the downside risks and the upside potential. Finally, it must decide upon an alliance form—the structure and systems that are to form the basic framework for bringing the alliance to life. All this needs to be done before the alliance can come into being. The quality of partner efforts toward establishing the venture makes the real work of managing the venture much more or less likely to succeed.

When a target partner is chosen, though, the transaction is transformed and real investment in the one partner begins in earnest. Learning about the partner, negotiating with the partner, investing in the alliance, turning down other suitors, auditing resources, developing new capabilities, and a host of other activities are undertaken to make *this* alliance go more smoothly and efficiently. These are expensive activities, so represent an investment in the cooperative venture in the hope of increasing future value. Moreover, this investment has little alternative value, so rapidly creates an incentive to close the deal with this partner. At the same time, Williamson says that such transaction-specific investment increases the cost of a failed venture, whether (his concern) due to opportunism, lack of information, or simply a bad fit. The partners will begin to learn about each other, both directly and indirectly, but are also likely to conceal their weaknesses from each other in order to gain negotiating leverage. Indeed, bargaining power and negotiating skills are the key concerns in the second stage of the alliance cycle, as the terms for the extended operation of the alliance are sorted out. Here, too, is the opportunity to identify untrustworthy partners, avoid adverse selection, and structure a deal that will minimize problems of opportunistic or unskilled partners. Deciding on the general and then the specific form of the cooperative venture must come after a partner is chosen and specific assets and capabilities are on the table, but before the final contract is signed.

The second stage of the venture process is, as the name suggests, largely concerned with negotiating a venture that is satisfactory to both parties. At this point, the chosen partners determine their relative levels of bargaining power, their own likely revenues and costs, the learning potential of the alliance (both for them and for their partner), the value of each to the partnership, responsibilities and control over activities, and other issues that can only be determined in relation to a specific partner. The bargaining period may vary considerably in length, depending on level of preparation, experience with and trust in the partner, cultural expectations, strategic importance of the alliance, type of alliance, need for safeguards to prevent or defuse moral hazard situations, and a variety of other points of concern. For instance, negotiating alliances in Asia, where local customs dictate a lengthy period of building social contacts, often takes years for Western companies even after the partner has been selected.

The chapters in this part cover these issues as follows. Chapter 5 considers the critical issue in the first stage of establishing cooperation, which is defining the multifaceted motivations behind the transaction in a way that makes a cooperative strategy preferable.

Chapter 6 considers the question of what sort of company would make a good partner. It notes that most companies are able to assess their prospective partners in terms of the complementarity of their assets and skills and the possible synergies that arise as a result of them. Few, however, devote sufficient attention to the cultural compatibility between the partners. Yet this factor is often responsible for the breakdown of alliances. Having considered the issue of how to choose a partner, the chapter then turns to the selection of an appropriate form of cooperation.

Chapter 7 deals with negotiation and valuation. A cooperative agreement has to be negotiated, even in cases where it remains an informal arrangement rather than one sealed by contract. The partners need to be satisfied that they have a fair and reliable agreement on the contributions and benefits they attach to an alliance in order for their relationship to develop fruitfully. An important element in reaching a fair agreement is the valuation of assets allocated by the partners.

Chapters 8 and 9 address forms of cooperation that situate alliances within wider business networks. Chapter 8 addresses the increasingly important phenomenon of networks of alliances. More and more, and particularly in technology-intensive industries, partnerships are not standalone deals with one partner, but are links in a web of alliance relationships. Multipartner networks have dramatic impacts on cooperative decisions from strategic choice to partner selection to governance and direction.

Chapter 9 discusses the developing phenomenon of the 'virtual corporation'. As information technology has made communication between units of a corporation faster and more comprehensive, companies have begun to outsource more and more of their non-core activities. However, these are provided by a network of allied suppliers based on long-term contracts and commitments rather than being purchased in the market at arm's length.

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# 5 Motives

## 5.1 What this chapter covers

This chapter deals with those aspects of cooperation that precede the actual business of working together. It considers possible motives for alliances, noting that there are generally at least two; a company's response to changes in the external environment and that company's feeling of vulnerability or deficiency in certain areas of its operations. It may have inadequate market access, technology, brand strength, product range or other factors; it may lack financial muscle, or feel the need for speed to take advantage of a market opportunity that will not be there for long.

## 5.2 Strategic motivations for cooperation

The motivation of the partner firms is a major issue in the formation of cooperative ventures, and particularly in the phase of analysis and search when the firm is deciding on cooperation as opposed to other strategic options. Tallman and Shenkar (1994) suggest that a variety of economic and organizational considerations enter into the decision to use a cooperative venture form. These inputs may lead the partners to decide that an alliance is the best alternative from the start, or the partners may find that market transactions are too uncertain and real merger too stifling for one side or the other. The very consideration of cooperative forms is driven by strategic motives, as is the choice of partner, the selection of form, the toughness of negotiation, and the level of commitment of the partners in overcoming the difficulties of organizing and managing alliances. It is important in any examination of cooperative strategy to isolate the conditions that make cooperation more likely; in other words, the motives for cooperation. This section examines some of the more salient of these motives.

The process of economic and industrial change in the West since the end of the Second World War has been realized in a number of phases (Chandler 1986). First there was the immediate post-war phase of inherited rigidities from the interwar period, and the protection of ravaged economies. Then from the 1950s onwards came the dramatic growth of the major multinationals, and of the divisionalized M-form of organization. As Chandler (1986) suggests, the multidivisional company replaced the market in many areas in coordinating the distribution of goods and services to the consumer. Ultimately, however, this led to administrative and bureaucratic diseconomies as the multinationals became too large and unwieldy to operate efficiently, and this had to be weighed against the achievement of the clear scale and scope of economies of large-scale operation. As Hrebiniak (1992: 399) puts it: 'Internal expansion, and the inevitable creation of hierarchy can negatively affect flexibility, speed of response to markets, and the free flow of information so desperately needed to implement global strategies.' Thus a third phase manifested itself in the late 1970s and the 1980s when the system 'began to unravel to a degree' (Jorde and Teece 1989). This period saw the growth of the venture-capital-funded entrepreneurial firm with substantial outsourcing of nonkey processes, leading previously internalized value-chain activities to be returned to the market place. In many cases this led to the disadvantage of fragmentation of companies, and to their developing resource limitations, particularly in the face of the increasing globalization of markets.

Partly in response to these forces, there has been a dramatic growth of strategic alliances and other forms of cooperative strategy between companies since the late 1980s, particularly in the areas of technology and marketing. 'The spectacular growth of international interfirm technical cooperation agreements represents one of the most important and novel developments in the first half of the 80's' (OECD report 1986 cited in Collins and Doorley 1991). And as Gomes-Casseres states (1987: 99): 'Joint ventures may often be instruments providing firms with flexibility in responding to trends that are difficult to predict.' Porter and Fuller (1986: 322) focus on the basic purpose of an alliance when they say: 'Coalitions arise when performing a value chain activity with a partner is superior to any other way. . . . Coalitions can be a valuable tool in many aspects of global strategy, and the ability to exploit them will be an important source of international advantage.' Flexibility of response is the key benefit of a real options approach to cooperative strategy. In emerging industries with untried or immature technologies, no proven firms, and uncertain markets, potential entrants bear high risks of failure. A portfolio of alternatives is preferable to one or two major investments, and can be achieved at relatively low cost through a portfolio of real call options on potential investments. Alliances can provide these options—the initial investment is relatively low, particularly for a contractual alliance, the partners have an opportunity to learn more about the business over time without further large investment, and the options can be allowed to expire if low value or be exercised (usually through acquisition by one partner) if they begin to show a high expected value. In this way, alliances can allow firms to move into new business areas while hedging against the uncertainties inherent to new fields.

### 5.2.1 Perspectives on motivation

There are many motivating factors behind the formation of strategic alliances and other cooperative strategies. Most may well fall within the basic need identified so succinctly for JVs by Aiken and Hage in 1968: 'Organizations go into joint ventures because of the need for resources, notably, money, skill and manpower.' Kogut (1988), also dealing with JVs, singles out three basic motivations for their formation: (*a*) that such a form represents the lowest transaction cost alternative; (*b*) that it enables an improved strategic position to be achieved, and/or (*c*) it gives an opportunity for organizational learning. These motives may be alternatives, although in some cases all three motivations may apply.

As we noted in Chapter 2, the transaction-cost motive deals in particular with situations where there would be small number bargaining, high asset specificity, and high uncertainty over specifying and monitoring performance. Joint ownership largely eliminates the potential costs that arise in such situations, as there is a mutual hostage position through joint commitment of financial or real assets which thereby align partners who otherwise may have potentially conflicting incentives.

The strategic-behavior motive addresses how a JV may enable competitive advantage to be developed in the JV that had escaped each of the partners operating alone. This depends then largely on the complementarity of the assets introduced to the JV and the synergies that arise as a result of this. 'Whereas the former [transaction cost motive] predicts that the matching should reflect minimizing costs, the latter predicts that joint venture partners will be chosen to improve the competitive positioning of the parties . . . ' (Kogut 1988: 322).

Kogut's third motive, that of capitalizing on an opportunity for organizational learning, may depend upon the setting up of a JV in order to transfer tacit knowledge (Polanyi 1966). By definition, tacit knowledge cannot be transferred by contractual codified means, and is communicated only by teams working together. A JV may be sought in order to achieve this.

Thus the three motives for JVs identified by Kogut are claimed by him to be quite distinct although sometimes overlapping:

> Transaction cost analyses joint ventures as an efficient solution to the hazards of economic transactions. Strategic behavior places joint ventures in the context of competitive rivalry and collusive agreements to enhance market power. Finally transfer of organizational skills views joint ventures as a vehicle by which organizational knowledge is exchanged and imitated. (Kogut 1988: 323)

All three, however, are in fact concerned with the overarching motive of enabling the partners to become more competitive in relation to their rivals in their chosen markets.

Other motivations have come into prominence more recently. They include the need to access superior capabilities, often in related, but not core, business areas, without actually developing or internalizing them. From this resource-based perspective, learning is not just about building skills internally by acquiring them in some way from partners, but of tapping the competencies of partners *without* actually acquiring either the partner or its secrets. Building a network of suppliers and customers can substitute for an extensive internal value chain, to the point of creating a 'virtual corporation'. An options strategy further suggests that alliances are created, at least in part, as real options on larger investments in particular industries or markets, permitting firms to retain flexibility while also providing first hand information about the new market to reduce uncertainty.

Many scholars have depicted alliance formation as an essentially rational and analytical process (e.g. Harrigan 1988). Tallman and Shenkar (1994), for example, develop a rational managerial decision model for international cooperative venture formation by multinational enterprises (MNEs). Contractor and Lorange (1988: 9) identify seven 'more or less overlapping objectives' for the formation of various types of cooperative arrangement:

1. risk reduction;
2. achievement of economies of scale and/or rationalization;
3. technology exchanges;
4. co-opting or blocking competition;
5. overcoming government-mandated trade or investment barriers;
6. facilitating initial international expansion of inexperienced firms;
7. vertical quasi-integration advantages of linking the complementary contributions of the partners in a 'value chain'.

These potential rationales for forming cooperative relationships raise the twin issues of how compatible are the partners' strategic motives for forming an alliance and how transparent are these motives. A lack of openness about motives is likely to limit the chances of trust developing between the partners later on, and may threaten the very survival of the partnership. Of course, as we shall note in Chapter 13, if one partner's motives for forming an alliance are primarily to 'milk' the other's technology and special skills in an opportunistic manner, so that the exchange of benefits is one-way and one-off, then the long-term survival of the alliance is not likely to figure highly among its goals.

However, the relationships that develop between partners in successful relationships may well be far wider and deeper than the economic perspectives put forward by Kogut and others. As Tallman and Shenkar (1994: 92) also note: 'The decision to form an ICV [international cooperative venture], as well as the selection of cooperative strategies, organizational forms and partners, is not strictly economic, but also a social, psychological and emotional phenomenon . . . It is no coincidence that ICVs are frequently described using such terms as "trust", "shared visions" and "understanding".'

A particular motive for adopting a cooperative strategy and entering into alliances is provided by the challenge of entering new international markets. Here, the choice is one between (*a*) exporting, (*b*) entry via cooperative contracting such as licensing, franchising, counter-trade, and contract manufacture, and (*c*) investment in the target market through setting up JVs with local partners (Young et al. 1989; Root 1994). It is possible to identify the most appropriate mode through a contingency analysis that refers to the company's strategic objectives, on the one hand, and to local conditions, on the other. The practical problem is that a company's strategic objectives are seldom fully consistent, and local conditions may not be fully understood (Root 1994: ch. 7).

Thus, although the formation of alliances and JVs is presented as typically the result of unitary decisions in the presence of sufficient information to make them, it is more usually the product of a coalition of views in both partners pointing to the possible advantages of such an alliance, when the actual benefits and costs cannot be known until the alliance has been in operation some considerable time. They are, therefore, as much political as economic decisions depending heavily on the internal corporate political power of their champions, and placed at risk if those champions should lose power in their home organizations (Tallman and Shenkar 1994).

Although decisions to set up alliances may be strongly conditioned by political issues and the relative positions of a number of stakeholders, economic arguments will almost certainly be advanced to justify the decisions, and these arguments are likely to be based on either the transaction-cost theory, or the resource-dependency perspective. More specifically, the argument will run along the lines that the alliance is the most likely solution to an environmental challenge on the grounds of it showing the best probable excess of probable benefit over cost, that the joint value chains of the partners give competitive advantage where neither did alone.

### 5.2.2 Drivers of cooperative strategies

Before discussing the specific drivers behind cooperative strategy it is worth noting that there are two distinct rationales for such a strategy: (*a*) learning and (*b*) skill substitution. In the complexity of an actual cooperative arrangement they may well get muddled, and substitution may turn into learning, but both exist conceptually as distinct rationales and they carry with them different risks.

Thus strategic alliances are generally formed because each partner feels inadequate in a particular area of its resources or activities and wants to learn from the other partner. Clearly this involves risk if total integrity is absent, as one partner may take and not give fully in return. Such partnerships may set up stronger competitors of the other partner. However, even if the alliance ends, the learning has taken place, so mutual benefit will have been obtained.

In skill-substitution arrangements one partner takes over a particular activity because it is the stronger performer. Thus one partner may manufacture, the other market and sell. This is less risky since proprietary information is less likely to be given away, and if the arrangement founders the partners merely need to find another partner. However, little learning may have taken place, so the feeling of failure may be all the greater. Such arrangements are less likely to spawn strong competitors.

Clearly many cooperative arrangements exhibit aspects of both variety of cooperation. Partners in virtual corporations may well also learn, and partners in learning alliances are likely to carry out some activity specialization within the alliance. Rover set out in its cooperation with Honda by seeking a knock-down kit of a Honda car to badge as a Triumph (skill substitution), and ended up in a major exercise of manufacturing-process improvement (learning). The two distinct concepts do exist, however, and are, we believe, helpful as ideas to be borne in mind when one organization is considering entering into a cooperative arrangement with another.

## 5.3 External challenges

From an economic perspective, the main argument for alliances is that they are usually formed as a result of an external stimulus or change in environmental conditions to which companies respond with a feeling of internal corporate need that they feel is best met by seeking a relationship with another corporation (Faulkner 1995; Nelson 1995).

What might be called an eclectic theory of alliance motivation (cf. Dunning 1974) suggests that all alliances are sparked off by a change in external trading conditions, and that this change reveals an internal resource inadequacy that needs to be corrected if competitive advantage is to be maintained. An alliance will result if both a company and its proposed partner, on analysis, find themselves to have complementary resources and perceived inadequacies. The theory is termed eclectic since there exists a long list of both external and internal conditions, any one of each of which is sufficient to provide the ground motivations for an alliance. For example, the external driver for one company might be the need to achieve scale economies to be able to compete on the world market and the internal need might be to fill underutilized factory capacity. For the other company, the external driver might be a shortened product life cycle, and the internal driver an insufficiently innovative design team, or inadequate investment funds.

Whatever the external and internal drivers, one or both is necessary for each potential partner to provide a strong enough motivation for a strategic alliance. Cooperation between the companies, however, might be motivated unilaterally. DeFillippi and Reed (1991) distinguish here between unilateral arrangements and bilateral agreements (strategic alliances). Unilateral arrangements come about when one company perceives resource-deficiency needs that can be satisfied by another company, but the feeling is not reciprocated by the other company. Thus Rover might have needed Honda's technology skills, at a time when Honda needed nothing from Rover. In this case Honda might have licensed the technology, and provided technical consultancy for a royalty and a consultancy day rate. This is a unilateral arrangement. A resource is transferred in exchange for money. Such arrangements are regularly provided in outsourcing agreements, consultancy studies, and externally provided training courses. These are still cooperative strategies but not strategic alliances. In fact, Rover did require Honda's technology, but Honda for its part required Rover's European styling skills. This provided the conditions for a bilateral agreement—that is, a strategic alliance.

The conjunction of certain conditions in the structure and nature of the external environment makes alliances more likely at some periods of economic and political history than at others, as illustrated in Box 5.1. Periods of trade protectionism, and of strong anti-trust movements, militate against alliance formation. At such times, cooperative activity between companies tends to be denigrated as anticompetition or as constituting cartels. Correspondingly, during periods when the power of the giant MNE is perceived as being excessive, but world trade is buoyant, the less threatening nature of the strategic alliance comes into favor, set up as it is to combat the threat of the multinational and frequently giving a competitive chance to smaller more flexible companies.

The growing globalization, and regionalization of markets since the mid-1980s, with the steady reduction of trade barriers, has led to the dramatic growth of cross-border alliances. This has been accompanied by considerable economic turbulence and uncertainty in world markets, and the growth of the free-market ideology in most countries of the world. This is in contrast to the immediately preceding period of economic history, when the ideology of the planned economies of the socialist and communist world stood as an apparently viable alternative economic system to that based on markets. The growth of trade with emerging nations in the Far East and with South America, and in

**Box 5.1 The external driving forces of the automobile market**

Rover and Honda set up a collaborative alliance in 1979 that lasted in its full form until Rover was bought from its parent British Aerospace in 1993 by BMW, a strong competitor of Honda. Although the motivations for the collaboration were strong and varied on the internal side, there were powerful external stimuli in the automobile industry driving manufacturers towards the conclusion of alliances with their competitors and their 'complementors'. The world automobile industry has become increasingly global over the last decade. It has also exhibited increasing demand turbulence. Economies of scale have increased in its dominant technologies in many areas due in large part to the growing use of robotics. A combination of fast-changing technologies and the growth of fashion demand has led to the continuing shortening of product life cycles, resulting in growing investment requirements which are frequently too onerous for one company to finance alone.

This same consolidation of the global automotive industry led more recently to an alliance between Renault SA of France and Nissan Motors of Japan. The alliance began with a purchase of an equity share in Nissan by Renault and the assignment of Carlos Ghosn from Renault to Nissan as Chief Operating Officer. The two companies set up eleven 'cross-company teams', overseen by an Alliance Coordination Bureau, to coordinate and standardize operations in various aspects of automobile production. Ghosn worked to reduce the complexity and costs of Nissan, and the two firms began to merge their operations, both back office and production, in different parts of the world, to share factory space, to cross-sell models, and to use common platforms by 2002. In May 2002, the two firms set up a formal 50:50 JV and have since accelerated their joint activities—by 2004, some 70 percent of the parts used by the two firms are being bought by the joint venture. In 2004, both firms are performing far above expectations, share values are up dramatically, and together the companies have the fourth largest sales in the industry.

*Sources*: Faulkner (1995), Yoshino and Fagan (2003), Bremner et al. (2004).

particular with an economic colossus like China, leads to a particularly strong external driver for the development of cooperation, since few Western companies possess the cultural knowledge to succeed alone in the East. Chapter 16 will discuss this particular issue in more detail.

Some of the key external driving forces for alliance formation at the persent day are:

1. turbulence in world markets and high economic uncertainty;
2. the existence of economies of scale and/or scope as competitive cost-reducing agents;
3. the globalization or regionalization of a growing number of industries;
4. the globalization of technology;
5. fast technological change leading to ever-increasing investment requirements, and
6. shortening product life cycles.

Turbulence, economic uncertainty, and technological change are often interrelated. This is particularly so at times where the revolutionary phase of the punctuated equilibrium paradigm is at its height (Gersick 1991). According to this concept, the economic phase operates under stable conditions for long periods, and only incrementally changing technologies spawn products with dominant design paradigms that are accepted by the market place. These periods are punctuated, however, by periods of economic ferment in which major technological changes take place, old products are replaced by new, old companies die, and new ones arise. In such circumstances the economic scene becomes very volatile, and the development of networks and alliances provides some security and buffering against external threats to survival. In such a theory, as the new equilibrium develops, the alliances are likely to be converted to mergers, and stability to reemerge. In reality, of course, such theoretical large-scale environmental determinism may be unduly simplistic. Much anecdotal evidence, however, can be adduced to illustrate the theory—for example, the transistor replacing the valve, expanding applications of the microchip, and so forth.

The external drivers of alliances of technology change, economic uncertainty, and increasing turbulence resonate also with Tushman and Anderson's (1986) identification of competence-enhancing and competence-destroying technological change. They observe that technology evolves through periods of incremental change shaken up by periodic technological breakthroughs that either enhance or destroy the competence of firms in an industry. Illustrations of technological discontinuities that are likely to be competence destroying are jet engines, float glass, or plain paper copying. These relatively rare technological changes trigger a period of technological and product/market volatility that does not cease until a new dominant design paradigm (Teece 1986) emerges. Incremental technological advances enhance and extend the underlying technology and thus reinforce the established technical order. Competence-destroying advances are likely to be developed by new firms (Tushman and Anderson 1986) and disrupt the existing industry structure. Competitive uncertainty is therefore increased and an external environmental driver for alliance creation is brought about.

Not all the above conditions, of course, are necessary to provide the external stimulus for alliance formation at any one time. Most, however, can readily be observed in the current economic and political world. Any single strong external factor impelling firms towards alliance formation is sufficient to set the alliance train in motion, without any one specific factor being necessary in itself.

Faulkner (1995) reports that managers in the ten alliances he studied (many of which have since been merged, dissolved or acquired) differed considerably in the external drivers they stated had been relevant for alliance formation. Only managers involved with the Rover–Honda alliance claimed that all the factors we have identified were important external drivers, and those in the ICL–Fujitsu alliance identified all except economic turbulence in their markets. The most common external factor identified was globalization of markets, followed closely by perceived opportunities for economies of scale or of scope, and the need to gear up to fast technological change. All three of these factors were emphasized by executives from the 'Eurobrek', Rover–Honda, ICL–Fujitsu, and Courtaulds–Nippon Paint alliances.

These findings are consistent with the most common explanation of the rapid growth of alliances in recent years, which takes the following form. Technological change has become increasingly rapid, and global in nature. As a result, the difference between regional markets has become smaller (Levitt 1960; Ohmae 1985). Globalization of markets has given major opportunities for companies to realize economies of scale and scope. These factors have lowered unit costs for the firms large enough to take advantage of them. However, a side effect of technological change and globalization has been shortening product life cycles, leading to ever-increasing demand for investment both to install the new technology and to develop new products. Competitive advantage has therefore accrued to the company able to adopt the new technologies, achieve economies of scale and scope, serve global markets, and change its product range regularly. Since few companies have the internal resources and competencies to meet this range of requirements, there has been a widespread resort to strategic alliances and other cooperative arrangements to cope with the needs of the new economic order. These alliances have been termed 'scale' alliances, since the motive for their formation is primarily to achieve economies of scale and/or reduce development costs (Hennart 1988; Garrette and Dussauge 1995).

A significant number of the alliances Faulkner investigated yielded clear evidence to support the above scenario. Eurovynyl Chloride, the JV between ICI and Enichem, was set up in response to the globalization of the PVC market. This had led to the growth of modern capacity in the Far East, which challenged the older capacity of ICI and Enichem in Europe. The JV had the primary purpose of retiring non-economic capacity in a measured way without damaging the market price of the commodity, and hence returning the European units to profit.

A similar argument applies to the ICL–Fujitsu alliance. This case offers a further interesting perspective in respect of Fujitsu's belief that the alliance route gives competitive advantage over the large integrated company with its bureaucratic costs and single view. IBM's internal restructuring from a unitary hierarchy to a federal structure gives some credence to the growing currency of this attitude. Fujitsu developed a world-wide 'family' as it describes it, so that it could become sufficiently powerful anywhere in the world to compete with IBM and HP. ICL, for its part, lacked the size, reach, and financial muscle to become a world player and could realize these strengths only through a Fujitsu-style partnership, first as an alliance and later as a subsidiary retaining its own legal and corporate identity.

The Courtaulds Coatings and Nippon Paint alliance was initially restricted to the marine paint market, where globalization and technology change are key factors. However, market access is also important, and this made Nippon attractive to Courtaulds, as the Japanese company could guarantee market access in its home country. The alliance was so successful by the mid-1980s that Nippon conceived the ambition to go global independently, thus throwing into doubt the congruency of objectives of the two partners.

The major external forces behind ISA formation are often interrelated and may stem from varying causes. For example, globalization of markets may lead to technology change, which in turn leads to increased turbulence. Alternatively, the initial driver may be technology change, or even economic turbulence brought about by other possibly political events. The key identifiable current factors, however, seem to be the globalization of markets and technologies, the shortening of product life cycles, and the consequent need for enterprises large enough to take advantage of scale and scope economies, and to be able to access adequate resources and competencies. Other factors exist in specific situations, and these are less generalizable in nature. As with the internal motivations, however, they relate in the main to perceived resource or competency imbalances in the face of the external challenges, threats, opportunities, and competition.

## 5.4 Internal needs

Pfeffer and Nowak (1976) and later Porter and Fuller (1986) suggest several possible reasons for concluding strategic alliances that may be seen from the perspective of internal stimuli:

1. to achieve economies of scale and of learning with one's partner;
2. to get access to the benefits of the other firm's assets, be these technology, market access, capital, production capacity, products, or manpower;
3. to reduce risk by sharing it, notably in terms of capital requirements, but also often in respect of research and development expenditure;
4. to help shape the market—for example, to withdraw capacity in a mature market.

There may also be opportunities through the medium of alliances for the achievement of value-chain synergies (Porter 1986) that extend beyond the mere pooling of assets and include such matters as process rationalization, and even systems improvement.

### 5.4.1 Resource dependence

Companies are motivated to form alliances for a wide variety of specific reasons, but most come under the heading of perceived resource deficiency (see Chapter 2 on the resource-based view and Chapter 3 on the resource-dependence perspective). Alliances may be of the defensive variety in which the partners collaborate in order to defend their domains in the face of an external threat from a common enemy. Or they may be aggressive, taking advantage of the globalization of their market to realize opportunities to operate with a partner on a global scale. In either case, the motivation for the alliance is resource based. Alone, the potential of each partner's value chains, financial and other resources, core competencies and skills, and networks of contacts is inadequate to achieve its identified objectives, but together the potential synergies from cooperation are perceived as leading to competitive advantage, jointly but not separately available.

A key internal motivation for alliance formation is thus to gain the requisite skills or resources needed to respond to an external challenge or opportunity of some sort. The alliance between ICI Pharmaceuticals and Sumitomo Chemicals provides an illustration (see Box 5.2).

**Box 5.2 ICI pharma**

In 1972 ICI Pharmaceuticals (now Astra Zeneca plc) established a JV with Sumitomo Chemicals to manufacture and market some of ICI's ethical products in Japan. The JV company was called ICI Pharma and sited in Japan. The internal motivations for this arrangement can be summarized as follows:

(a) ICI, although a worldwide chemicals company, was at the time very deficient in business knowledge of Japan. It had few contacts in that part of the world and lacked the ability to market there unaided. The Japanese market was very nationalistic and products made by companies without a Japanese partner did not find ready acceptance. ICI lacked experience in acquiring the necessary pharmaceutical consents and patents to sell its products in Japan. It was also unaccustomed to manufacturing in that country.

(b) Sumitomo was able to supply the skills to make up for ICI's deficiencies in these areas. It in turn had its own resource problems. Sumitomo was a very small player in the worldwide pharmaceutical market and lacked a wide range of proprietary products upon which to build a pharmaceutical business. It also lacked ICI's reputation in this area. The respective internal dependency drivers of the companies were therefore complementary.

*Source*: Faulkner (1995).

The specific needs will vary in nature, but all can normally be classified as feelings of a specific resource, skills, or competency inadequacy or imbalance. Such an imbalance does not need to be skill deficiency. It may, for example, be surplus production capacity, as it was with Rover, which operated with half-empty plants when it first met Honda. Each of the partners in an alliance is likely to seek a different resource or skill compensation from the other. Unless both are able to match their resource or competency needs in a particular partner, then they do not have the right partner. Their options are then to seek a different partner, or alternatively to buy in the skill from the proposed partner, but without providing a complementary skill in return. In this case the deal will be a unilateral exchange and not an alliance.

Bartholomew (1997) illustrates this at a national level in biotechnology research. She notes that German firms typically enter alliances with US firms as a means of operating in a more flexible regulatory regime. Japanese firms, however, tend to form alliances with US partners largely in order to gain access to leading-edge research as well as learning how the US research system works. US firms, however, cooperate across borders largely to spread the financial risk of expensive R&D programmes. In all cases the partners tend to get what they want, and it is the provision of skills or resources in which they feel themselves to be limited.

Faulkner (1995) found that its reputation was the strongest internal motivation for choosing the particular alliance partner, coupled with the access to new and strong brand names that the partner could provide. This would suggest a difficulty in forming an effective alliance for companies without either a well-established reputation or strong brand names. An alliance of two weak companies leads to a vulnerable alliance. Local knowledge, marketing skills, and distribution channels were other factors commonly cited.

Of other possible resource needs, key labor skills of one type or another were declared as motivating needs by Eurobrek, ICI Pharma, and C&W. In a number of alliances the partner's managerial skills were the attractions. The EVC and Imperial Tobacco alliances were attracted by at least one of the partners' access to raw materials, and C&W identified legal requirements as its basic need in seeking to ally with a consortium of major Japanese corporations. The Disney–Pixar alliance brought together the animated storytelling skills, distribution power, capital, and brand name of Disney and the software and animation technology skills of Pixar to make five hit animated features. Alone, neither firm could have revolutionized the animated film industry, but together they changed the face of motion pictures (see Box 5.3).

**Box 5.3 The rise and fall of the Disney–Pixar alliance**

Pixar was originally founded by George Lucas to develop computer-generated images and was bought by Steve Jobs in 1986. Pixar created the software to create 3-dimensional animated scenes and developed various short subjects. When Pixar decided to move into animated feature films, however, they had neither the capital nor the production and distribution skills to complement their technical wizardry. Disney was the long-time leader in traditional animated films, as well as the owner of a variety of entertainment distribution outlets and a true power in Hollywood under the direction of CEO Michael Eisner. Pixar and Disney worked on technology projects, and in 1991 agreed to collaborate on three films, beginning with *Toy Story*. This project was extended in 1997 to a 5-film deal, and a more balanced relationship was arranged. Initially, Disney kept 85 percent of the profits and retained the intellectual property rights to the films and any sequels. As Pixar's technical and story-telling skills grew, though, Jobs was able to arrange for an even split of revenues after Disney took a 12.5 percent distribution fee. The two firms have now made and distributed six animated features, all hits, and have one more in progress. However, by 2004 the alliance needed renewal as the last picture came to the end of production. Jobs and Eisner were not able to come to an agreement. Reportedly, Jobs was not willing to pay more than 5 percent for distribution, Pixar's name had outstripped Disney's on computer-animated films, and the run of hits meant that any production company would be happy to work with Pixar. At the same time, Eisner had come under strong pressure from the board of Disney, led by Roy Disney, the nephew of Walt Disney, to step down from his post as CEO. As a result, even though Disney was willing to reduce its share on the last two films produced by the alliance, negotiations failed and the alliance ended. For Pixar, a much more lucrative deal is likely for its future. Disney, though, let its animation studio shrink to nearly nothing, lost its brand identification advantage, and was not able to offer distribution clout beyond that of several other studios. The bargain had become obsolete, and Pixar was ready to try its luck in the market. Disney is left with the sequel rights to the first six films, but without the technical competencies of Pixar, and with the current turmoil surrounding Eisner, may be unable to fully exploit these.

*Source*: Waters and Larsen (2004).

For an alliance to be formed, it is clear that a mutual resource-dependence perception is often a key internal motivator, and that both partners are likely to have different but complementary resource needs which they perceive their chosen partner can help them to meet. The specific nature of the resource dependencies will of course be contingent on specific circumstances.

There is more than one way of dealing with a perception of resource deficiency. Alternative actions might involve raising further capital in the market, recruiting key personnel in areas of perceived expertise weakness, a merger, or an acquisition, or the development of contractual arrangement to license technology in or distribution out. Resource deficiency, then, is one important condition for alliance formation, but not a necessary one, in the face of the alternative ways of dealing with that deficiency.

### 5.4.2 Learning

Powell et al. (1996) look at the question of alliances and the motivation for forming them from a different perspective. In their view, the resource-dependence view, whilst insightful, does not capture the fundamental motives of firms and academics involved in the scientific networks that lead to much breakthrough research in biotechnology. They stress that:

> Knowledge creation occurs in the context of a community, one that is fluid and evolving rather than tightly bound or static. The canonical formal organization with its bureaucratic rigidities is a poor vehicle for learning. Sources of innovation do not reside exclusively inside firms; instead they are commonly found in the interstices between firms, universities, research laboratories, suppliers and customers. (Powell et al. 1996: 118)

The motivation of firms involved in such innovation is to become part of a community in which new discoveries will be made. The aim is therefore that of learning, a theme that underlies so much of this book. The research conducted by Powell and his colleagues provides strong evidence for the contention that in industries which are complex and expanding, and where the sources of expertise are widely dispersed, innovation will be found mostly in networks of learning firms rather than in individual firms. They suggest, in fact, that the R&D intensity of such an industry is positively correlated with the number of alliances it exhibits. In highly networked industries like biotechnology intense and long-term relationships develop that are fundamentally directed at innovation, and are not one-off arrangements that make up for mutual resource deficiencies. They are dynamic in that they look to the shaping of the industry in the future. Biotech firms, Powell et al. found, grow through being connected to rich R&D networks. The most successful biotech firms were those most central in the various networks of research alliances in the industry.

Powell et al. also note that the cycle of learning which was visible in the firms researched was path-dependent, but that actual innovations were serendipitous, as they frequently are in scientific research. The complexity, intensity, and variety of alliances were important factors in affording the flexibility to a learning constellation necessary to take advantage of such unexpected discoveries. In their industry, firms without ties are becoming increasingly rare; the modal firm has multiple partnerships . . . the field is becoming more tightly connected not in spite of, but because of, a marked increase in the number of partners involved in alliances with dedicated bio-technology firms. . . . We take this increasing connectivity within an expanding universe as further evidence that two processes of learning are occurring simultaneously and recursively. First, firms are increasingly using ties to enhance the inflow of specific information, resources, and products. Second, firms are becoming much more adept at and reputed for the general practice of collaboration with diverse partners (Powell et al. 1996: 142).

Learning is one of Kogut's three major motivations for alliance formation. In effect, if a firm cannot develop critical knowledge internally or buy it in the marketplace, it can either acquire a firm that has unique knowledge or it can ally with such a firm. Acquisition has many difficulties, from often excessive costs to the internalization of unwanted assets to moral hazard when dealing with targets before and after the acquisition to the defection of needed employees. Alliances can permit firms to access knowledge, even highly tacit knowledge, with fewer commitments and costs and smaller investments. Whether the firm hopes to internalize partner knowledge or simply access it, it engages in organizational learning to add to its own unique know-how.

### 5.4.3 Risk limitation

A further factor advancing alliance formation as opposed to the alternatives of merger/acquisition or organic development is the need to limit risk. The spreading of financial risk is frequently cited as a fundamental motivation for the formation of strategic alliances (Mariti and Smiley 1983; Porter and Fuller 1986). It seems also intuitively likely that a company with only moderate financial resources may deal with either an opportunity or a defensive challenge, by seeking an alliance with a partner who can help spread the financial risk. This is particularly prevalent in R&D alliances between medium-sized partners, or between business corporations and academic institutions. Stata (1989) cites collaborative research of this nature as a strong force in bringing about innovation in industry. It is an area in which the Western business world has some catching up to do compared with say Japan or other developed Far-Eastern countries where such collaboration is embedded in the culture (Gerlach 1992).

### 5.4.4 Speed to market

Another motive behind the conclusion of strategic alliances is the need for speed in reaching the market (Lei and Slocum 1991). In the economic world of the 1990s, first-mover advantages are becoming paramount, and often the conclusion of an alliance between a technologically strong company with new products, and a company with strong market access is the only way to take advantage of an opportunity in time. Even if a company has sufficient funds to approach an opportunity through organic development, this may not lead to substantial market presence fast enough to take successful advantage of the opportunity. Alliances are the fastest means of achieving market presence to meet an opportunity, if the partners each have strong resources and competencies, but alone insufficient to achieve critical mass. Internal development would take much longer, and acquisition has the disadvantage of the possible demotivating effect of the subsidiary relationship, and the higher level of investment required. Eight out of ten of the cases analyzed by Faulkner (1995) claimed speed to market as an important motivating factor in alliance formation.

In increasing-returns industries, speed to market can make all the difference between market dominance and being rapidly marginalized, however superior one's technology. Competition between technologies may have multiple potential outcomes, quite by chance, or through an early lead that locks out competitors. Historical events may indeed lock in an industry to the monopoly of an inferior product. The issue is of path dependence and ultimate single-technology dominance. Such increasing-returns industries are volatile, and have no predictable equilibrium. As Arthur (1989) claims, the adoption of petrol rather than steam for cars seems to have happened largely by chance early in the century, although the automobile industry is not one that would be normally associated with the increasing-returns phenomenon. Speed to market, however, may be a vital key to success, as is an early development of the dominant design.

### 5.4.5 Cost minimization

The question of the efficiency of the alliance form in meeting a need is a further factor for an organization to consider when deciding whether or not to pursue the alliance route. The efficiency criterion is captured in transaction-costs theory, which holds that companies will form alliances, rather than adopt other strategic options, only if the transaction costs involved in so doing are perceived to be lower than those for the other options. Transaction costs are in many aspects highly judgmental entities, since they involve such basically unquantifiable costs as loss of proprietary expertise to a partner who subsequently becomes a competitor. Although such costs may well be important, they cannot easily be computed, as can costs of production, and it is questionable whether they are considered in detail before deciding to set up an alliance.

It is often suggested by the organizational economics school (Williamson 1985) that an alliance will be set up only if the partners consider that the transaction and other costs involved in the proposed alliance are less than those that would be incurred by alternative strategic actions. This proposition is a difficult one to substantiate, mainly because the decision-takers in the alliances are generally unaware of the concept of transaction costs, and its somewhat sophisticated implications. When it was explained to them in Faulkner's research, no interviewee claimed it had been even an implicit motivating factor in the setting-up of the alliance.

In the literature on strategic alliances, transaction-costs analysis holds a very strong position (e.g. Williamson, 1975, 1985; Barney 1986; Thorelli 1986; Beamish and Banks 1987; Hennart 1988; Griesinger 1990; Hill 1990). Chapter 2 has addressed the issue in some detail and it can be seen that, while firms may not consciously calculate transaction costs in deciding whether or not to set up an alliance, if they decide on a course of action in which transaction costs are high they will become uncompetitive and have either to adjust or to fail.

Before adopting the transaction-costs perspective—that is, the efficiency motivation—as a necessary and sufficient criterion for alliance formation, it should be noted that transaction-costs analysis ignores a number of factors, which critically influence decision-makers. As Ring and Van de Ven (1994: 93) point out, transaction-costs analysis deals only with costs and hence efficiency, but does not allow equity or fairness to play a part in the decision-making process:

> As reflected in transactions cost theory, researchers use efficiency to define the most expeditious and least costly governance structure for undertaking a transaction, given production cost constraints. We assume that an equally important criterion for assessing a cooperative IOR is equity, defined as fair dealing . . . perceptions of equity operate as a lower-bound constraint on efficiency.

Transaction-costs analysis also omits to value the importance of trust in establishing alliances. An alliance may be proposed to minimize transaction costs, but if the partners mistrust each other it is unlikely to be a successful alliance. Trust is a difficult area, since people who may be trustworthy in their private lives may fail to be in their corporate life, if the corporate culture of their employer emphasizes guile and hard bargaining as corporate values (Guitot 1977, cited in Ring and Van de Ven 1994).

Finally, transaction-costs analysis does not take adequate account of the varying levels of risk involved in different governance structures (Faulkner and Bowman 1994). To carry out an activity internally *ceteris paribus* clearly involves less risk than does any other method, since the highest level of employee control is present, and teams within a company have experience of working together. Alliances have in general a fairly high level of risk. They involve less investment than acquisitions or internal development, and only come about after extensive negotiation, but they still involve unfamiliar actors working together across company boundaries. Acquisitions generally carry the highest level of risk.

Motives geared to the reduction of transaction costs can therefore account only partially for alliance formation. The evolutionary economists' argument (Nelson 1995) that natural selection will ultimately leave only the naturally selected lowest-transaction-costs actors in the game is also highly deterministic. As Hannan and Freeman (1989) point out, inertia often prevents transaction costs leading to changes in organizational form, and political and institutional factors are often stronger action determinants than efficiency arguments. Patterson (1993) cites Jacquemin (1987), Litwak and Rothman (1970), and Mariti and Smiley (1983) as advancing arguments to the effect that costs are only one factor in alliance form determination, and not necessarily the most important one. There is little evidence to show that, in computing costs, such factors as the potential cost of opportunism, of impacted information, or of contractual arrangements are taken into account, as they would be in any transaction-costs analysis, although the potential leakage of proprietary information outside the agreement is a common worry. Thus, whereas the low costs of an alliance relative to an alternative form is a positive factor in motivating partners, transaction-costs analysis in its purist sense is neither understood nor calculated even in qualitative terms. It has to be admitted that, even if the concept were fully understood by decision-takers, it is difficult to see how an agreed transaction-cost figure could be arrived at that would quantify such factors as information impactedness, opportunism, or inappropriate proprietary expertise transference. This is not, however, to dismiss the concept of transaction costs as unimportant in the longer-run 'ecological' sense, since what may not be a strong motivating factor for alliance formation can still exert a powerful influence on ultimate survival.

### 5.4.6 Current poor performance

Bolton (1993) suggests in her research that a prime motivator for becoming involved in cooperative activity, particularly in innovative R&D, is existing poor performance. This leads the top management of the organization to seek out a means of changing the formula it is presenting to the market. Cooperation is a readily available means of doing this. Poor performers were found by Bolton to be early joiners of R&D collaborations, whereas good performers were late joiners. This is explicable by reference to an implied risk profile. If performance is currently poor, there is little to be lost by finding something different to do in order to improve results. Such an incentive is much weaker when things are currently going well, although an alliance may still be considered to address a deficiency that is thought likely to impact on performance in the longer term.

## 5.5 Conclusion

Alliances need for their initial stimulus a challenge from a changing external environment. If then an organization develops a feeling of resource deficiency in relation to such an external change, or if it wants to spread risk, or needs to get into a market fast, and believes that the transaction costs of an alliance would be less than those incurred from internal development or acquisition, then the motivation for an alliance exists. If a partner can be found with a similar and complementary motivation, then the circumstances for the conclusion of an alliance are in place. So runs the economic argument for the establishment of alliances. However, such explanations need to be supplemented by the identification of motivations that stem from political agendas within firms. The economic arguments may be necessary but they are not always sufficient. Ultimately neither transactions costs, the extent of risk, nor future economic benefits can be known at the time the decision is taken to set up an alliance. There must, therefore, also be a political motive for the alliance, perceived by a coalition of the company's key decision-makers. Political agendas are many and varied within a corporation, and, in the absence of corporate champions able to focus such a coalition towards cooperative action, the motives for the formation of strategic alliances may be insufficient to lead to their creation. Finally the motivation to cooperate remains high even when the alliance has exposed the partners to the temptation to steal each others' secrets and run, so long as the alliance is of indeterminate length, the penalties for defection are high, and reputations matter.

## 5.6 Summary

1. Alliances need for their initial stimulus a challenge from a changing external environment. Such challenges as globalization or economic uncertainty are current stimuli to alliances formation.

2. If an organization develops a feeling of resource need in relation to such an external change, or if it wants to spread risk, or needs to get into a market fast, and believes that the transaction costs of an alliance would be less than those incurred from internal development or acquisition, then the motivation for an alliance exists.
3. An alliance can be seen as similar to a real option in that it enables a firm to learn more about a market for a relatively small investment, before committing itself in a major way.
4. Kogut suggests the three basic motivations are (*a*) to achieve the lowest transaction costs, (*b*) to improve strategic position, and (*c*) to give an opportunity for organizational learning.
5. If a partner can be found with a complementary motivation, then the circumstances for the conclusion of an alliance are in place. Thus if one partner is strong in marketing and weak in production, and the other is strong in production and weak in marketing, then the possibility of organizational learning is strong.
6. Such explanations as the above need to be supplemented by the identification of motivations that stem from political agendas within firms. There must also be a political motive for the alliance, perceived by a coalition of the company's key decision-makers. In the absence of corporate champions able to focus such a coalition towards cooperative action, the motives for the formation of strategic alliances may be insufficient to lead to their creation.
7. The motivation to cooperate remains high even when the alliance has exposed the partners to the temptation to steal each others' secrets and run, so long as the alliance is of indeterminate length, the penalties for defection are high, and reputations matter.
8. Skill substitution and learning are two distinct rationales for alliance formation. The former aims at meeting a need in the short term, whereas learning aims to develop competencies for the longer term.

## 5.7 Questions for discussion

1. Can rationales for alliance formation be mixed or must they always be either learning or skill substitution?
2. Are there any other motives for alliance formation other than those listed above?
3. What should be done if needs are not reciprocal between potential alliance partners?
4. What partner actions most threaten the survival of an alliance?
5. How does the resource-dependence perspective illuminate motives for alliance formation?

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# 6 Partner and form selection

## 6.1 What this chapter covers

This chapter considers the critical issue of what sort of company would make a good partner. It notes that most companies are able to assess their prospective partners in terms of the complementarity of their assets and skills and the possible synergies that arise as a result of them. Few, however, devote sufficient attention to the cultural compatibility between the partners. Yet this factor is often responsible for the breakdown of alliances. Having dealt with the issue of how to choose a partner, the chapter then deals with the selection of an appropriate form of cooperation.

## 6.2 The alliance imperative

Richardson (1972), in an early article on the importance of cooperation in the organization of industry, emphasizes that a major reason for its growing importance is the increasingly specialized nature of needs. Whereas, he suggests, it can safely be left to a market to coordinate supply and demand when large numbers of relatively undifferentiated products are bought and sold by large numbers of economic agents, this is not the case when small numbers of buyers and sellers deal in highly differentiated products. In such cases both buyers and sellers need to match their production and purchasing plans, and this sets the scene for cooperation. As Adam Smith and Alfred Chandler might have agreed, the 'visible hand' replaces the 'invisible hand'. A further need for cooperation comes about in Richardson's view when an economic agent seeks in Ryle's concept (1949: ch. 2) 'knowledge how' as opposed to merely 'knowledge that'. 'Knowledge how' is difficult to communicate through the relationshipless mechanism of the market.

Cooperation then is becoming more and more necessary but how does one select a partner? It follows from what has already been said about the importance of trust, and the bases on which it can be created, that the choice of partner is key to the ultimate success of a joint enterprise. This is an issue which is difficult to research by means of interviews or questionnaires, since partners in an existing alliance are unlikely to express doubts over their choice of partner, whatever the reality of the situation. Considerations of which partner and what form of cooperation appear to provide the best chance of success are the closing issues in the first phase of the alliance process. The decision having been made by (or forced on) the focal firm, the choice of contractual or equity alliance (and the details within each of these broad categories) and the choice of which of the prospective partners will be most compatible together move the process toward the critical transactional step of one-on-one negotiation. At this point, transaction-specific investments of time, money, and effort increase dramatically, as do the pressures to close a deal successfully, and the risks of a badly structured deal or poorly chosen partner climb. Bargaining and negotiations are critical to a strong alliance, and may result in changes to the initially preferred form, but choice of partner is difficult (and costly) to reconsider, plays a large part in the eventual success of the negotiation of the deal, and ultimately a poor selection cannot be corrected by the structure of the deal.

Porter and Fuller (1986) identify six criteria by which they believe the appropriateness of an alliance partner may be judged:

1. *Possession by the partner of the desired source of competitive advantage*. By this Porter and Fuller mean that the partner should have the requisite scale, technology, market access or other contribution to give the coalition the competitive advantage that neither partner possesses alone.
2. *The need for a complementary or balanced contribution from the partner.* Porter and Fuller should perhaps have written 'and' not 'or' before 'balanced', since it is probably necessary that the partners are both complementary in their contributions, but also are roughly similar in size or strength so that the partnership is one of equals and not dominated by one or the other partner.
3. *A compatible view of international strategy.* If one partner is intent on concentrating in one trading area, this must be acceptable to the other. Their attitudes to the international coordination and configuration of their joint enterprise must also be congruent.
4. *There must be a low risk of the partner becoming a competitor.* This criterion is often ignored, however, as many alliances are set up between competitors. Examples are Toyota and GM with their American JV NUMMI and, as discussed in Chapter 5, Rover and Honda. Clearly such potential future competitiveness does not preclude the possibility of a successful alliance. It does, however, make the ever-present tension between the need to cooperate and the urge to defect and fight one's erstwhile ally more of a problem to the establishment of trust and commitment than it would be in an alliance between partners cooperating at different points in the value chain. As Chapter 2 noted, the dilemma of cooperation versus competition can be *elucidated by game theory.*
5. *The partner has preemptive value in relation to rivals*. Setting up an alliance with the partner would thus undermine the range of apparent strategies of competitors.
6. *The partners' organizational compatibility is high*. This criterion, in Porter's and Fuller's view, reduces the probability of future problems due to cultural conflict.

Lorange and Roos (1992: 30) take a similar view to that suggested by criteria 1 and 2 above:

> The business that each party brings into the strategic alliance should also be assessed in terms of its strength relative to its competition. Is it an established leader? Or is it more a follower, behind its

competition and in need of catching up? . . . What are the broad readily apparent benefits from this strategic alliance for each partner? How can the two parties complement each other to create common strengths from which both can benefit?

Bleackley (1991: 49) also notes:

The choice of a partner has to be more than just a good idea: It is imperative that, when evaluating potential partners, companies must consider the reasons why the partner would itself wish to enter into an alliance and how it could enhance the partner's strategic position.

It is important that both partners not only complement each other, but actually need each other. If this is not the case, the one with the lesser degree of need is likely to become aware of this, and exploit its power to the detriment of the alliance. If the need is all one-way, then the deal is best handled by a unilateral arrangement in which money rather than an alliance completes the transaction. Thus if Company A needs Company B's technology but Company B has no matching need for anything Company A has to offer, then Company A should pay Company B a royalty, plus a per diem for technological advice to effect the technology transfer, if Company B is willing to do business. A key issue is therefore to identify the level and nature of the companies' respective expectations from each other before the alliance is concluded. Bronder and Pritzl (1992: 417) further extend the questions to be addressed in the partner selection process:

A win-win situation from which both partners benefit is an ideal supposition. . . . What are the risks associated with realizing these potentials within a reasonable time frame? What are the sources of these risks? Is our partner really interested in the alliance or is he planning a hidden take-over? How stable is the business environment and the industry? Can we expect fast changes that might lead to an immediate exit of our partner? What is the influence of parent companies?

Kanter (1994), while approving of the complementarities theme, takes a different approach to the partner-selection process. She, like many others before her, likens the process to the personal-relationships courtship ritual. If it is like that, she argues, then it is driven by emotional attachment as much as by cold-blooded analysis. The selection process therefore needs three fundamental factors to fall into place for an alliance to be concluded:

1. *Self-analysis*. Relationships benefit when the partners know themselves. It is also important that they are sufficiently experienced to be able to assess each other's qualities fairly accurately.
2. *Chemistry*. Deals often turn, she stresses, on the rapport between chief executives, and it is equally important that the executives from the two companies further down the hierarchy get on well.
3. *Compatibility*. The courtship process tests companies' cultures, their philosophies, and fundamental ways of doing business. It is vital that these be broadly compatible between the companies, if they are to work closely together.

Geringer (1991), while also stressing the importance of the complementarity of assets, provides a more complex view of the appropriate determinants of partner-selection criteria, particularly in relation to IJVs. He first distinguishes task- and partner-related dimensions of selection criteria, and argues that 'the relative importance of task-related selection criteria is determined by the strategic content of the proposed IJV and the parent firms, specifically the critical success factors of the venture's competitive environment and the parents' static and dynamic position in relation to these factors' (Geringer 1991: 45). Geringer examined previous research on the selection of IJV partners, which he concluded was vague regarding selection criteria. As a clarification, he distinguished between two categories of selection criteria. 'Task-related' criteria are those which 'refer to those variables which are intimately related to the viability of a proposed venture's operations' (Geringer 1991: 45), and include features such as access to finance, managerial and employee competencies, site facilities, technology, marketing and distribution systems, and a favorable institutional environment or a partner's ability to negotiate acceptable regulatory and public policy provisions. By contrast, 'partner-related' criteria refer to those variables which characterize the partners' national or corporate cultures, their size and structure, the degree of favorable past association between them, and compatibility and trust between their top management teams.

Geringer's second contribution lies in the development of a contingency-based conceptual scheme for explaining the weighting of task-related selection criteria. Here he advances three criteria associated with a parent firm's strategic intent:

1. the extent to which the dimension is perceived to be critical to the venture's performance.
2. the parent's existing strength in the critical success factor dimension in question.
3. the anticipated future level of difficulty likely to be encountered in internal efforts to achieve a viable competitive position in relation to the critical success factor.

Geringer's empirical research suggested that parent companies' evaluations of selection criteria typically involved analysis of both their firm's current and future competitive position in relation to achievement of a full set of critical success factors relevant to their target area of competition. Geringer thus emphasizes the importance of the critical success factors in the area to be attacked and a partner's specific weakness in relation to some of them as key determinants of the type of partner sought in a JV.

A number of observations can be drawn from Geringer's work and that of others on partner selection. The relative importance of a given task-related criterion appears to depend on the partner's perception of how crucial the feature is for the cooperative venture's performance, how strong is the partner's ability to provide or gain access to the feature, and how difficult the partner thinks it will be in the future to compete in terms of the feature. If, for example, a company perceives technology leadership to be crucial for the venture's performance (and indeed its own), but that it cannot provide this on its own, it will logically give high priority to finding a partner with which an alliance will be capable of securing that leadership.

The selection criteria applied by partners to an alliance between firms from developed and less developed countries tend to differ quite clearly. The former are generally oriented towards market access and accommodation to governmental regulations which may restrict that access to firms which invest directly in the country. Low-cost production and access to scarce materials are also sometimes priority criteria for firms from developed countries. The latter group normally seek access to technology, know-how, managerial expertise, capital, and international markets.

A useful tool for identifying asset and capability complementarities is the make–buy–ally (MBA) matrix, illustrated in Figure 6.1 below. This assists a company's management to determine how best it should carry out particular activities. The two axes measure dimensions of the relative competencies of firms needing to carry out specific activities, and the strategic importance of particular activities to the competitive success of those firms.

The following thinking informs the matrix. All companies, even the largest, have finite and therefore scarce resources. It is therefore critical that available resources are internally deployed on strategically significant activities. Very few companies make their own travel arrangements, for example. They subcontract them to a travel company who can then take advantage of scale economies and the experience curve to provide a better and cheaper service than the company could, if it were to carry out the activity itself. It is also doubtful if it is wise to carry out activities in which the company shows little expertise or skill.

Thus, if the activity is of little strategic significance to the company, it should be bought in, even if the company would be very proficient at carrying it out itself. It is not the best use of its scarce resources. If, however, the activity is fairly-to-very strategically significant, and the company carries it out very well, this activity should be performed internally. If the activity is very strategically significant, and the company performs only fairly well, it should invest to improve its performance in the activity. If, however, the activity is fairly-to-very strategically significant, and the company performs it moderately to poorly, an alliance may be needed to enable the company to learn the necessary skills to improve its performance in the activity.

Of course, if there are doubts regarding the company's core business and some claim within the firm that activities in which it is acknowledged to be excellent might actually be of high rather than low strategic significance with a change in business focus, then the matrix cannot help much. A strategic debate needs to take place and be resolved on the issue 'What is our core business and hence our strategic core competencies?'

The operational value of the above schema depends on how accurately it is possible to measure strategic significance and efficiency of performance and on an agreed corporate view of the company's mission and scope.

| *Strategic importance of activity* | | | | |
|---|---|---|---|---|
| | High | Ally | Invest and make | Make |
| | Medium | Ally | Ally | Make |
| | Low | Buy | Buy | Buy |
| | | Low | Medium | High |
| | | *Competence compared with best in market* | | |

**Figure 6.1** The make–buy–ally matrix.

The horizontal axis is relatively easy to measure. Benchmarking activities against those of competitors should give a reasonable measure of a firm's relative competence in a particular activity. Measuring strategic significance is, however, much more difficult. Perhaps the key measure is whether the activity is important to the achievement of competitive advantage. Hence, when Apricot, a computer hardware company, subcontracted all its manufacture to Mitsubishi in 1988, it was taking a large strategic risk, as it was consigning the production of items upon which its reputation depended to a company it did not control. The outcome was that Mitsubishi ultimately bought the whole of Apricot's hardware business in 1989, leaving the company to operate independently only in software. On the other hand, Dell Computers makes virtually none of the parts that it assembles into personal computers, but relies on an extensive network of suppliers to provide what have become commodity parts. Dell's competitive advantage lies in its efficient logistics and branding, not component manufacturing.

Tonka Toys is an illustration of a company that subcontracts all its production. It might be thought therefore that, like Apricot, it is putting out a strategically significant activity and thereby making itself vulnerable. However, the company is basically a product selection and marketing company, so the risk is less, since Tonka's competitive advantage lies in the selection of particular toys and their brand marketing.

In selecting a strategic alliance partner, both firms need to complete the matrix noting which activities fall into the ally 'L' shape on the matrix. If their prospective partner's ally 'L' activities are counterbalanced by an appropriate one in their own 'make' inverted 'L' then synergy exists between them. Thus in Rover's MBA matrix manufacturing quality was in its top-left-hand box but in Honda's top-right-hand box; thus Honda could help Rover improve its quality significantly. This is not yet enough for an alliance. However, Honda's top-left-hand box contained the styling skills necessary for European entry and this corresponded with Rover's styling skills being in their top-right-hand box. This configuration of MBA matrices provided the basis for an alliance that came to involve mutual learning at its core.

## 6.3 Partner selection

The two basic qualities sought in a partner are contained in the simple terms:

1. Strategic fit,
2. Cultural fit.

This can be illustrated on the matrix shown in Figure 6.2. The optimal alliance partners will be in box 2. By contrast, partners in box 4 have little chance of being successful. They have no obvious way of achieving competitive advantage in the markets in which they operate, and their cultures are likely to clash. Partners in box 3 are unlikely to do much better, since, although they may get on well together, their lack of strategic fit will limit their market effectiveness. Box 3 is particularly enticing to firms with existing relationships as parts of broader networks with multiple connections and high levels of mutual trust—but perhaps little strategic fit. Box 1 represents a good strategic fit, through which

| Strategic fit | | Cultural fit: Low | Cultural fit: High |
|---|---|---|---|
| | High | Box 1<br>Many start here | Box 2<br>Optimal |
| | Low | Box 4<br>No point | Box 3<br>No competitive advantage |

**Figure 6.2** The strategic fit–cultural fit matrix.

partners have the incentive to work on their cultural differences and reduce the potential conflict in this area. In highlighting the main issues of appropriate partner selection, however, the above matrix also raises the question of how the factors comprising strategic and cultural fit are to be identified.

## 6.3.1 Strategic fit

The fundamental issue in assessing strategic fit is whether the joint value chain of the partners seems likely to achieve sustainable competitive advantage for the partners. This can be assessed by means of the MBA matrix described above, and in addition by use of Porter's (1985) value-chain tool for company internal analysis. If the answer is that the companies are indeed complementary in asset and capability terms, then the problem of how to set up the alliance should not prove too intractable. If competitive advantage from the joint value chain seems unlikely, then the success of an alliance would be doubtful regardless of its nature and form. The two aspects of the individual value chains to be sought are complementary assets, and potential synergies (Porter and Fuller 1986; Lynch 1990; Bleakley 1991; Lorange and Roos 1992; Madhok and Tallman 1998). Both are necessary for success but each insufficient by themselves. Two partners may have complementary assets; for example, one may have good products and the other an efficient sales force. But unless these strengths are sufficiently synergistic to beat the competition, success cannot be expected. Similarly two management teams may display synergistic working methods, but without complementary assets the alliance is likely to have problems settling the issue of who does what, and how the joint organization is to function. Thus, Nissan was known for efficient manufacturing and solid engineering, while Renault had superior design, marketing, and component purchasing and stronger financial management at the start of their alliance, and the two firms have been able to both learn from each other and combine for major savings and market power in subsequent years.

Given synergies between the companies and complementary assets, the potential for achieving competitive advantage will be strong. This will not, however, necessarily guarantee a successful and enduring alliance. For this, the balance of need between the partners must be similar in strength, although it will probably differ in nature (Bleeke and Ernst 1991). Otherwise the alliance will tend towards one-sided dependency (Bertodo 1990). As noted in Chapter 5, resource dependence of one form or another is often a significant factor in bringing the partners together. One partner may have only moderate need of some of the other's resources or skills, but be quite capable alternatively of buying them in the market, if the alliance runs into difficulties. However, the other partner may have urgent need of partner one's resources. In this case, partner two will become excessively dependent on partner one, and this will adversely affect the power balance within the alliance. In the Rover–Honda alliance, the partnership's architect Bertodo (1990) was always afraid that the relationship would, as he put it, fly off into a centrifugal orbit in that Honda would become independent and no longer need Rover in Europe, or a centripetal one in that Rover would become too dependent on Honda and lose its autonomy. In fact Rover was ultimately sold to BMW and so lost its autonomy anyway.

Such a power imbalance may arise if partners are of a significantly different size or, as Bleeke and Ernst (1991) suggest, if one is strong and the other weak. Cooperation between a very large and a very small partner is unlikely to be successful in the long term as an alliance, although of course it may lead to competitive advantage and eventually to the more powerful partner buying the less powerful one on terms acceptable to both, as happened when Mitsubishi Electric bought Apricot Computers, its UK partner, in 1989. On the other hand, a difficult or less important market may be served by an alliance for a long period, as Robins et al. (2002) found in Mexico. They found U.S. based firms that were very happy with long-term (ten or more years) cooperative relationships with Mexican partners, both equity and contractually based.

A further criterion of strategic fit is that both partners must supply a deficiency in the other's resources, skills, or other qualities. There is no strategic fit, for example, where one partner has good products but is resource dependent for marketing skills, and the other partner is cash rich, product deficient, but also lacks marketing strength. In this set of circumstances the first mentioned company should probably seek a different partner with strong marketing ability, which also values access to its products, or it should seek to strengthen its marketing by external recruitment. The second mentioned company might consider an acquisition to deploy its financial strength most effectively. Robins et al. found that successful partnerships combined strategic resources from the American partner with locally derived capabilities in such areas as labor markets, political connections, and marketing expertise on the part of the Mexican partner. This study also found that strategic success required that the alliance entity itself (whether an independent equity venture or a contractual quasi-organization) develop competencies in daily operations, such as sourcing inputs or managing people.

An important condition for continuing success in an alliance is that the long-term objectives of the partners do not conflict (Spekman and Sawhney 1991). This does not mean that they need to be identical, an unlikely scenario where two or more companies are determined to retain their separate identities. Thus in an alliance one company may be concerned to develop its technology worldwide, while the other wishes to economize on R&D expenditure by employing the partner's technology on developing its local market. There is no conflict in this. However, if both wish to develop globally, yet the one importing the technology has limited itself at the outset to being a local partner, future conflict will be difficult to avoid. This was the case when Courtaulds Coatings, a worldwide player and indeed market leader in marine paints, set up an alliance in Japan with Nippon Paint, at the time number four in market share in the Japanese domestic market. The agreement was limited to Japan, with the contractual clause inserted by Courtaulds that Nippon agree not to compete with Courtaulds in the rest of the world. The alliance was very successful in Japan, and Nippon rose to number two in Japanese market share; whereupon its global ambitions increased and the partners' corporate objectives ceased to be congruent. This caused severe problems to the future of the alliance, and led both companies into an extended phase of renegotiation. In the same way, Fuji-Xerox, a JV of Fuji Film and Xerox Corp. was originally restricted to selling in East Asia and the Pacific Basin, even as its small copiers became very successful—indeed, sales of small copiers licensed from Fuji-Xerox were critical to the parent company. Fuji-Xerox felt that they could be a dominant player in the small copier market, even against their local rival Canon, if permitted to sell into a world market, so the restrictions created considerable friction between parent and JV. These examples illustrate the fact that a strategic fit present when an alliance is set up may not endure several years on.

To summarize, a good strategic fit is likely to involve partners of similar size and/or strength, with a similar degree of mutual resource or skill need, and with congruent or at least not overtly conflicting objectives, possessing such complementary assets and potential mutual synergies as are likely to enable them to achieve and retain competitive advantage through optimal use of their joint value chains over at least the medium term. A good strategic fit without an evolving cultural fit leads to a 'technological trap', though, in which the firms stick together despite suboptimal results driven by a bad relationship, never escaping Box 1.

## 6.3.2 Culture fit

It is possible that an alliance will show tangible results, justifying itself unconditionally on the grounds of meeting its declared objectives, but will still be in danger of foundering, owing to friction between the partners. This demonstrates the importance of cultural factors in the smooth running of an alliance (Kanter 1989; Lorange and Roos 1992). It is not necessarily important, as we emphasize in Chapter 15, for the cultures of the partners to be similar. If it were, few alliances would succeed, since cultural similarity between companies is extremely rare, especially between partners from different nationalities. Also, since organizational learning is a key to successful alliances, companies that are too similar are unlikely to have much to learn from each other. However, an attitude of understanding of cultural differences, and a willingness to compromise in the face of cultural problems, may well be vital to alliance effectiveness. A consistent finding in JV studies is that incompatible and immutable cultures are the cause of many alliance failures (Pothukuchi et al. 2002). The factors of strategic fit are more likely to be measurable and apparent, and equitable terms more negotiable in this area. Cultural differences are hard to identify with precision, are easy to see as open to change with greater familiarity, and may well be covered up by the personal chemistry of the negotiators (a reason why internal champions in the partners are so important to alliance success).

The culture of a company inheres in more than just its systems and structures (Hampden-Turner and Trompenaars 1993). Waterman et al. (1980) with their 7 S model of a firm, which describes the seven aspects of an organization they believe are key, demonstrate that there is more to a firm than the 'hard' factors of strategy, structure, and systems. Its style, the nature of its staff, its skills and perhaps above all its superordinate goals are equally important in contributing to the evolution of its culture. A culture web of the type depicted by Johnson and Scholes (2003) in which a central corporate paradigm is encased in a set of dimensions including symbols, power structures, organization structure, controls, rituals and routines, and stories may be a valuable device for revealing the cultural characteristics that lie behind the way a company operates. If prepared for both partners, it can reveal possible sources of future cultural conflict in the absence of mutual adaptation. Figure 6.3 illustrates the cultural web of a UK clearing bank in the eyes of some of its managers, as described at a training course run by Faulkner.

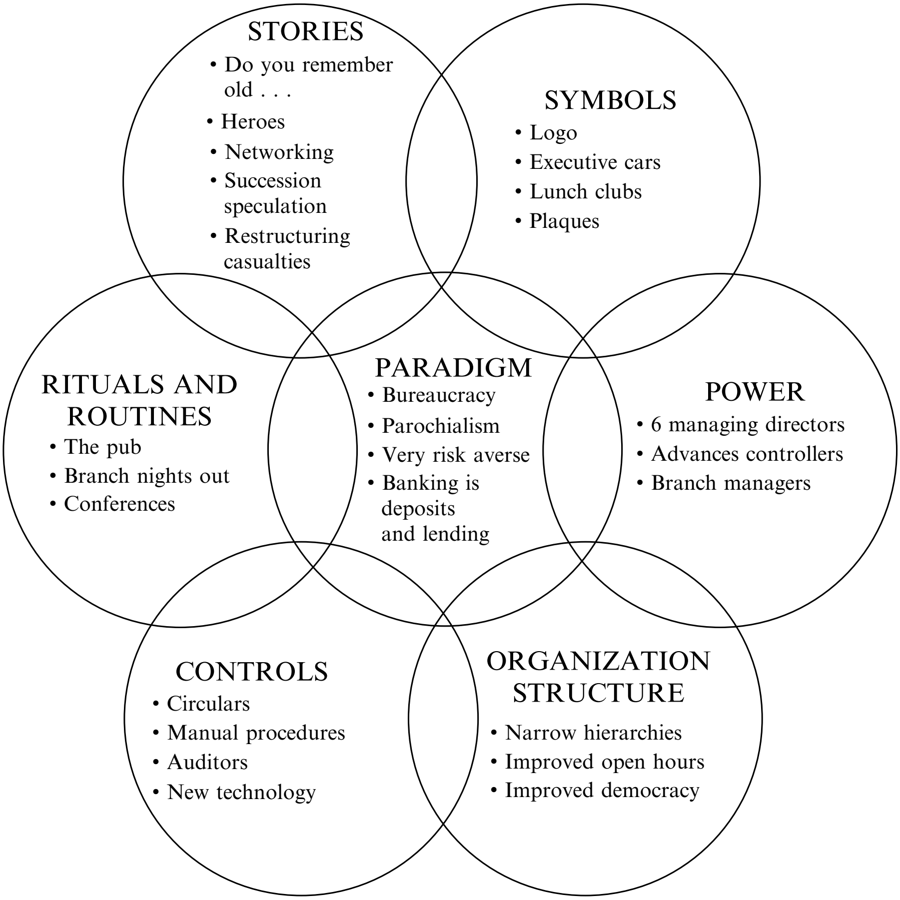


**Figure 6.3** The culture web of a UK clearing bank.

*Source*: Adapted from Johnson and Scholes (2003).

Bronder and Pritzl (1992) suggest a further way of assessing cultural fit, which is illustrated in Figure 6.4. This spider diagram develops a profile of both companies that is overlaid the one on the other to show clear areas of potential cultural conflict. The areas of culture selected by Bronder and Pritzl are employee orientation, environmental orientation, international orientation, customer orientation, technology orientation, innovation orientation, cost orientation, and quality orientation. Clearly the importance of these factors will vary by industry and other contingent circumstances, but a clear difference between the profiles of two prospective partners on any of these dimensions would raise an issue.

Buono and Bowditch (1989) suggest a number of alternative reactions on identifying areas of potentially conflicting cultural orientation:

1. *Cultural pluralism*. The two distinct cultures may be allowed to exist next to each other.
2. *Cultural assimilation*. The positive aspects from both cultures can be combined to form a new culture over a period of time.
3. *Cultural transfer*. One partner may attempt to transfer its culture, as both partners regard it as the stronger culture and the more likely to be successful in the competitive market.
4. *Culture resistance*. The cultural differences may be ignored and a strong 'us and them' attitude will develop to the detriment of the smooth working of the alliance.

When ICI Pharamaceuticals set up a JV with Sumitomo Chemicals to manufacture and market some ICI drug products in Japan, strategic fit clearly existed between the companies, but the cultural fit and cultural sensitivities were not present and the venture was

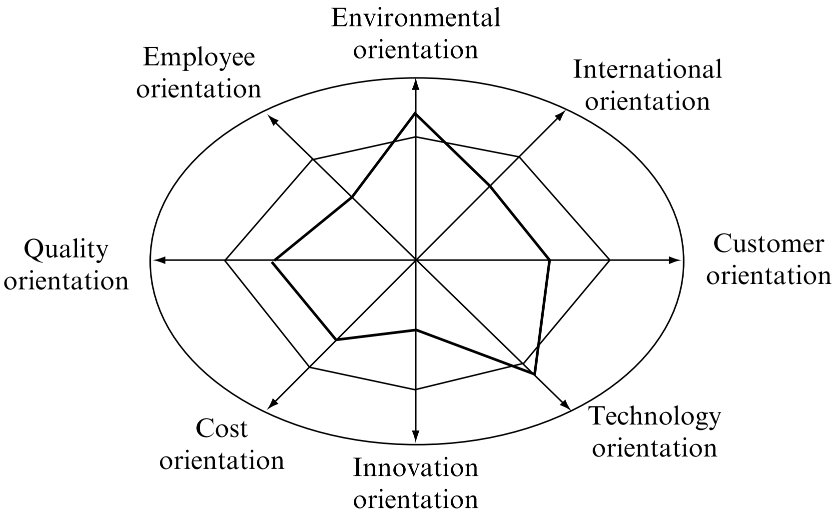


**Figure 6.4** The cultural profile.

*Source*: Adapted from Buono and Pritzl (1992).

only a limited success. Similarly the Dowty Group created a JV with the Sema group to bid for Ministry of Defence command and control projects. A considerable amount of work was won, but little profit was made as the cultural incompatibilities of the Dowty 'harbourmasters' and the Sema software 'techies' limited the company's ability to produce to time and at cost and hence achieve budgeted profit. The cultural divide between the visionary 'techies' of Pixar and the 'Hollywood types' at Disney was as important to the split of that highly successful alliance as any financial factors.

Of course, if no more than a short-term relationship is expected, dealing with a transitory situation, and it is envisaged that the alliance will eventually be resolved by merger, or dissolution, then cultural fit is less necessary, and a regime of mutual caution, and detailed adherence to closely negotiated contractual arrangements, may well be the most appropriate policy. However, if the alliance is intended to be long term, compatible cultural attitudes assume greater significance, especially in respect of flexibility towards cultural differences, an eagerness to learn from a partner different from oneself, and strong commitment and mutual trust between the partners. However, firms must avoid 'relationship traps' in which they ally with firms in their own social networks in order to foster or take advantage of existing relationships but with little strategic basis.

### 6.3.3 The ideal partner

The motivations for setting up alliances appear to stem principally from feelings of resource and skill inadequacy in the face of the challenges presented by an increasingly global market affording scale and scope economies, but requiring ever higher investment. Clearly globalization is a key factor at this point in business and economic history. It is of course in an overall sense only a special case for determining alliances. The general motivating case can be stated in the form: if the skill and resources are perceptibly less than those required to meet a challenge or opportunity most effectively, and the prospective partners appear to be able to supply each others' deficiencies, then there is a motivation to form an alliance to supplement those skills and resources.

Thus firms tend to seek a partner whom they perceive to have complementary assets from which synergies can be realized. They prefer firms of similar size and stature, in order to minimize the risk of domination, avoid excessive dependence, and to achieve an equitable balance of benefits. They do not so frequently consider compatible cultures as key criteria in partner selection (Faulkner 1995), but, to the degree that this aspect of a potential partner is ignored, the probability of future interorganizational problems is increased. This chapter has thus far discussed some criteria for choosing partners, concentrating on those which have strategic fit, and those whose cultural sensitivities are such that they can reasonably be expected to develop cultural fit. Once a partner has been found, however, there is a need to agree on the best form for the alliance to take.

## 6.4 Forms of cooperation

Although, as illustrated below, many writers have addressed the question of how to classify the different types of cooperative agreements, the classifications that have emerged from their deliberations have varied widely and few have successfully met the accepted taxonomic principles of mutual exclusivity and parsimony. Furthermore, little empirical work has been done relating circumstance to choice of appropriate alliance form and ultimately to performance. This part of the chapter outlines the nature of a number of cooperative arrangements, suggests a robust taxonomic approach to alliances, and proposes situations in which the major alliance forms may most appropriately be adopted.

Interorganizational forms are defined in a wide variety of ways in the literature. Porter and Fuller (1986) talk of 'international coalitions', while Oliver (1990) dubs such arrangements IORs (interorganizational relationships), a term also used by Ring and Van de Ven (1994). Jarillo (1988) uses the term 'strategic networks', while Miles and Snow (1986) choose 'dynamic networks' as their descriptive term. Borys and Jemison (1989) talk of 'hybrid organizational arrangements', while Kanter (1989) coins PALS (P–pools resources, A–ally, L–link systems). Perlmutter and Heenan (1986) talk of 'industrial systems constellations' and Ulrich (1983) has MOEs (multiorganizational enterprises). There are also the ubiquitous 'strategic alliances' and 'joint ventures', frequently used interchangeably, and of course the Japanese have their 'keiretsu', and the Koreans their 'chaebols', hub and spoke subcontracting systems developed around the major manufacturing and other corporate giants.

Cooperative arrangements are characterized neither by fully market-dominated relationships, nor by the organizational hierarchy characteristics of fully merged companies. In relation to Williamson's dichotomy (1975) of markets and hierarchies, Powell (1990: 296) explains:

> Transactions that involve uncertainty about their outcome, that recur frequently and require substantial transaction specific investments of money, time or energy, that cannot be easily transferred, are more likely to take place within hierarchically organized firms. Exchanges that are straightforward, non-repetitive and require no transaction specific investments will take place across a market inter-face. Hence, transactions are moved out of markets into hierarchies as knowledge specific to the transaction (asset specificity) builds up. When this occurs the inefficiencies of bureaucratic organizations will be preferred to the relatively greater costs of market transactions.

However, there are many intermediate points between markets and hierarchies, as Thorelli (1986) points out. He suggests that, for networks or alliances to come about, there needs to be at least a partial overlap between some of the dimensions of the partners' corporate domain—that is, product, function, clientele, territory, or time: 'The network can be viewed as an alternative to vertical integration and to diversification, and as an instrument for reaching new clientele and additional countries' (Thorelli 1986: 46). Following this lead, Osborn and Baughn (1990) classify international alliances as market-dominated contractual agreements and quasi-hierarchical EJVs. Tallman and Shenkar (1994) make a similar distinction. Intermediate forms may be assumed to exist, due to what Masten (1984) calls their 'differentiated efficiency' as organizational forms.

When an enterprise starts up in business, it initially purchases its supplies in the market. In this sense a market is defined as a transaction in which there is no future obligation between buyer and seller, and no relationship beyond the spot transaction. However, arm's-length market relationships frequently develop into established suppliers and distributors as the entrepreneur continues in business. In such circumstances relationships do develop, and future expectations come about between the transactors. If the relationship is satisfactory, each builds the other into their plans for the future, and they begin to discuss how they can do more business together. This may be as far as matters go.

In some instances an even closer relationship develops both between the two operators and others at different points in the value chain and value system in which they are located. This takes on the nature of an equal-partner network that can be operationalized by any member wanting to embark upon a project needing the skills of network members. The relationship is normally informal and does not actively extend beyond the project in hand. However, members are always there, available for future projects. Many small management consultancy networks operate in this fashion. In a network each member has immediate access to specialized skills and competencies to meet special situations, without the need to meet the overheads involved in developing the competencies internally. As Powell (1990: 303) comments:

> The basic assumption of network relationships is that one party is dependent on resources controlled by another, and that there are gains to be had by pooling resources. [On the other hand] all the parties to network forms of exchange have lost some of their ability to dictate their own future and are increasingly dependent on the activities of others.

Further up the ladder of integration are the closely knit subcontractor networks like the Japanese keiretsu, or, nearer home, the close relationships Marks & Spencer has with its suppliers. In the latter, annual prices are determined so as to give the supplier an acceptable margin, product is scheduled over a long period and delivered as required, and very demanding inspectors are introduced by Marks & Spencer into the supplier firm to ensure product quality. Such systems are described as dominated networks in Chapter 8, as they are normally dominated from the centre by the brand-name company.

Licensing agreements come next in degree of integration. In such agreements the relationship between the licensor and the licensee is integrated from the viewpoint of activities in a defined area, but both retain their separate identities and ownership. Licensing arrangements vary in nature considerably. A franchise is a form of licence in which the licensee takes over the personality and brand of a brand name normally for a specified geographical area. The licensor provides such support as marketing and training. The licensee agrees to present the licensor's product in a way specified by the licensor and pays royalties on all sales. Other licences may be less onerous than franchises and will include varying degrees of exclusivity with regard to competition in an area.

In terms of levels of interdependence a new form of network is currently manifesting itself, that of the virtual corporation also described in Chapter 9. This form has come about as a result of the information revolution, and is composed of activity performers linked by various types of information software. Each activity is normally separately owned, but the configuration of the virtual value chain enables the virtual corporation to present itself to customers as an enterprise able to deliver packages of goods and services competitively with those of more traditional corporations.

Between virtual corporations and traditional hierarchies, where rule by price (markets) is replaced by rule by fiat (hierarchies), comes the most integrated form of rule by 'adaptive coordination' (Johanson and Mattsson 1991)—namely, that found in strategic alliances. This form differs from all other forms of cooperative agreements in that its fundamental purpose is that of organizational learning. All other forms of cooperation have as their base the fact that each partner is regarded as competent to carry out a specific function, and owes its place in the network to this perceived competence. There is no assumption that one partner will attempt to become competent in the skills provided by another. In the strategic alliance there is just such an assumption. Indeed the least successful alliances are those where skill substitution is the limit of the relationship. In the most effective alliances both or all partners grow in competencies as they learn from each other.

Figure 6.5 illustrates the two basic motivational drives that lead to different cooperative forms: those that seek organizational learning, and those that aim at skill substitution, as described in Chapter 5. This chapter deals with the learning forms—that is, alliances—while Chapters 8 and 9 deal with skill-substitution cooperative forms.

### 6.4.1 **Alliance forms**

After the decision has been taken to form an alliance, and a partner chosen, the selection of an appropriate form is an important element in the design of the alliance. The forms of alliance may take a variety of different configurations, and are defined in different ways by different researchers. There are technology-development coalitions, marketing and distribution agreements, operations and logistics coalitions, single-country and multi-country alliances, JVs creating a daughter company from two or more parent partners, minority share exchange agreements, licensing agreements, and no doubt others.

Ghemawat et al. (1986) attempt to classify all alliances as either *x*—that is, vertical coalitions, alliances between partners carrying out different activities in the value chain—or *y*—that is, horizontal coalitions, partners carrying out the same activity in the value chain.

In addition there is a third variety of alliance within this basic concept—that is, 'the diagonal alliance' (Bronder and Pritzl 1992), which applies to cooperative activity between companies in different industries. However, the concept of industry is a difficult one here. In the Dowty–Sema JV, for example, the Dowty Group is in the engineering

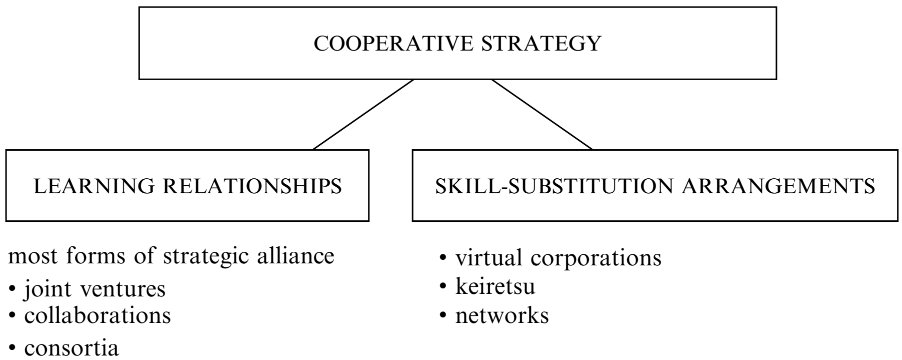


**Figure 6.5** The two fundamental motives for cooperative strategy.

industry, and Sema in the software industry, yet from a different viewpoint both are in the defence industry. Allocation of an industry to a company or an alliance may be more perceptual than objective.

Ghemawat et al. (1986) classify strategic alliances according to their legal nature (JVs; licences; supply agreements) and also according to their functional areas of concern (technological; operations and logistics; marketing, sales, and service). However, an alliance may typically be a technological one from the viewpoint of one partner, yet a market-access one from the viewpoint of the other.

Pucik (1988) notes that in the past alliances were mainly concerned with reducing capital investment needs, and lowering the risk of entry to new markets. While these motivations are often still present, the dominant emphasis has shifted currently to taking advantage of the increased speed of technological change, and adjusting to the rapidly growing competitiveness of global markets. However, the one motivation will no doubt relate to one partner, but the other partner may have quite a different one.

The types of alliance in Pucik's classification are:

1. alliances for technological change reasons, for example, cross-licensing;
2. co-production and OEM agreements;
3. sales and distribution ties;
4. joint product-development programmes;
5. the creation of joint ventures.

All have the aim, he states, of 'attaining the position of global market leadership through internalization of key added value competencies' (Pucik 1988: 78).

Kanter (1989) identifies three fundamental types of alliance:

1. multicompany service consortia, for example, for R&D;
2. opportunistic alliances set up to take advantage of specific situations, that is, most joint ventures;
3. stakeholder alliances: these are what other researchers refer to as vertical alliances, or alliances between companies at different parts of the value chain, for example, supply/producer complementary coalitions.

Consortia, she notes, try to achieve the benefit of large-scale activity by pooling resources. For example, the Micro-electronics and Computer Technology Corporation (MCC) was set up in the USA to compete with the Japanese in R&D. These alliances are very popular in new technology areas, between companies that are normally competitors. They often founder though, she states, as a result of a low level of commitment by their members, and from having mediocre seconded staff. Opportunistic JVs are, she believes, the most unstable of alliance forms. Each partner supplies the competencies that the other lacks. The principal driving forces are technological transfer and market access. However, due to their opportunistic nature, these alliances find difficulty in achieving the necessary robustness when circumstances change, especially if they change asymmetrically for the parties. Stakeholder alliances institutionalize previous interdependence, and are often quality or innovation driven. That is, a firm treats a supplier as a partner in order to increase quality and cement the alliance. These alliances should be stable, as they have high commitment and little competition. Kanter's taxonomy does not necessarily involve mutually exclusive categories of alliance, since, for example, any one alliance might be an opportunistic vertical consortium. Airbus Industrie and other combinations are cases in point.

Collins and Doorley (1991) identify six forms of alliance:

1. strategic partnerships between large companies, for example, GM and Toyota, or ICL and Fujitsu;
2. collaborative R&D alliances;
3. relationships with suppliers especially for just-in-time (JIT) purposes;
4. venture-capital-backed joint ventures normally in new technology areas;
5. value-added distribution alliances, customizing for local markets;
6. partial mergers, often in mature markets to organize phased withdrawal from a market by one partner.

This categorization, while ingenious, might also involve alliances that fall into several categories at the same time, a cardinal sin for taxonomists.

Cravens et al. (1996) have developed a classification of wider cooperative forms which they present as a matrix with volatility of environment as one axis and degree of collaboration as the other. This is shown in Figure 6.6. The four types of networks, as they call them, are hollow networks, flexible networks, value-added networks, and virtual networks.

Volatility of environmental change implies characteristics such as speed, degree, unpredictability, and uncertainty of radical change in the markets addressed. The hollow network is a largely transaction-based network of the kind that is addressed in Chapter 8 of this book. It is largely transaction based and therefore not a true alliance, and relies heavily on other organizations and individuals to carry out many of the functions necessary to present its offering to the customer. It represents a buffering mechanism

| | | |
|---|---|---|
| *Collaborative* | Virtual network | Flexible network (strategic alliance) |
| *Transactional* | Value-added network (outsourcing) | Hollow network |
| | Low | High |
| | *Environmental volatility* | |

**Figure 6.6** Classification of network organizations.

*Source*: Adapted from Cravens et al. (1996: 209).

against the vagaries of the environment by providing the flexibility to shift rapidly to new opportunities and sources of contribution.

A flexible network is Cravens et al.'s name for what we call a strategic alliance or alternatively a 'keiretsu'. It comes about in environmentally volatile conditions but involves real collaboration. It has intraorganizational links that tend to be long term in duration, and requires the development of considerable depth of knowledge, technological competence, and response capability.

The value-added network is much more transactional in nature and develops in environments that are fairly stable. It is the product of the subcontracting, outsourcing movement. The core organization typically may retain responsibility for R&D and product design but then outsource many of the other functions such as production and sales to low-cost suppliers. It is largely transactional in nature because the subcontracting companies do not need to make large product-specific investments and can be relatively easily replaced by other subcontractors if quality is unsatisfactory.

Cravens et al.'s fourth category is the virtual network, which is similar to the virtual corporation we describe in Chapter 9. It is collaborative in that the members of the virtual corporation conceive of themselves as forming a long-term enterprise not merely subcontracting on an arm's-length basis. It is most likely to arise in high-technology industries where electronic communication is the norm.

Despite the interesting variety of taxonomies in cooperative forms there is little unanimity amongst researchers onto one set of classifications. Some classify according to legal form: JVs, minority equity exchange, distribution agreements, and so forth. Others classify according to the position in the value chain of the partners: for example, vertical alliances, horizontal alliances; or by the functions performed, such as sales and distribution, manufacturing, or R&D alliances. Yet others, like Kanter (1994), use a more eclectic taxonomy, including opportunistic alliances, service consortia, and stakeholder alliances.

Faulkner (1995) analyzes alliance form on three distinct dimensions—namely, scope, legal nature, and size of membership, the major form-selection options can be categorized mutually exclusively. Thus such a taxonomy can be represented on three axes, with scope represented on a focused/complex continuum, the corporate legal entity shown on a JV/collaboration dimension, and the number of partners shown on a two-partner/consortium axis.

The focused alliance is a collaborative arrangement between two or more companies, set up to meet a clearly defined set of circumstances in a particular way. For example, a US company seeking to enter the EU market with a given set of products may form a focused alliance with a European distribution company as its means of market entry. The US company will provide the product and the market and sales literature, while the European company provides the sales force and local know-how. The precise form of the arrangement may vary, but the nature of the alliance is a focused one with clear remits, and understanding of respective contributions and rewards. Thus, in November 1989 Cincinnati Bell Information Systems (CBIS) of the USA set up an alliance with Kingston Communications of Kingston-upon-Hull to market CBIS's automated telecommunications equipment throughout the European Community. CBIS provides the equipment and Kingston the sales effort.

The complex alliance may involve large parts of, or even the complete value chains of, each partner. The companies recognize that together potentially they form a far more powerful competitive enterprise than they do apart. Yet they wish to retain their separate identities, and overall aspirations, while being willing to cooperate with each other over a wide range of activities. CFM International is a good example of a complex alliance. GE and SNECMA engage in joint R&D, joint manufacturing, joint development, and joint sourcing of parts. The companies remain separate but parallel in assembly, however, and in the critical marketing and sales areas, both companies retain clearly distinct images with CFM also distinct as the sole purveyor of the CFM-56 engine.

A JV involves the creation of a legally separate company of which the alliance partners are normally founding shareholders. A US company, for example, may set up a JV with a UK company to market in the EC. The partners normally provide finance, and other support resources including some personnel, until the venture is able to develop its own. The aim of the JV is typically that the new company should ultimately become a self-standing entity with its own aims, employees, and resources quite distinct from its parent shareholders. Unilever is a good example of a successful JV set up in the 1920s by Dutch and English companies that is now a major multinational enterprise.

A collaboration is an alliance form that has no JV company to give it boundaries. It is therefore both the most flexible form, and potentially the least committed form, at least at the outset. Companies can set up a collaboration on a very minimal basis to see how matters develop, and then allow it to deepen and broaden by feeding new projects into it over a period of time. Just as the collaboration requires no major initial commitment, it also has no limitations. It is probably the most appropriate form where the extent of the possible relationship is impossible to foresee at the outset, when the alliance is not bounded by a specific business or set of assets, and when joint external commitment at a certain level is not specifically sought. It may be that the collaborative form is most appropriate if the activity concerned is a core activity of the partners. If it is noncore, a JV may be more appropriate. Such guidelines, however, are often not crucial in choice of alliance form. The alliance of the Royal Bank of Scotland and Banco Santander is a good example of a successful collaboration. The partners collaborate over a wide range of activities, but have no single JV company to provide boundaries to the alliance.

### 6.4.2 The number of alliance partners

A two-partner alliance may be taken as the most common form. However, the consortium is a distinct form of strategic alliance that has more than two partners, and is normally a large-scale activity set up for a very specific purpose, and managed in a hands-off fashion by the contributing shareholders. Consortia are particularly common for large-scale projects in the defence industry, where massive funds and a wide range of specialist skills are required for specific purposes. Airbus Industrie is a consortium where a number of European shareholders set up an aircraft manufacturing enterprise to compete on world markets with Boeing and McDonnell Douglas (which have now merged). The European shareholders, although large themselves, felt the need to create a large enough pool of funds and skills to ensure that they reached critical mass in terms of resources for aircraft development, and chose to form an international consortium to do this. Strategic alliances, therefore, can be categorized by reference to:

1. whether they have a focused objective, or the relationship is a complex one involving many parts of the partners' value chains;
2. whether they involve a legally separate JV company or not, and
3. whether they have two or more than two partners.

Dussauge and Garrette (1999) have perhaps the most attractive form of typology of alliances amongst the many on offer. They firstly divide alliances into (*a*) those between noncompeting firms and (*b*) those between competing firms. In the first category they have three divisions:

1. international expansion
2. vertical integration
3. diversification.

In the category of alliances between competing firms they class:

1. complementary alliances;
2. shared supply alliances, and
3. quasi-concentration alliances.

Alliances between noncompeting firms generally have expansionist motives. Figure 6.7 below illustrates the options available.

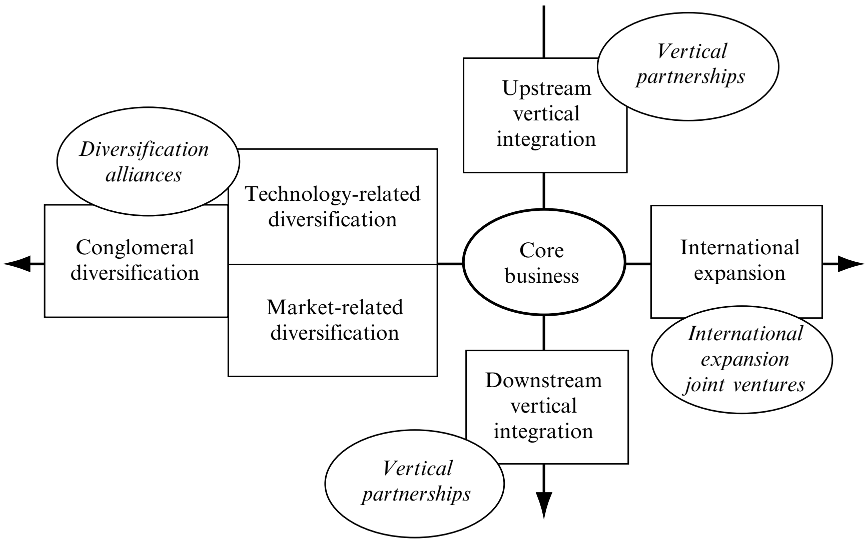


**Figure 6.7** Expansion options and types of partnership.

Adapted from Dussauge and Garrette (1999: 51).

International expansion is a strategic move that companies make when they decide to expand into new geographical areas. Thus Proctor and Gamble, Coca-Cola and McDonalds have all used this method to aid their development into multinational corporations. Vertical integration alliances enable a firm to secure its supply line or distribution outlets without the larger expenditure of acquisition. Thus Ford took a stake in Hertz and Hertz cars for hire became overwhelmingly Fords. Diversification alliances take a company into unfamiliar territory outside its own comfort zone. Thus BMW formed an alliance with Rolls Royce Aero engines. This unrelated move is not necessarily the case and diversification can be related through common technologies or markets. If such expansion is carried out by means of an alliance it generally carries less risk and less expense than if carried out by means of an acquisition. Alliances between competitors always present difficulties whatever benefits they may give to the partners. As Dussauge and Garrette put it:

> In alliances between competitors each partner must be open enough to collaborate efficiently with its rival allies, while still concealing critical knowledge in order to protect its vital interests.

Thus such alliances are sometimes genuinely collaborative and at others covertly still competitive. The three categories of the Dussauge and Garrette typology of such alliances are: (*a*) complementary, (*b*) shared supply, and (*c*) quasi-concentration as illustrated in Figure 6.8 below.

In the first category, the assets provided by the firms are different in nature. For example, a manufacturing plant on the one side and a distribution network on the other. In shared supply alliances firms get together to produce products which they then market separately under their own brand names. Thus IBM and Siemens jointly produce semi-conductors which they use in their respective product lines. In quasi-concentration alliances the whole production process may be involved as it is in the Airbus Industrie consortium.

Complementary alliances involve companies with different contributions to make to a common offering. Thus Rover sold rebadged Honda cars at the beginning of its ultimately more complex alliance, and Ford sold re-badged Mazda cars (and GM sold re-badged Japanese and Korean vehicles from various sources) in the USA. Such alliances are formed generally between companies whose core competencies and resources are radically different or who operate largely in quite different geographical markets. Complementary alliances may be between companies of quite different sizes. The motor and telecoms industries have many such alliances.

Shared supply alliances generally come together to achieve economies of scale in regard to a specific component or at a particular stage in the production process. Thus Volkswagen and Renault allied to produce automatic gear boxes. Neither company had a large enough demand for the automatic gear box car to achieve the minimum efficient size of production alone. Such alliances are generally between equals and involve the production or R&D activities.

Quasi-concentration alliances are similar to shared supply except that they only produce one final product and market it together. The partners present a united face to the market but compete for power internally. Such alliances are very common in the defense and aerospace industries.

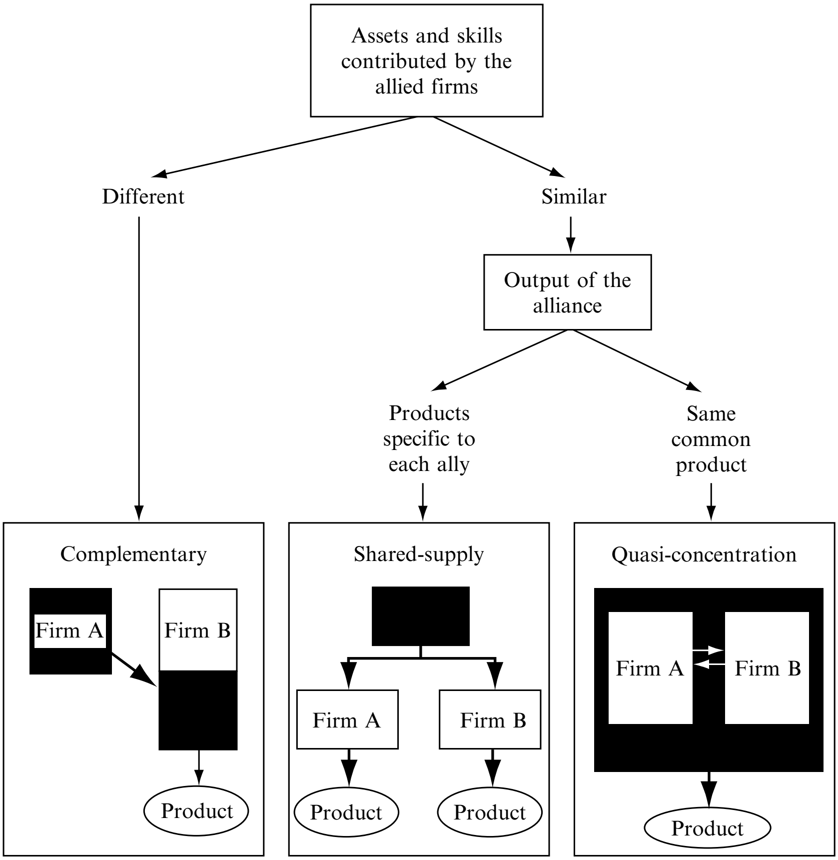


**Figure 6.8** The three types of alliances between competitors.
From Dussauge and Garrette (1999: 58).

## 6.4.3 **Choice of form**

An evolutionary perspective on organizational form (Hannan and Freeman 1989) might suggest that the particular alliance form will be chosen that fits the relationship between the set of activities involved in the agreement and the environment, and that the pressures of natural selection will bring about alliance failure if an inappropriate organizational form is chosen: ‘Ecologically, intergroup relations that persist over time must be effective. Otherwise the groups would decouple or be integrated in one unit’ (Williamson 1975). Economists frequently fail to note that many existing forms may in fact ultimately be bound to ‘decouple’ owing to their lack of fit with the environment, but at the time the research is carried out are still in existence. Indeed, little definitive work has been done relating alliance form to appropriate internal and external conditions. Lorange and Roos (1992) take a contingency approach and claim that: ‘No particular type of strategic alliance is better or universally more correct than others; what matters is to make the appropriate choice of strategic alliance form given the particular conditions at hand.’

Gupta and Singh (1991) are more precise, and recommend the selection of the JV if the assets are specific and separable, and if there is a need to manage them separately. Johnson and Scholes (2003) adopt a similar view but add the comment that the JV form with each partner holding shares in the alliance vehicle reduces the risk of asset appropriability, and is therefore more suitable as a vehicle when partners fear this. If the JV grows away from the partners, and becomes ultimately a self-standing entity, and ripe for divestment, and capitalization of the investment, then this may be more a sign of success than of failure of the alliance. Such potential is always inherent in the JV form, and is often seen by the partners, even at the outset, as a possible and acceptable outcome.

The conditions appropriate to JV formation are ones which enable the partners to regard the alliance as something distinct from their overall relationship, like the son or daughter of a marriage. Faulkner's (1995) research suggests that a strategic alliance should be set up as a separate JV company if:

1. the scope of the alliance constitutes a distinct business;
2. the alliance assets are specific, easily separable from the parents, and need to be jointly managed;
3. the alliance objectives can be clearly measured in relation to the use of the assets;
4. there is a perceived need to tie in the partners;
5. it is legally necessary—for instance, to enter a national market;
6. the partners wish to allocate a predetermined level of resources to the venture, and
7. the scope of the venture is not central to the partners' core business, or is at least geographically distinct.

Frequently, when potential partners identify each other, they cannot, at the outset, determine the extent or the nature of their possible collaboration, as it may develop over time. Also they may not wish to announce, internally or to the world, the nature of their cooperative strategy, and may prefer to allow the relationship to develop in a flexible and incremental way. In these circumstances the collaboration, with its inherently flexible nature, may be the preferred alliance form. The collaborative form is appropriate for an alliance if:

1. there is high uncertainty as to what tasks will be involved in the cooperative enterprise;
2. there is a great need for flexibility between the partners;
3. visible commitment by the partners is not sought, and
4. the boundaries of the alliance do not circumscribe a distinct business area.

Consortia are difficult to manage, as they involve a number of simultaneous relationships, and as a result almost always require a JV form to prescribe and set limits for their boundaries. Even in these circumstances the varied agendas of the partners, the different cultures, and the frequent dilution of management control inherent in working with a number of partners, makes the consortium a difficult form to manage. They seem, therefore, to be resorted to principally if the scope and scale of the challenge make this the only solution. However, most defense and aerospace enterprises and other industries requiring very high levels of R&D have these characteristics, and the consortium form is most frequently met in these sectors (Kanter 1989; Collins and Doorley 1991; Lei and Slocum 1991). A consortium is the appropriate alliance form if:

1. two partners alone cannot realistically provide sufficient resources to meet the identified challenge or opportunity;
2. large size is necessary for the enterprise to be credible to potential customers, such as governments;
3. the specialist skills required are so wide and varied that two companies could not provide them adequately;
4. extensive geographical coverage is needed to achieve strong market presence, and
5. there is the need to spread and limit the financial risk to each partner.

## 6.5 Conclusion

This chapter has identified some criteria for partner selection, described a number of taxonomies of alliance forms, and suggested conditions in which each of the taxonomic alliance forms is likely to be the most appropriate form. Important criteria for partner selection are the need for the partners' assets to be complementary, and for the identification of potential synergies between the prospective partners. It has been stressed that, while strategic fit is normally carefully assessed before concluding an alliance, the extent of cultural compatibility is frequently neglected. Yet culture clashes are the most commonly cited reason for alliance failure. Chapters 8 and 9 look at some other forms of cooperative activity—namely, the various forms of network and the so-called virtual corporation, and identify some of their distinct characteristics.

## 6.6 Summary

1. This chapter has identified some criteria for partner selection, described a number of taxonomies of alliance forms, and suggested conditions in which each of the taxonomic alliance forms is likely to be the most appropriate form.
2. Important criteria for partner selection are the need for the partners' assets to be complementary, and for the identification of potential synergies between the prospective partners.
3. It has been stressed that, while strategic fit is normally carefully assessed before concluding an alliance, the extent of cultural compatibility is frequently neglected. Yet culture clashes are the most commonly cited reason for alliance failure.

4. Cultures need not be similar, but cultural sensitivity between the partners is necessary if the alliance is to succeed.
5. Geringer emphasizes the importance of critical success factors in the selection of partners. Firms are more likely to ally if they see their potential partner as being able to strengthen their position in relation to the market's critical success factors.
6. There are many forms of cooperation between markets and hierarchies, alliances representing the most closely integrated form.
7. Garrette and Dussauge divide alliances between noncompeting firms and competing firms.
8. Amongst noncompeting firms there are three types: those aiming at:
   - international expansion
   - vertical integration
   - diversification
9. Amongst competing firms there are three types:
   - complementary alliances
   - shared supply alliances
   - quasi-concentration alliances
10. The most common forms of alliance are JVs, collaborations (contractual alliances) and multifirm consortia.

## 6.7 Questions for discussion

1. How should one select an alliances partner?
2. How important is cultural compatibility in the first instance?
3. How can one best choose an alliance form?
4. Is there one right alliance form for any given situation?
5. Should one ever form an alliance with a direct competitor?

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# 7 Negotiation and valuation

## 7.1 What this chapter covers

The subject of this chapter is negotiation and valuation. A cooperative agreement has to be negotiated, even in cases where it remains an informal arrangement rather than one sealed by contract. Partners need to be satisfied that they have a fair and reliable agreement on the contributions and benefits they attach to an alliance in order for their relationship to develop fruitfully. An important element in reaching a fair agreement is the valuation of assets allocated by the partners.

## 7.2 Alliance negotiation

Alliances, because they maintain the independence of the partner (parent) firms, represent ongoing processes. These can be, and must be, managed, as is discussed in Chapter 10. The success of this effort is determined in part by the choice of partner and form of the venture organization, which were covered in Chapter 6, and also by the quality and the outcome of the process of bargaining and negotiation during the second phase of the venture process identified by Tallman and Shenkar (1994). A badly negotiated arrangement is likely to be strained from the start, even if the partners have many of the right attributes and if the form itself is potentially strong. Feelings of resentment, perceptions of bad faith, political leverage, lack of control of people and technology, mismatched inputs and benefits, and a myriad of other problems that can result from a poorly managed negotiation can negate the benefits of what might appear to be a good match. It is important to be clear on some ground rules for negotiating alliances, and in particular for valuing the contribution each partner is able to make to the joint enterprise, in a way acceptable to both or indeed all the partners. In this regard a number of issues arise:

1. In negotiations, should an alliance be treated in a similar fashion to an acquisition, and if not how should it be different?
2. What are the key outcomes desired from the negotiation of a strategic alliance?
3. How is it possible to value a partner's contribution in the varying types of alliance forms adopted?

This section will address these issues by suggesting key points, which it will then relate to a number of existing case studies of international strategic alliances with which the authors are familiar, in order to examine whether the evidence in these case studies supports the points made.

Strategic alliances differ from acquisitions in a number of ways. In particular, acquisitions involve the transfer of ownership and hence authority to make decisions from the acquired to the acquiring company. The acquirer has thus the right to make any changes in the operation of its new subsidiary that it thinks fit, constrained only by law and the specific conditions of sale involved in the deal. Certain characteristics are normally found in acquisition deals. First, the acquirer may have had to pay a premium of up to 30 percent for the company, if it is a company whose shares are quoted on the stock exchange. If the bid has been a strongly contested one, the premium may be even higher. At all events, it is certain that the sellers will have been determined, if they were to sell their company, to get the highest possible price for it. Other frequent side-effects of acquisitions are the demotivation of executives made rich by the deal, and the disappearance of key executives unhappy about the change of ownership. A further characteristic of acquisitions is that the purchasers are often only able to gain access to limited information about the operation of the target company before the conclusion of the deal, and they may therefore encounter some unpleasant surprises when they actually take over control.

None of these factors is likely to obtain in a strategic alliance. Therefore strategic alliance negotiations should be and are likely to be conducted in a different fashion from acquisitions. Far more attention will be given to the fact that the negotiators need to work closely together once the alliance is successfully concluded. Thus a 'successful' negotiator who has driven a hard bargain may come to regret his 'success' when he encounters resentment in working with his new partners.

Both acquisitions and alliances seek synergies through the putting-together of potentially complementary assets and skills. However, strategic alliances do not seek, as a price for the realization of these synergies, the incorporation of the partner into one enterprise and the subjugation of its identity, as is often the case in acquisitions. Alliances normally concede the separate identities of their partners, and seek to maximize the benefit that can be obtained from putting together parts of two value chains (Porter and Fuller 1986) in order to achieve competitive advantage in chosen markets together, when this could not be achieved alone. Thus the negotiation of an alliance seeks to achieve a relationship between partners that can enable them together to achieve business success, without either partner needing to accept loss of identity or ultimate independence.

In negotiating a strategic alliance, or collaborative agreement of any sort, two frequently conflicting aims must be simultaneously held in the mind of each body of negotiators. First, how do we configure the collaboration so as to achieve the greatest possible level of competitive advantage for the joint enterprise, and secondly how do we get the best deal for our company?

The agenda for dealing with the first issue will include the following items:

1. *An analysis of the strategic fit between the companies*. Unless there is a clear complementarity of assets and competencies, so that a joint value chain can be constructed with a high probability of giving competitive advantage, the alliance will not succeed in economic terms.

2. *An analysis of the cultural fit between the companies*. It is unreasonable to expect the prospective partners to be culturally similar, since corporate cultures are as varied as fingerprints. However, it is valuable to attempt to identify possible cultural barriers to smooth working, and to reassure oneself that both partners are sensitive to the need to adjust culturally. Chapter 15 will deal with this issue more fully.
3. *Identification of goal congruence*. Goals and objectives need not be the same. However, they must not be in conflict if the alliance is to succeed. It is valuable to identify clearly one's own and one's partner's objectives both generally and from the alliance at this early stage.
4. *Identification of a primary joint project and of its scope*. Until a clear project has been identified, the alliance is little more than a declaration of intent. The first project should often be a relatively limited one embarked upon with a primary objective of developing methods of working together.
5. *Identification of the level and nature of the contribution expected from each partner*. Issue 4 will require resources, and the initial negotiations can usefully move forward to discussing broadly what each partner would expect to contribute to the joint project.
6. *Agreement on the structure of the alliance and its decision-making machinery*. This is often left for later, and then becomes a problem. If addressed at the outset it will give confidence to both parties that the alliance is being professionally and competently approached.
7. *Agreement on a termination formula in the event of one or both partners wishing to exit the alliance*. This may seem an odd item to discuss at the start of a relationship. However, both partners will know that a significant percentage of alliances are dissolved within five years. To agree at the outset on a formula for such a termination therefore is a sensible move to avoid possible later acrimony.

The question of how to do the best deal for one's company inevitably involves striking a bargain of some sort. All alliances involve compromises, even if only voluntarily to limit a partner's autonomy in certain areas. For a bargain to be possible, there needs to be an overlap between the strength of the perceived needs of both partners. Thus, in a bazaar negotiation where your highest buying price for the souvenir is £20, and the trader's lowest selling price is £10, a deal is possible with the final price dependent upon the respective negotiating skills of the players, which will include their respective abilities to imply at each move that they will go no further; this is their last offer. If, however, your highest buying price is £10 and the trader's lowest selling price is £20, then no deal is possible, and any time spent negotiating is time wasted. The basic situation is the same in alliances, but the attitudes of the negotiators need to be subtly different. As an alliance is a negotiated relationship, it is inherently unstable, as changing conditions make the initial negotiation obsolete, requiring reconfiguration or termination (Gray and Yan 1992). The negotiation is also the originating point of the strategy and structure of the cooperative arrangement. As such, the initial bargain has a major impact on the survival and performance of the alliance.

Since the negotiation is the prelude to working together on a project, it is vital that both parties leave the negotiation feeling that they have not just a workable deal, but a positively good one for them. Thus, paradoxically, if both partners negotiate generously and take it as a primary objective to ensure that their partner has a good deal, thereby suboptimizing on their immediate deal from a selfish viewpoint, they lay the groundwork for optimizing the long-term probability of success of the proposed alliance. Figure 7.1 illustrates graphically the best approach to the negotiation with a potential alliance partner. An attempt must be made to end up in the top right-hand box of the matrix. This contrasts starkly with the attitudes typically adopted in acquisition negotiations, when both parties attempt to arrive at a deal that will put them in either the top left-hand box or the bottom right-hand box respectively.

The very fact that negotiation is taking place implies a willingness on the part of both parties to make some compromises with regard to their interests in relation to those of the other party, and such a cooperative activity is seen to be in the best interests of both parties. Otherwise the imposition of force would be the method chosen to achieve one's ends. This fact was recognized in the management literature as far back as 1968, where Nierenberg stated:

> Negotiation is a cooperative enterprise; common interests must be sought; negotiation is a behavioral process, not a game; in good negotiation, everybody wins something . . . there are other advantages to the cooperative approach. Results can be greater, solutions more lasting. (Nierenberg 1968)

However, as Lewicki and Litterer (1985) point out, negotiation may take place in two quite different situations: that involving a zero-sum game and that involving a non-zero-sum game. In a zero-sum game, a fixed-size pie is divided up between the parties and where one gains the other loses. In such situations compromises mean pain and loss. In non-zero-sum games, this is not the case. A potentially expanding pie is conceived so that, if the right deal is struck, both parties may hope to benefit without sacrifice. Often such negotiations require imaginative proposals, and an understanding of the differing strength of individual needs that make gain possible without perceived loss. A hypothetical Arab company in a desert may be very willing almost to give away petrol but would pay dearly for water. A Western company may be willing to pay dearly for petrol but will

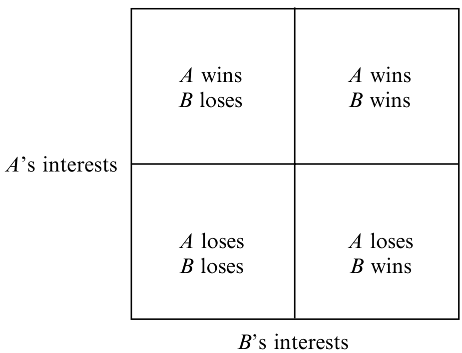


**Figure 7.1** Possible negotiation outcomes.

give away water. In such an imaginary situation a deal can be struck that will make both parties happy, as they are each able to trade commodities that have close to zero marginal utility to them, for a commodity with a relatively high marginal utility. Similarly, as in the theory of comparative costs in international trade where countries have different ratios of costs for their factors of production, there is an opportunity for trade to their mutual advantage. The theory of mutual advantage can be extended dynamically where companies have complementary assets able to achieve synergies when combined. However, as in prisoner's-dilemma games, the competitive solution and the cooperative solution may both exist in the same situation, and the achievement of the mutually beneficial cooperative solution depends upon one player's belief in the trustworthiness and perceptive imagination of the other.

Lewicki and Litterer call the win–win approach integrative bargaining. This is contrasted with distributive bargaining, where the objective is to achieve a mutually acceptable distribution of the resources available. Integrative bargaining depends upon firstly identifying a common shared goal and then developing a process to achieve it. They stress that this approach is by no means the only one or even the most obvious one available to the parties.

Five possible avenues are open to the negotiator. He or she may:

1. compete and attempt to force the other party to back down;
2. accommodate, that is, back down himself;
3. compromise, that is, agree to split the difference;
4. take avoidance action by refusing to consider the issue;
5. collaborate by inventing and considering problem-solving approaches.

Blake and Mouton (1964) integrated these five possible approaches into a matrix that they called the Managerial Grid, illustrated in Figure 7.2. This shows clearly that a collaboration approach, as shown in the top right-hand corner of the grid maximizes

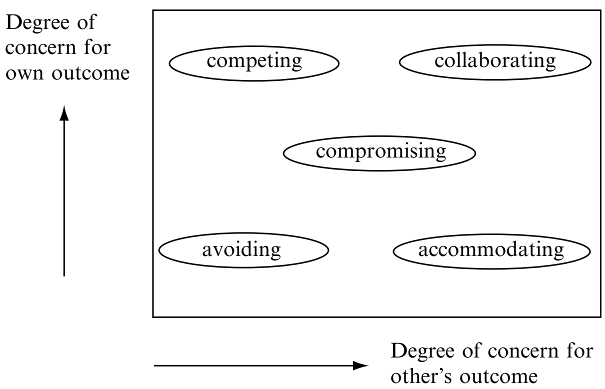


**Figure 7.2** The managerial grid of negotiating possibilities.

*Source*: Adapted from Blake and Moulton (1964).

the result from a strong concern by both parties for each other's outcome as well as for their own.

Lewicki and Litterer identify a number of preconditions for achieving success in the collaborative integrative-bargaining approach. It is necessary genuinely to understand the nature and strength of each other's needs. There must be a free flow of accurate and honestly presented information between the partners. The negotiators must have the ability to focus on what they have in common rather than their differences, and they must be willing energetically to search for solutions that meet both sides' primary goals. Such negotiations will be characterized by a high degree of trust, strong motivation and commitment, the development or identification of a binding common objective, and a willingness by both sides to accept that the other's needs are valid.

Should such a negotiation start to move into conditions of conflict, Osgood (1962) suggests a procedure he entitles GRIT (graduated reciprocation and tension reduction). This involves role reversal, keeping the number of issues debated under strict control, searching anew for superordinate goals to reunite the parties, and repackaging proposed solutions to make them more attractive.

Pruitt (1981, 1983) identifies similar possible behavior options to Lewicki and Litterer but stresses that they are psychologically extremely difficult to combine. You cannot easily start off competitively and then move into collaborative mode with any credibility, as the other party will suspect your motives. Pruitt sees two types of coordinative behavior:

1. concession exchange;
2. problem-solving discussions.

Concession exchange is intellectually less taxing. So long as the respective concessions are tracked and realistically evaluated, a fair deal can be struck. The problem-solving approach involves far more imagination but can also be far more rewarding as it is more likely to establish the real non-zero-sum nature of the situation which concession exchange will not. Pruitt identifies three levels of risk in coordinative behavior—high risk, medium risk, and low risk. High-risk behavior may be exemplified by the late Anwar Sadat's trip to Jerusalem in an attempt to break the Arab–Israeli deadlock. Such an act involves a lot of trust as it risks loss of face and is difficult to reverse. Moderate-risk coordinative behavior occurs when less trust exists. It may involve signaling a willingness to exchange concessions in such a way that, if the gesture is not reciprocated, it can be cancelled with no loss of face. Low-risk coordinative behavior may involve indicating a willingness to deal in minor and unimportant areas, but with the underlying motive of getting negotiations underway, in order subsequently to move to more substantive matters. Pruitt confirms the view that, the greater the level of trust and bonding, the greater the likelihood of coordinative behavior.

Another aspect of the art of negotiating is to understand the culture of your partner. This is particularly relevant in the setting-up of cross-border alliances, as the other party will be from a different nationality, possibly will speak a different language, and will certainly have a different culture with all the attendant opportunities for misunderstanding that follow from this. This is illustrated by Hendon and Hendon (1989) in their citation of two quotations respectively from a Japanese describing the Americans, and from an American describing the Japanese.

> Most Americans are very very individualistic—you could almost say egotistical. [Executive of Kyocera Corporation of Japan]

> We're the father and you're the children. We'll tell you what's good for you, and you do everything you can to make us successful. That doesn't wash here. [Executive of the AFL-CIO of America talking about the Japanese]

At least it can be said that these two executives had at least a caricatured view of the cultures of their respective potential partners, and were not totally ethnocentric in their assumptions. It is vital in Hendon and Hendon's view to make a list of cultural assumptions regarding your negotiating partner if you are to avoid misinterpreting signals. However, one should also note that individuals do, of course, differ from their national caricatures.

Tung (1984) brings this issue to life with her characterization of the qualities to be expected in the Japanese when engaged in negotiations, as compared with the Americans:

1. The Japanese generally operate through consensus-making with frequent reference back to head office, whereas US companies take more individual decisions at a lower level and consult less.
2. The Japanese have a much longer time perspective in regard to expected corporate results, and also conduct negotiations at a deliberately leisurely pace. The Americans want fast results and expect to fly in Friday and have an agreement by Monday.
3. The Japanese are much more thorough in their preparation and their scrutiny of documents than the Americans.
4. The Japanese are much more concerned than the Americans if an agreement has to be changed after it has been agreed.

Tung follows with some pertinent advice for Westerners negotiating with the Japanese.

1. Be patient; things take longer and a longer time-frame is adopted.
2. Maintain the continuity of negotiating teams as trust is the key to success and this is personally allocated, and takes time to build up.
3. Do not adopt ethnocentric attitudes, respect cultural differences.
4. Study the foreign market and work within the system, noting that some Japanese industries are open to foreign goods and some are not.
5. Ensure compatibility of objectives and complementarity of needs. Western companies generally seek profit while Japanese companies usually seek growth and market share.
6. Equity levels are always a sensitive issue. You will only get a majority in a JV in Japan if you have a unique and exceptionally valued product.
7. Maintain a constant and continuous dialogue to avoid misunderstandings.

Advice such as this emphasizes the importance of not just getting to know the other party personally, but also developing an understanding of the culture that has brought about his value system if the alliance negotiation is to be successful and the subsequent relationship to be lasting.

## 7.3 The bargaining process

Fisher and Ury (1981) suggest that there are seven important steps to the successful negotiation of a strategic alliance:

1. Gather all possible information.
2. Identify and evaluate the strength of your own and your partner's needs.
3. Identify the major issues for negotiation and assign minimum values to your position.
4. Make proposals and listen to the responses.
5. Show flexibility by suggesting alternative approaches.
6. Exchange concessions and compare notes honestly about their value.
7. Close the deal and tie up the details carefully.

These steps each involve complex behavior, as follows:

1. *Information-gathering*. Find out all you can about your prospective partner's current position—for example, financial strength, capabilities and vulnerabilities, aims and objectives, personnel, technologies, and market position in the main markets in which it operates. Draw up a similar catalogue of your own qualities, and satisfy yourself that there is probably an acceptably broad zone of possible agreement.
2. *Needs assessment*. This step is frequently a difficult one, since it involves seeing behind both your own and your partner's confident public posture to the world, and trying to discover how it sees the inevitably uncertain future, and its own ability to survive and prosper in it. This step involves not only estimating these factors from the viewpoint of the prospective partner firm, but also from the viewpoint of the negotiating team. Is the chief negotiator close to retirement, or an up and coming executive, intent upon making his mark? The success of this step may be vital to knowing how far to go later in the process when trading concessions.
3. *Issue identification*. This step attempts to set the agenda for the negotiation. The issues will emerge from the work done in steps 1 and 2. Once you have agreed on what they are, it is important to role-play a practice negotiation within the company and agree worst positions that may be conceded for each issue. This will involve discovering whether you have a credible BATNA and how strong it is. A BATNA is the 'Best Alternative to a Negotiated Position' option, and it clarifies the strength of one's negotiating position, when compared with the partner's BATNA. Thus if you determine that your BATNA is either to go it alone, or to form an alliance with

another well-positioned company then you are in a strong position. If you have great difficulty in seeing any realistic BATNA, then your negotiating position is not strong, and it is likely that the other party will know this. Recognition of such a situation should influence you in your attitude to the making of concessions.

4. *The proposals stage*. The time has now been reached to negotiate in earnest face to face. Fisher and Ury recommend that the other side should be encouraged to make the first set of proposals, and that these should not then be met by a counter-proposal but by a set of questions designed to raise issues in a constructive manner. The attitude should always emphasize the win–win nature of the negotiations, and that both partners are looking at a situation objectively rather than 'negotiating a deal' that is in their individual self-interest. Open questions (how?) rather than closed ones (yes or no?) are recommended at this stage to tease out issues and attitudes. Signaling positively through choice of words and body language helps build momentum and develop consensus.
5. *Show and encourage flexibility*. Take opportunities to repackage proposals that seem to be meeting resistance. Flexibility can also be demonstrated by increasing the number of variables under discussion. It may be valuable to have a list ready of items that might be introduced if the negotiations start to lose momentum or to meet road blocks.
6. *Exchange concessions*. There is always a risk in negotiations that, when one party makes a concession to help the negotiations along, the other party pockets it and continues on its way. A concession by one side should generally be met by one on the other side so that the perception of equity is retained. It is best, of course, not to use the term concessions but rather to describe the movement in position as an alternative way of dealing with a problem or issue.
7. *Close the deal*. This stage, of course, is the crucial one, in the absence of which the alliance will not come about. It involves accurately summarizing the position reached, getting both sides to agree to the summary, and following up with a written record of the agreement composed in plain English rather than legal jargon. Frequently in the euphoria of a successfully concluded alliance, the details are not dealt with and consequently a time bomb is planted for future meetings.

These recommendations are offered for a negotiation between Western parties. They require modification to take account of cases where there are more marked cultural differences between the negotiators. As Child (1994), Pye (1982), and others have pointed out, for example, the process of negotiation in an East Asian environment such as China can be rather more complex and fraught (see Box 7.1).

Gray and Yan (1992) offer a bargaining power model of alliance negotiations. In the process of bargaining described above, the relative influence of the two parties will determine how much one partner can influence the other to gain more favorable outcomes. The party that is perceived as relatively more important to its partner is likely to experience more power in the bargaining process. Gray and Yan suggest that the components of bargaining power include: relative equity share, similarities of expertise, strategic importance of the venture to each parent, the alternatives available to each parent, and (in international settings) the intervention of the host government. These

**Box 7.1 Negotiation with the Chinese**

Negotiating alliances or trade deals with the Chinese usually generates considerable uncertainty among the representatives of foreign organizations, which can easily turn into anxiety if the foreign negotiators do not appreciate what is going on. The Chinese have a long tradition of putting the other side at a psychological disadvantage, which goes back to classic writings such as Sun Tzu's *The Art of War*. Child arrived at the following guidelines for negotiating with Chinese partners, based on his own experience and on conclusions drawn from research studies:

- be prepared for erratic progress, with prolonged periods of no movement;
- practise patience;
- discount Chinese rhetoric about future prospects and the value of friendship, control against exaggerated expectations;
- steel yourself against Chinese attempts to influence proceedings through shaming and extreme language;
- try to understand the Chinese culture of negotiation and resist the conclusion that difficulties are necessarily brought about by your own mistakes;
- always keep in mind your negotiating objectives and the limits beyond which you are not prepared to go.

*Source*: Child (1994: 234–9).

factors will influence decisions about control, alliance structures and procedures, the partner relationship, and the performance assessment of the alliance.

Gray and Yan identify five structures for ownership and control that can result from bargaining:

1. *Dominant parent*. One parent runs the alliance (most likely in an equity relationship) as a virtual subsidiary.
2. *Shared management*. Both parents have large and approximately equal influence, often through a joint board structure.
3. *Split control*. Each parent is responsible for some part of the alliance operations.
4. *Independent management*. Neither parent is actively involved and the alliance managers operate largely as an independent organization.
5. *Rotating management*. Designated management teams from each parent serve terms in positions of authority.

These alternative control structures are tied to relative bargaining power during the negotiations to found the alliance, and may change if relative power changes during the life cycle of the alliance. Through structural characteristics, bargaining power can influence performance. Gray and Yan point to two key issues, autonomy and parental conflict, as the key factors in determining performance. In studies that have included the alternative, independence of JV management has typically been tied to higher performance. Dominant parents seem to perform better in some circumstances than do shared structures, but the opposite has also been found to be true. However, autonomy and dominance both reduce the ongoing negotiation that is a shared management venture. Parental conflict, on the other hand, is usually detrimental to performance. These conflicts are often driven by differences in organizational and/or national culture and strained relationships rather than by incompatible economic inputs. These 'soft issues' are difficult to negotiate and are not usually tied to bargaining power, as they are generally difficult to quantify and as their exact tie to performance can be tenuous.

## 7.4 Valuation of partner contributions

The second part of this chapter deals with the difficult issue of how to place a value on the partner's initial contribution to the alliance. It is far more difficult to calculate the value of a partner in a strategic alliance than in an acquisition. In an acquisition, after all, the market will decide the ultimate price in most cases, and opportunities will be afforded for other bidders to enter the process. This is far less the case in an alliance, as most alliances are concluded largely outside the view of the market, as a result of confidential negotiations carried out over a period of time. The form that the alliance is to take also affects the valuation. If no JV company is formed, it is, for example, very difficult to determine where the boundaries of the alliance start and stop. Thus the assessment of a partner's value to the alliance will depend on an estimation of its present and future likely contribution, and will vary in its measurability on the choice of alliance form and the nature of the assets involved.

Once the partners have decided to form an alliance and more specifically to adopt a particular alliance form, they have to face the issue of how to value each other's contribution. This is a very uncertain art rather than a precise science as the following arguments and boxed case studies will show.

### 7.4.1 Collaboration

A collaboration has no legal entity distinct from the partners, the question of valuation is frequently not expressly addressed, since there is no requirement for either partner to put capital or specific assets into a new enterprise. A collaboration often takes the form of a series of projects each of which needed to be separately resourced and provided with an action plan. In such circumstances each partner needs to assess its costs and estimated prospective costs for the project, and get them agreed by the other partner. The partners then agree a budget and can thereby ensure that a 50:50 split is achieved of the costs. Subsequent projects may involve such activities as joint design, joint manufacture, and joint component sourcing. In each case the costs need to be separately assessed in advance and also *post hoc* to ensure equity between the partner contributions. In a collaboration the valuation of the partner's contribution is never finished. Each new project requires new estimates. The valuation of the transfer of technology or manufacturing process expertise often generates problems. However royalties and consultancy fees can be used as techniques to reach an accommodation on these matters. If a collaboration involves a share exchange between two unquoted companies, the share value should be agreed at the commencement of the alliance. Net assets and typical price earnings ratios for the sector can be used as guides for reaching such an agreement. Thus although some attempt is generally made to value cost in relation to the collaboration, few real attempts are generally made to value benefit, and thus to discuss how it should be appropriated, since this is so uncertain at the outset.

### 7.4.2 Joint ventures

In JVs, which are often 50:50, estimates are made and agreed of the value of the assets to be contributed to the JV by the partners. In order to capitalize the venture appropriately, the new JV company is generally allowed to take on loans at an agreed rate of interest, repayment to be made from JV profit, but with the loan often guaranteed by the JV partners. If one partner is unable to provide the necessary finance to justify a 50:50 share split the equity may be differentially divided, the smaller partner may be required to guarantee a loan to make matters equal, or some other form of accommodation may be agreed. Further agreement is needed at the outset on what contribution each partner is expected to make in addition to initial capital. The partners may supply raw materials, provide free consultancy advice, or at a per diem, second key personnel to the venture and provide blueprints and other proprietary information to the JV. Account should be taken of all these forms of contribution when assessing the value of each partner's contribution. Most consortia also involve the setting up of a distinct consortium company and to that extent the issues involved in partner contribution assessment are similar to those of two-partner JVs.

While it is not possible to eliminate uncertainty from any assessment of partner contribution, the example below illustrates (Zyla 2002) how a rational approach can be taken to valuation, that at least should reassure the partners that they are behaving fairly to each other, and therefore set the trust developing process in train.

Let us assume that the owner of a conventional business wishes to set up a JV company with the owner of a web-based company to market the products of the conventional company on the internet. The first step is to identify the assets and other contributions that each partner intends to make to the JV. Let us assume they are as set out below:

| **Conventional company** | **Web-based company** |
|---|---|
| trade name | technology |
| intellectual property | computer equipment |
| office space | technology expertise and research skills |
| inventory | intellectual property |
| working capital | contact network |
| management | |

Since the valuation must be concerned not only with the current value of the assets, but also with their potential value in the new company, the first thing to do is to produce a financially based business plan for the medium term future, say three or perhaps five years, depending on the level of uncertainty of the business. This will generate profit and loss and balance sheet statements on a proforma basis for the company and can provide a best guess basis for valuing the assets. No one would suggest that the future will work out exactly like the figures in the plan, but at least the figures are those that the owners are willing to sign off on. An agreement may be inserted at this point if the owners are very uncertain, that at the three or five year point a reassessment will be made of achievements and an adjustment made to ownership equity or loan to reflect this. Such a clause is however unusual. The plan will, however, give some numbers for the expected valuation of the company at the end of the plan period.

In the preparation of the plan each of the contributions will have to be assessed and costed, and to do this a methodology will have to have been agreed for such a costing. This might look something like the following.

#### 7.4.2.1 The conventional company partner's contribution

*Trade name*. This is perhaps the greatest variable item. If the trade name is an internationally known and respected name it may command a high value. If it is a new one bought off the shelf its value will be zero. One method of valuation is the 'relief from royalty' method. Here the market is searched for a trade name of similar reputation that is licensed, and this is used as a guide for royalty level to be applied. This may be 5 percent of sales. The figure is then capitalized to arrive at a value of the contribution

*Property*. This is easier. A value can be imputed to the cost of renting the office space plus the desks and other property to be involved in the new business. Such valuation should take into account both the cost of buying equipment new, and the agreed state of the equipment to be contributed.

*Inventory*. This will already have a value in the company's accounts. This value only needs to be reviewed to ensure it is up to date and reasonable.

*Working capital*. The business plan will reveal the estimate of the necessary working capital for the business, and the partners only need to agree the level of their respective contributions, which will then be an input to the ultimate calculation for the equity split.

*Management*. If management is to be seconded from the two parent companies existing salary level can be used as a guide to contribution value. If new management needs to be recruited, the costs of such recruitment needs to be allowed for and an agreement made as to who will bear them.

#### 7.4.2.2 The web-based company partner's contribution

*Technology*. The fees that the company would charge a third party for the technology provided in developing the necessary web pages can act as a guide here to the value of the contribution. Some evidence would be needed here to show that the fees were at an appropriate level for the industry and the reputation of the web page provider.

*Computer equipment*. This is also an easy figure as, once the equipment necessary has been agreed, the prices are freely available from retailers.

*Technology expertise and research skills*. Note should be taken here of the web-based company's established technology skills over and above those of the staff allocated to the venture. The valuation would reflect the sunk costs of past technology development that had brought the company to its current state of technology strength. Either a capitalized consultancy per diem calculation or a calculated royalty figure would be appropriate methods of valuation here.

*Intellectual property (e.g. patents)*. This will probably be licensed rather than absolutely contributed, and once more the cost of such licensing can be treated in a capitalized royalty fashion.

*Contact network*. This is undoubtedly a major contribution on both sides. However it is rarely given a value figure in any valuation. The assumption is generally made that it is one of the factors that attracted the companies to each other in the first place, and its importance will be determined by how successfully the JV partners work together.

Once figures have been attached to the above contributions it will be possible to see in financial terms what the relative contributions are, based on the assumptions contained in the business plan. These will show an appropriate equity split based on the contribution valuations. If the agreement is to be 50:50, an adjustment to the lighter partners contribution can be made in cash or some other form of commitment. Or of course alternatively the split can be agreed to be other than 50:50. However, in the latter case the implications need to be spelt out regarding matters of control and responsibility. Clearly in such a situation, the owner with more than 50 percent has the greater residual responsibility for the company, and the power that goes with that. Some agreement for the protection of minority rights might be necessary here to reassure the other partner.

### 7.4.3 Pharma–biotech alliances

One situation in which it is the normal case for the big company to have the majority of the equity is in the growing area where large biotech companies buy into a number of small biotech companies in the hope of spotting and being invested in the next real winner. Here valuation of what the biotech has to offer is extremely difficult, as many great hopes in this area inevitably fail. There are a number of different ways in which such deals can be structured (Hardy 2003):

- Minority investment alliance—one company buys stock in another as part of a strategic relationship.
- Product licensing—this type of alliance carries very low risk and these types of agreements are made at nearly every stage of pharmaceutical development.
- Product acquisition—where a company purchases an existing product license from another company and thus obtains the right to market a fully or partially developed product.
- Product fostering—a short-term exclusive license for a technology or product in a specific market. This will typically include handback provisions.
- Co-marketing—where two companies market the same product under different trade names.
- Co-promotion—two parties promote the same product under the same brand name.

The financial terms for such deals depend on a variety of factors, principally the strength of the intellectual property position of the biotech, the exclusivity of the rights agreed upon, the territorial exclusivity granted, the uniqueness of the technology to be transferred, the competitive position of both companies, the stage of the technology developed, and risk of the project being licensed or sold elsewhere. When these factors have been assessed, payments to the biotech may take several different forms.

*Equity investment*. Equity investment is becoming an increasingly common component of many biotechnology deals. This gives the organization making the investment a potential element of control in the company it's buying into. Obviously, this can generate a sense of security for some organizations, but this too involves calculations, because the parties have to agree a valuation, but this valuation will also depend strongly on the negotiating strength of the partners.

*Upfront payments*. This is frequently an intense issue in negotiations because the risk is the highest for the Licensee, while for the Licenser it may represent the only payment for the work performed if the project is unsuccessful. Depending on the value of the technology, there may be additional cash demands and assurances that the money will only be spent on the project in question.

*Milestone payments*. Milestone payments represent cash payments paid by the Licensee associated with the progress of the project reaching specific milestones. There are several different events that can trigger these types of payments including:

- filing a patent;
- granting of a patent;
- identification of a lead compound within a drug discovery program;
- initiating preclinical development;
- initiating/completing Phase 1, 2 and 3 clinicals;
- submitting the documentation for government approval, and
- receiving approval.

Typically, milestone payments increase as a project moves through clinicals reflecting diminishing risk.

*Royalty rates*. As new molecular entities advance through the clinical trial process, they become considerably more valuable in licensing deals, and thus negotiated royalty rates go up. We identify below some of the variables that influence royalty rates in biotech–pharma deals:

- Strength and scope of intellectual property rights.
- Territorial and exclusivity rights.
- Durability of the technology and level of innovation.
- Inherent risk, degree of competition, and stage of development.
- Strategic need and portfolio fit.
- Therapeutic field.
- Availability of finances and deal structure.

Often the royalty rates are set and agreed upon before the cost of manufacturing the product is finalized, so assumptions have to be made on the eventual profitability of the product. The amount of revenue available for royalties will then depend on the profitability of the overall project and obviously, this should be estimated by all parties involved in the negotiations.

Ultimately, everything considered, the value of the deal to the bio-tech company depends upon an agreed discounted cash flow (DCF) valuation of the projected cash flow from the next few years of the company's operation. However, the other factors mentioned above, particularly the earliness of the stage of development, will influence the confidence that the pharma will place in the DCF projections and its conservativeness in agreeing figures. In short the earlier the stage, the lower the payment.

### 7.4.4 A valuation overview

The valuation of partner's contributions to an alliance is a very inexact process, and depends very much on the partners' attitudes to alliances, and the way in which they expect them to be managed and to evolve over time. It becomes an even less exact process in countries without transparent market mechanisms like China (see Box 7.2), where a market price for some assets does not exist. It would seem that, the more sophisticated the valuation process, the greater the risk of the development of a subsequent 'them-and-us' attitude amongst alliance members, to the detriment of good cooperative strategy. However, there are some principles that can be applied to partner contribution valuation.

First, different types of alliance have different valuation needs. JVs, whether two partner or consortium, have corporate forms, and therefore some of the assets that may need to be valued if they are introduced into the JV company are capital, a partner's expertise, specific assets, a network of contacts including those involving market access, and any technology transfer. The sum total of the valuation of these factors accounts for the value of the partner's equity share.

Collaborations do not have a corporate form. Therefore there is no equity to crystallize contribution valuations. Similar factors need to be considered as in JVs, although, since there is no company, assets are not introduced, nor is capital. The more intangible factors like technology transfer, access to markets and other contacts, use of brand names, and expertise also need to be considered. Valuation in collaborations is generally carried out when projects are costed, but frequently the intangibles are not expressly valued, as can be seen from the case studies described in the boxes.

The following factors should be taken into account in valuing the respective types of asset introduced to the alliance:

1. *Fixed assets*. Here a number of considerations will influence valuation, notably the cost of the asset, the specificity or uniqueness of the asset, its replacement value, and whether it is possible to assess its net present value calculated on the basis of the income stream it is expected to generate and the appropriate discount rate.
2. *Working capital*. Usually valued at face value, unless there are reasons for discounting it to some degree, as with possible bad debts that are taken over.

**Box 7.2 Valuation of contributions to joint venture equity in China**

While the majority of foreign investors in China contribute to joint venture equity wholly in the form of cash, this is the exception rather than the rule among Chinese partners. It is often difficult for cash-starved Chinese state-owned enterprises to subscribe to joint venture equity through cash payments and the question arises how they can compensate through having other inputs valued as equity. Chinese partners are, therefore, likely to insist that non-cash resources be valued as joint venture equity in order to preserve some rights as part-owners. Many have had their land, buildings, plant, and equipment valued as equity. A few manage to get agreement that brand names, distribution channels, and production technology should also be valued as part of their contribution to equity. In the absence of a non-administered market for land, it can be difficult for the Chinese and foreign sides to agree a 'fair' price. The Chinese party will seek to have land it supplies classified by the local government as being zoned for commercial use, in which case its valuation as a component of equity is raised according to administrative rules made by the very authority which has a sponsoring interest in the Chinese enterprise. Similarly, the Chinese side tends to value plant and equipment by reference to original cost and subsequent depreciation, the annual rate of which is very low compared with international norms. The foreign side will value the same plant and equipment in terms of its income-generating capability compared to equivalent assets that are of world-class standards. If the plant and equipment supplied by the Chinese partner can produce outputs which are technically acceptable and cost effective when combined with relatively low local labor costs, that partner has a basis on which it can insist on a higher valuation being accorded to those resources than would be warranted in a high-labor-cost developed country. In practice, Chinese facilities and equipment are often antiquated and in poor shape. Quite often the valuation that is given to Chinese assets represents what is acceptable in order to get a partnership agreed rather than an economic calculation.

3. *Expertise*. This is normally ignored in calculations, on the basis that the partner's expertise is the basic reason it was approached for partnership. If a return is demanded on it, this can be based on a time approach, for example, so many man-years at so much per day. Strength of need may also be a factor.
4. *Contact network*. This is also often vital in partner selection, but then not given a valuation. It might be valued on the basis of a royalty or possibly an introductory commission for successful sales in collaborations. In JVs it will have a notional valuation in determining the equity shares. The same considerations apply to the ability by one partner to provide access to the market that the other partner wants.
5. *Brand names*. These intangible assets can be crucial to the success of a product in a market. Accountants have great difficulty in valuing them. However, acquiring companies are often willing to pay large sums for them—for example Nestle's purchase of Rowntree. Although based on somewhat uncertain numbers, the DCF (discounted cash flow) or NPV (net present value) methods of valuation seem most appropriate here, or the 'relief from royalty' approach.

6. *Technology transfer*. There are several possibilities here, including time-based valuation as for other forms of expertise, royalties on subsequent sales using the new technology, and a capital value based on forecast future benefits. It may even be possible to develop an acceptable formula including all of the above.

If a JV is the chosen alliance form, the sum total of the valuation of the above six factors will account for the equity share, balanced by a cash item if a 50:50 deal is politically determined. If royalties are included in the valuation or time-based fees, these will, of course, not feature in the capital valuation. In a collaboration the means of paying for the assets in the broadest sense brought by each partner to the alliance is more difficult to manage. In many cases the most intangible of the assets are just ignored, and those subject to royalties or fees dealt with in that way. The remaining assets are usually picked up in the project by project costing as the alliance gets under way. We illustrate below the matters taken into account in valuing contributions in three case studies of alliances.

### Case 1. Royal Bank of Scotland–Banco Santander

These two banks formed a complex collaboration alliance that also involved a number of JVs and a funds transfer consortium involving a number of additional banks. The rationale behind the alliance in this case was that two somewhat insular European banks (Scottish and Spanish) were concerned both that the development of the EU would lead to a regional rather than a national banking structure and that their relatively small size in European terms when compared with giants like Deutsche Bank or Crédit Agricole would be a disadvantage. There was therefore an attempt to develop a whole laundry list of activities in which the two banks might operate together, to the overall improvement of both their reputations and their effectiveness.

The philosophy behind the alliance was at all times one of equality, although in fact Santander was somewhat the richer bank. A decision was therefore taken to exchange a small percentage of shares, which, since both banks were publicly quoted, represented no problem of valuation. Subsequently Santander bought a further tranche of RBS shares from the Kuwait Investment Office, with RBS's active agreement, since RBS had come to regard these shares as a potentially volatile holding in its portfolio of equity holders. This further purchase by Santander was not, however, allowed to disturb the underlying philosophy of the two banks of an alliance of equals.

This philosophy dictated their 50 percent each shareholdings in the Gibraltar, German, and Belgium financial-services acquisitions that they made. There were, therefore, no valuation negotiations in this alliance that might have involved specific difficulties in valuing the two banks' respective contributions to the partnership. Issues of which bank's needs were the greater were, given the equality philosophy, not allowed to arise, and thus did not become a factor in contribution valuations.

As years passed the relationship matured and trust deepened. Santander helped RBS make its largest acquisition, that of National Westminster Bank in the UK. A tally was made annually of the respective costs involved in the alliance to ensure that parity of contribution was maintained, but given the collaboration nature of the alliance specific projects always had their own budgets.

### Case 2. The Cable & Wireless consortium

This alliance is an international telecommunications consortium instigated by C&W to tender (successfully) for the second Japanese international carrier license. In order to do so C&W developed a focused consortium JV with seventeen Japanese and one US partners. The consortium has been very successful during its lifetime, and has certainly enabled C&W to achieve its main aim of being accepted in Japan as a good corporate citizen, welcome to do business in that country.

In a new JV, whether a consortium or otherwise, basic ownership of the company is determined by the distribution of the equity. Either this is allocated at par in proportion to the capital contributed or a more complicated formula is adopted of which there are many variants. If specific tangible or intangible assets are contributed by a particular partner, they may reasonably make claims that this be reflected in an appropriate increase in its shareholding. C&W brought all the telecommunications expertise. However, this was not reflected in its shareholding.

C&W was allocated 17 percent of the equity and paid for it with cash when the consortium was set up. There were three major shareholders: C Itoh, Toyota, and C&W, each with 17 percent, totalling 51 percent, a bare majority. The remaining shareholdings were thus widely distributed and generally small in percentage terms. The presence of C&W in the top three equity holders was a largely symbolic recognition of its telecommunications expertise, and of the fact that it was the initial entrepreneurial instigator of IDC.

No consideration was given to what each partner differentially brought to the consortium, or to recognizing this by means of valuations of expertise, royalties, or any other rewarding device. This was the Japanese way, and C&W had to accept it, if it was to ally successfully with Japanese companies in Japan. For C&W, the investment was a ‘strategic’ one to help establish the company in Japan, and to enable corporate learning about the Far East theater of operations to take place. In such circumstances it was not motivated to risk damaging partner relations by developing sophisticated valuation formulae that might more fairly have reflected its expertise contribution. Indeed, so concerned was it to maintain good relations that it did not object when it was decided that only the Japanese would have check-signing power in the company.

### Case 3. ICI Pharma (now AstraZeneca PLC)

This JV between Sumitomo Chemicals and ICI Pharmaceuticals (later Astra Zeneca PLC after the flotation) in Japan was a focused two-partner JV. Although it was set up in 1972, it is generally regarded as an example of a cross-border alliance that has not really flourished, and has subsequently become a wholly owned subsidiary of Astra Zeneca. ICI’s objectives were to develop its business in Japan. Sumitomo’s were to develop its pharmaceutical business, which at that time was not very strong. ICI provided the product specifications for a number of pharmaceutical products, some capital, and the use of the brand names. Sumitomo agreed to manufacture the products, provided licensing credibility in Japan, and provided the marketing and sales network. A 50:50 JV named ICI Pharma was set up in

Japan, owned 60 percent by ICI and 40 percent by Sumitomo. It is ICI's belief that in the initial negotiations Sumitomo got the best of the bargain, and has reaped most of the profit. The deal has not, however, been renegotiated, and ICI has developed subsequent business in Japan through other vehicles. If ICI had taken the C&W view and regarded the investment as the price of learning how to do business in Japan, all might have been well. However, it took a more carefully calculated view, and perhaps owing to lack of knowledge of Japanese circumstances arguably miscalculated.

When interviewed, an ICI senior executive said that in valuing its own and its partners' contribution to a joint venture, it takes the following factors into account:

1. The actual expenditure the partner has made on the asset to be put into the JV, not the current market value, however calculable, of that asset. Thus, if an entrepreneurial company had developed a very specific technological asset giving competitive advantage, the partner might find difficulty in getting ICI to value it at more than its cost.
2. The overall strength, however defined, of the potential partner company. Thus if a small company stretched for capital were to approach ICI with a proposal for a JV, ICI would it seems be likely to take advantage of its greater industrial strength in the negotiations.
3. The perceived urgency of the partner's need. Negotiations taking advantage of this factor would be very likely to cause resentment once that need lessened in the future.
4. A comparison of prices put on similar deals in the market. This is, of course, a valuable benchmark for acquisition deals. However, for alliances such prices are more difficult to unravel, are rarely published, and may well militate against the win–win philosophy that must be applied in alliances if they are to survive and prosper over the longer period.
5. The value to be put on control. Thus ICI would expect to pay more for 51 percent of a JV, thereby failing to give much credence to the understanding that alliances only really prosper if the partners are genuinely equals at least in the relationship, and need to act in a consensual rather than a hierarchical mode.

Given these somewhat power-based attitudes to JV partner-contribution valuation, it is very difficult to make the mental transition to that required for a successful alliance. If the negotiations have been power-based, and implicitly centered on each potential partner driving the hardest possible bargain supposedly for its shareholders, the subsequent management of the venture is likely to reflect similar attitudes. It is not perhaps surprising, therefore, that ICI has felt less than enthusiastic about the management and evolution of ICI Pharma in Japan.

## 7.5 Summary

1. This chapter has emphasized that negotiations in alliances must be win–win—that is, of advantage to both or all partners, since the partners will be working together subsequently, which is not necessarily the case in acquisition negotiations. It stresses the importance of trying to make the negotiations a positive rather than a zero-sum game, so that both parties may feel they have gained from the process.

2. On the question of partner-contribution valuation, it is clear that this is a very inexact science and depends heavily on corporate politics and the respective attitudes of each partner to their future work together. Some strike a very hard bargain, and others a very easy one in the interests of future goodwill and cooperation. Some principles, however, apply universally.
3. The creation of a perceived win–win situation leads to a more effective alliance, even if it means negotiating in a less hard-nosed way than is customary in company negotiations. The benefits and not just the costs should be considered in valuing assets to be put into or used in the alliance.
4. The Blake and Moulton grid illustrates the importance to both parties of maximizing the outcome for both.
5. The strength of need of the partners will influence the value negotiations to some extent.
6. The development of a BATNA is equally necessary in alliance negotiation as in acquisitions.
7. The uniqueness of a particular asset, such as brand name or technology, creates a premium value determinable only by negotiation.
8. The valuation range of an asset will be somewhere between its existing value and the assessed NPV of the future benefits to the alliance accruing from its use.
9. The position in that range will depend upon the relative strength of the partners, their possible alternative courses of action to the alliance, the uniqueness of the assets, and the negotiating ability and forbearing or hard attitude of the partners.

## 7.6 Questions for discussion

1. Why is it important not to drive too hard a bargain in an alliance?
2. What attitude should be adopted towards the negotiation process?
3. How can the key assets being contributed by the partners be valued?
4. Is there any precise valuation method for contribution from partners?
5. How firm and irrevocable should initial negotiations be? Why?

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# 8 Networks

## 8.1 What this chapter covers

This chapter starts by considering the reasons why firms develop networks. It identifies power and trust as the two key necessary conditions for the development and effective operation of a network. It distinguishes three types of network, namely the internal network, the stable network, and dynamic networks. It then lists the three distinct broker roles in networks as the architect, the lead operator, and the caretaker, and describes the different characteristics of the dominated network and the equal partner network.

## 8.2 Network rationales

The terms ‘strategic network’ and ‘strategic alliance’ are often used interchangeably, and there are situations in which they do overlap—for example, in the Japanese keiretsu form. However, there is a clear distinction between the idea of a network with its implication of multiple close but nonexclusive relationships, and that of an alliance which, however loosely, implies the creation of a joint enterprise at least over a limited domain. A virtual corporation (Chapter 9) generally exhibits some of the features of both. Networks are becoming critical aspects of competition in a variety of industries. Most of the major airlines lead networks of smaller and regional carriers in code-sharing alliances. The global automotive industry is evolving rapidly into groups of regional manufacturers tied through equity participations, acquisitions, supplier agreements, and distribution networks to one of the major Triad firms—some of which also ally with each other. The pharmaceutical industry is supported by networks of biotechnology suppliers, cross-licenses, and distribution agreements.

The term ‘network’ is often very loosely used to describe any relationship, from an executive’s ‘black book’ of useful contacts to an integrated company organized on internal market lines (see Snow et al. 1992). Powell (1990), however, attempts to distinguish between a network and Williamson’s (1975) famous dichotomy of markets and hierarchies by means of the framework set out in Table 8.1, adapted by the authors to include the virtual corporation.

As the last row in Table 8.1 concedes, many markets have some of the aspects of networks, and indeed networks have some of those of hierarchies. The terms, it would seem, are destined to remain more indicative than precise. For cooperative strategies,

**Table 8.1** From hierarchies to markets

| Key features | Hierarchy | Virtual corporation | Network | Market |
|---|---|---|---|---|
| Normative basis | Employment relationship | Complementary strengths | Complementary strengths | Contract property rights |
| Means of communication | Routines | Electronic | Relational | Prices |
| Conflict resolution | Fiat; supervision | Leadership of brand | Reciprocity and reputation | Haggling and resort to law |
| Flexibility | Low | High | Medium | High |
| Commitment | High | Medium | Medium | Nil |
| Tone | Formal | High-tech | Open-ended | Precision |
| | Bureaucratic | Modern | Mutual benefit | Suspicion |
| Actor preference | Dependent | Independent | Interdependent | Independent |
| Mixing of forms | Informal organization | Equality Subjugation | Status<br>Hierarchy | Repeat transactions |
| | Profit centres | Market relations | Multiple partners | Contracts |
| | Transfer pricing | | Formal rules | |

*Source*: Adapted from Powell (1990).

networks provide a larger setting for individual alliances. For firms that are members of networks, many of the 'soft' issues discussed in the previous chapters of this section have been resolved, and forming dyadic relationships can be quicker and reflect higher degrees of confidence. However, networks also mean that individual alliances do not exist independently, but operate and must be evaluated as parts of a larger whole.

Johanson and Mattsson (1991) make a useful additional distinction between network theory and the form of strategic-alliance theory that is based upon transaction-cost analysis. Alliances may be concluded for transaction-cost reasons, but networks never are. Networks generally exist for reasons stemming from resource-dependency theory—that is, one network member provides one function which is complementary to and synergistic with the differing contribution of other members of the network. Although costs enter into the calculus of who to admit and persevere with as network members, the existence of the network, and the loose bonding implied by it emphasize autonomy and choice, in contrast to the more deterministic governance structure and stable static equilibrium applied to alliance theory by transaction-cost theorists.

We think the relationships among firms in networks are stable and can basically play the same coordinating and development function as intraorganizational relations. Through relations with customers, distributors, and suppliers a firm can reach out to quite an extensive network. Such indirect relationships may be very important. They are not handled within the transaction cost approach (Johanson and Mattsson 1991: 264).

Networks of whatever type arise for a number of distinct reasons:

1. *To reduce uncertainty*. This motive has been suggested as the prime reason for the development of all institutions (North 1996). Impersonal relationships in markets are fraught with uncertainty, in that a transaction once made can never be assumed to be repeatable since it implies no more in relationship terms than is contained in the exchange. Networks imply developing relationships and thus promise more in terms of mutual solidarity against the cruel wind of economic dynamics.
2. *To provide flexibility*. This quality is offered not in contrast to markets but to hierarchies. Vertically integrated companies establish overheads and production capacity, and in doing so forsake the flexibility of immediate resource reallocation that networks provide.
3. *To provide capacity*. A firm has certain performance capacities as a result of its configuration. If it is part of a customary network, however, such capacity can be considerably extended by involving other network members in the capacity-constrained activity.
4. *To provide speed*. Speed may be needed to take advantage of opportunities that might not exist for long, and may require a fast response—the classical 'window of opportunity' which is open for a short period and then shut for ever. An existing network can put together a package of resources and capacities to meet such challenges in a customized response which, in its flexibility and scope, lies beyond the capacity of an unnetworked vertically integrated firm.
5. *To provide access to resources and skills not owned by the company itself*. In a network such as those found in the clothing industry of northern Italy (Lorenzoni 1982) the

strength of one company is a reflection of the strength of its position in its network, and the facility with which it can call on abilities and skills it does not possess itself to carry out tasks necessary to complete a project.

6. *To provide information*. Network members gain access to industrial intelligence, and information of a diverse nature with far greater facility than executives imprisoned in a vertically integrated company. In such firms the 'need-to-know' principle is far more likely to operate than in networks where all members regard information-gathering as one of the principal reasons for establishing themselves in networks. Even in companies that recognize the importance of making their knowledge and experience available to all their members often by appointing Chief Knowledge Officers, as did Coopers & Lybrand, the breadth of knowledge may still be more limited than that embedded in a wide network.

Networks are vital to the newly recognized increasing-returns knowledge-based industries (Arthur 1996) described in Chapter 2. They tend to operate in dense networks which provide advantages under all six factors listed above. Microsoft could not have achieved its dominance of the word-processing software market without its intense involvement in networks including Intel and others. It has become powerful, not because it has the best system, but because it has the largest installed base of customers. To survive in such industries involves a mindset that emphasizes strategic flexibility and cooperation simultaneously with competition. Networks provide the appropriate ecology for companies operating in such fast-changing markets.

## 8.3 Power and trust

If price is the key regulator and dominant factor in markets, then, in Thorelli's view (1986), power and trust are the factors that dominate network relationships. They are the dominant factors in any political economy, and networks have many of the qualities of such institutional forms. 'The interorganizational network may be conceived as a political economy concerned with the distribution of two scarce resources, money and authority' (Benson 1975: 229, cited in Thorelli 1986: 39).

To create a network, firms whose domains (that is, their products, markets, mode of operation, and territories) overlap need to contact each other and perceive the benefit of working together. Until a certain critical mass has been achieved in the level of cooperation and exchange transactions, the network does not merit the name.

Thorelli (1986) identifies five sources of network power for a member: its economic base, technologies, and range of expertise, coupled with the level of trust and legitimacy that it evokes from its fellow members. It needs to be differentially advantaged in at least one of these areas. All network members, although formally regarded as equals by virtue of their membership, will not have the same degree of power, and it is the linkages between the members and their respective power over each other in causing outcomes that determine the culture of the network.

Although networks accord membership to firms, they are not static closed bodies. Entry, exit, and repositioning are constantly going on in networks occasioned by a particular firm member's success, or failure, and the strength of demand or otherwise for the contribution other member firms believe it can make to their proposed projects. The ultimate justification for the cost to a firm of maintaining its position in a network is the belief that such network activity strengthens its competitive position in comparison to operating on a purely market-based philosophy.

Even networks themselves, however, wax and wane in power. As Thorelli (1986: 43) puts it, 'In the absence of conscious coordinative management—i.e. network management—networks would tend to disintegrate under the impact of entropy.' Networks depend on the establishment, maintenance, and perhaps strengthening of relationships in the hope of profits in the future. In this sense they are different from markets, which exist to establish profit today. It is, therefore, the perceived quality of relationships in networks that matters, since quantitative measures cannot easily be applied to them. Trust is essential here.

As has been discussed in Chapter 4, trust may be classified in three forms. Trust based on calculation is trust that exists at the outset of a relationship because the partners perceive that it is in their self-interest to set up the relationship, and to do so they must accord their partner some measure of trust. Trust based on understanding develops as the partners discover by working together that each is as good as his word, and one partner's actions may therefore be accurately predicted to be as it commits them to be. Trust based on bonding or personal identification through a warm human relationship may then develop over time, but does not necessarily do so in all business relationships. If it does, however, it is the best guarantor of a successful relationship.

Parts of networks are often appropriable by individuals in a way that technologies and production capacities are not, partly because only the calculative trust stage has been achieved. To that extent, although a firm may join a network to reduce its vulnerability, it may end up replacing one form of vulnerability for another. The successful corporate finance directors of merchant banks in the City depend almost entirely on their networks, and are eternally at risk of being bid away to other institutions through a large enough offer.

The network, as opposed to other intraorganizational forms, brings with it its own strengths and vulnerabilities. In a turbulent and global economic world, however, few players can risk being entirely without networks, or conversely being entirely dependent upon them.

Richardson (1972) sees firms as 'islands of planned coordination in a sea of market relations'. But, as Powell (1990) stresses, the sea is by no means clear, and this description of the alternative methods of exchange in economies is of doubtful use. Strong relationships and dense commercial networks have always existed wherever economic exchange occurs, sufficient to make the metaphorical antithesis of solid land and fluid sea an unrealistic one. It would be extreme, however, to blur the distinctions between markets, networks, and hierarchies such that they are rejected as useful categories. At the very least their underlying philosophies differ in essence. In markets the rule is to drive a hard bargain, in networks to create indebtedness for future benefit, and in hierarchies to cooperate for career advancement. As Powell (1990: 302) notes:

Prosperous market traders would be viewed as petty and untrustworthy shysters in networks, while successful participants in networks who carried those practices into competitive markets would be viewed as naïve and foolish. Within hierarchies, communication, and exchange is shaped by concerns with career mobility—in this sense, exchange is bound up with considerations of personal advancement.

Powell believes that networks score over other governance forms, particularly where flexibility and fast response times are needed, 'thick' information is needed, and varied resources are required owing to an uncertain environment. He also points out that the social cement of networks is strengthened by obligations that are frequently left unbalanced, thus looking to the future for further exchanges. This differs from other governance forms, where the pursuit of exchange equivalence in reciprocity is the norm.

Although trust and its general antecedent 'reputation' are necessary in all exchange relationships, they are most vital in network forms. It is true that you need to trust your colleagues in a hierarchy, and you need to trust the trader who sells you a product in a market, at least to the extent of believing that the good is of the declared quality. But in these circumstances tacit behavioral caution and legal remedies can to some degree compensate for doubtful trust in hierarchies and markets respectively. However, without trust, and a member's reputation on admission to a network, such a mode of cooperation would soon wither, probably into a market form.

Jarillo (1993) looks at a network as more than a rather randomly determined set of business relationships created because its members felt uncertain of the future, and believed that knowing particular differentiated trading partners well provided a stronger capability than the flexibility that comes with having only market relationships or the costs involved in vertical integration. In Jarillo's view what he calls strategic networks are merely another, and often better way of running the 'business system' necessary for the production and sale of a chosen set of products. By business system he means the stages and activities necessary for designing, sourcing, producing, marketing, distributing, and servicing a product; a form of analysis similar to Porter's (1985) value chain.

From this perspective Jarillo's strategic network requires a hub company to provide scope definition and leadership. It decides if it will carry out a particular activity internally or through network subcontractors. His exemplars of such a network system are thus Toyota and Benetton. Conditions that make such a system the preferred solution to vertical integration are in Jarillo's view:

1. widely varying optimal scale for different activities in the business system; some activities benefiting from small-scale providers;
2. varying optimal cultures for the most efficient production of particular activities;
3. business systems in which innovation most commonly comes from small entrepreneurial companies, and
4. widely varying expected rates of profitability from different business-system activities, as a consequence of their positioning in different industry structures as analyzed by a five-forces method (Porter 1980).

Jarillo bases his theory of the growth of strategic networks largely on the observation of the current trend towards company 'downsizing', a major component of which is the replacement of internal noncore functions by subcontracted providers, thereby contracting the size of the core salaried workforce. Frequently the company contracted to carry out the outsourced activities is a newly formed management buyout from the previously vertically integrated company. Greater motivation is instilled in the subcontractor at a stroke, better services are provided, greater flexibility is achieved by the hub company, and the size of the company's required capital base is accordingly reduced. There are in theory gains all round, although the motivation of those removed from the parent company may often be damaged, and the feeling of security of those remaining may be compromised.

Davis et al. (1994: 565) confirm this movement in their description of the decline and fall of the conglomerate firm in the USA in the 1980s. The authors talk of the firm as an institution being increasingly replaced by a reductionist view of the firm as a network without boundaries. They cite Zukin and DiMaggio's (1990: 7) description of firms of the future as no more than: 'dense patches in networks of relations among economic free agents'. This modern construct is developed further by Snow et al. (1992: 5), who also claim that the modern firm is becoming 'a new form of organization—delayered, downsized, and operating through a network of market sensitive business units—[which] is changing the global business terrain'.

This is clearly Jarillo's strategic network in another guise, although Snow et al. go further. They identify three distinct types of network:

1. *The internal network*. This is a curious identification as a network, since it is described as the introduction of the market into the internal organization of the firm. Thus activities are carried out within the firm and then 'sold' to the next stage of the value chain at market prices, with the purchaser having the right to buy externally, if he can get a better deal. The activity may also in turn develop third-party clients external to the firm.
2. *The stable network*. This is the firm employing partial outsourcing to increase flexibility and improve performance, with a smaller base of permanent employees. It is similar to the Japanese keiretsu in Western form.
3. *Dynamic networks*. These are composed of lead firms who identify new opportunities and then assemble a network of complementary firms with the assets and capabilities to provide the business system to meet the identified market need. Dynamic networks are sometimes otherwise described as Hollow Corporations (Business Week, 3 March 1986), since the entrepreneur lacks the capacity to carry out the range of necessary activities from its own resources.

Snow et al. take the network concept further by observing that the change in organizational form leads inevitably to a change in the required qualities of executives. In markets traders need above all to be quick witted, streetwise, and able to negotiate effectively. In hierarchies executives need a range of personal attributes including leadership qualities, administrative abilities, and diplomatic capacity. An autocratic style although not fashionable is not necessarily an inhibitor to success in many company cultures. In setting up and running networks, however, such a style would almost inevitably lead to the failure of the network or at least to the executive's replacement.

Snow et al. identify the broker as the ideal network executive, and they specify three distinct broker roles:

1. *The architect.* He is the creator of the network or at least of the project in which appropriate firms in an existing network are to be asked to play a part. The architect is the entrepreneur, and, dependent upon his creativity and motivational abilities, he may be instrumental in providing the inspirational vision that brings a network into being, in introducing new members to it, or merely in resourcing a project from existing network members.
2. *The lead operator.* This broker role is often carried out by a member of a downstream firm in the network according to Snow et al. He is the manager rather than the entrepreneur, and provides the brain and central nervous system that the network needs if it is to function effectively on a defined mission. As the name suggests, he needs to provide leadership, but in a more democratic style than would be necessary in a hierarchy, as the members of the team in which he needs to operate are not his employees.
3. *The caretaker.* This role prevents Thorelli's (1986) famous 'entropy' risk being realized. The caretaker will need to monitor a large number of relationships. He will need to nurture, to enhance, and even to discipline network members if they fail to deliver their required contribution. In Axelrod's (1984) 'tit-for-tat' strategy it will probably be the caretaker who applies the network discipline if one member defects or threatens to defect.

Snow and Thomas (1993) conducted some qualitative research into the validity of these broker roles in networks and found them to be broadly valid. While this contribution to network theory is valuable, it may be questioned whether the threefold taxonomy of Snow et al. is a valid one, since the internal network is in reality not a network at all, but merely a method of running an integrated hierarchy that many multinational firms have adopted. There is no doubt, however, that the network with a strong hub firm at the center is very different in nature and character to that which is set up amongst firms with greater claims to mutual equality. Even equal-partner firms will inevitably be differentiated in terms of their actual power though, and such power relationships will themselves almost inevitably change over the lifetime of the network's operation.

## 8.4 Network relationships

It is difficult to position networks on the cooperative strategy spectrum of ascending interdependence, since some networks exhibit firm-like qualities like the Japanese keiretsu, while others are little more than media for the fast transmission of informal industry information. However, the problem becomes easier to solve, if networks are classified into two distinct categories as suggested above—that is, the dominated network, where one firm maintains bilateral relations with a number of normally smaller companies, and the equal-partner network, in which a number of firms develop close relationships with each other, and work together in variable configurations on a variety of projects. These forms approximate to Snow et al.'s (1992) stable and dynamic networks. Their third category, the internal network, is regarded as outside the brief of cooperative strategy.

The spectrum of ascending interdependence, as shown in Figure 8.1, runs as follows. Markets exhibit the lowest degree of interdependence, indeed no interdependence at all in their pure form, with each transaction implying no specific probability of a repeat transaction.

The first level of interdependence is probably the equal-partner network. In such networks, firms, in Powell's (1987: 82) words, engage in 'reciprocal, preferential, mutually supportive actions. Reputation, trust, tacit collusion, and a relative absence of calculative quid pro quo behavior guide this system of exchange. In network forms of organization, individual units exist not by themselves, but in relation to other units.' Yet they do not submerge their personalities in each other or engage in wide exclusive arrangements with each other. In Pfeffer and Salancik's view (1978), such networks are formed to reduce the level of uncertainty in a firm's perceived environment. It is these networks that will form the major focus of this chapter.

Continuing up the chain of interdependence, we reach the unilateral cooperative agreements (DeFillippi and Reed 1991). In such arrangements one firm provides another with a service on a fairly intimate basis in exchange for money. Consultancy projects, training programmes provided by an outside training company, technology-transfer agreements, and relational subcontracting are all illustrations of such unilateral

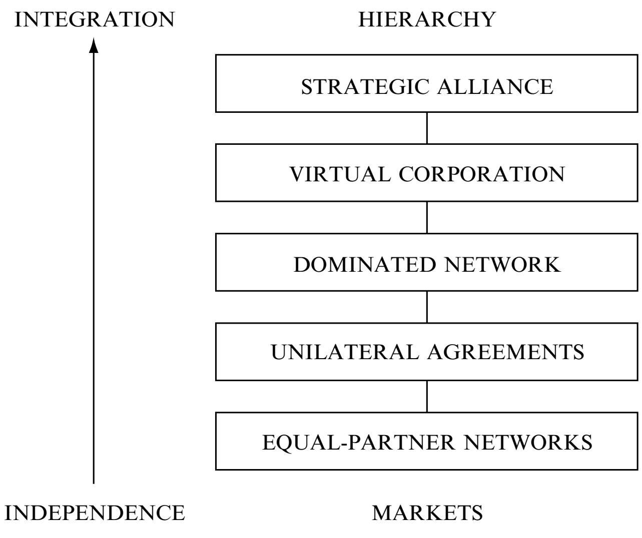


**Figure 8.1** Level of ascending integration of cooperative forms.

agreements. A minority investment by a large company in a smaller one can also be classified as a unilateral cooperative agreement. Thus, where one firm has a product and another market access, a unilateral agreement may be set up on an exclusive geographically limited basis, including royalties, minimum sales levels, and special distributor prices. This form falls short, however, of a mutually dependent strategic alliance. Such arrangements are purely financial, in the sense that a defined service is carried out in exchange for payment, and therefore represent very limited firm interdependence. In general the ending of a relation as a supplier or distributor with one firm is followed by the development of a similar relationship with a replacement firm.

The next level of interdependence beyond the unilateral cooperative agreement is the dominated network. This is most frequently exemplified by the Japanese keiretsu (Gerlach 1992), in which a major corporation—for example, Mitsubishi—exists with a wide and varied network of subcontractors and associated companies, which provide it with services on a regular basis. The network is regarded by all the institutions concerned as a kind of family, with the hub company as the paterfamilias and the periphery companies as its children. Hub companies often have seats on the boards of the keiretsu companies and may hold a small percentage of their equity. The network structure is used to ensure reliability and quality of supply components, and to make production tools like just-in-time logistics easier to administer.

The next level of interdependence is to be found in the virtual corporation, which is a loosely coupled enterprise in which the parts are held together through the medium of sophisticated information-technology packages. Virtual corporations may be a transitional stage of company development on the path to complete hierarchy, or they may be loosely packaged specialist functions coordinated by one firm to meet a market opportunity that may be short term. As with networks, the virtual corporation may be an equal-partner one or a dominated one, little different from a keiretsu mediated by IT. The virtual corporation will be described in more detail later in the chapter.

The highest level of interdependence short of hierarchy is the strategic alliance, which may cover a wide variety of functions but is normally one of three basic structures—the EJV, the collaboration (little or no equity exchange and no created boundary company), and the consortium. In the strategic alliance, companies merge a limited part of their domain (Thorelli 1986) with each other, and attempt to achieve with their joint value chains the competitive advantage that might individually have eluded them.

A hierarchy (Williamson 1975) is, of course, a fully integrated corporation in the traditional mould, which has been created normally to take advantage of economies of scale and scope, and of risk reduction, and to facilitate administrative coordination (Chandler 1962, 1990). They flourish best in only incrementally changing product–market environments, and display weaknesses of structural inertia when required to respond rapidly in turbulent economic conditions.

The focus of this chapter, then, is on two of the three interorganizational forms: the equal-partner network and the dominated network. Because of its greater stability and simplicity as an organizational form, we will begin with the dominated network. The virtual corporation form is the subject of Chapter 9.

### 8.4.1 The dominated network

This network form owes its recent growth in the West to two major unconnected factors: the international success in certain high-profile markets of industrial Japan, and the fall from grace of the large vertically integrated multidivisional industrial corporation, and its replacement as a favored paradigm by the downsized, delayered, core-competence-based 'lean and mean' organization, relying on outsourcing for its production in all functions except those deemed to be strategically vital and close to its core competencies.

The Japanese industrial keiretsu represents the archetype of the dominated network. In Gerlach's words (1992: 68):

> the vertical keiretsu are tight hierarchical associations centred on a single large parent and containing multiple smaller satellite companies within related industries. While focused in their business activities, they span the status breadth of the business community, with the parent firm part of Japan's large-firm economic core and its satellites, particularly at lower levels, small operations that are often family-run.... The vertical keiretsu can be divided into three main categories. The first are the sangyo keiretsu or production keiretsu, which are elaborate hierarchies of primary, secondary, and tertiary-level subcontractors that supply, through a series of stages, to parent firms. The second are the ryutsu keiretsu or distribution keiretsu. These are linear systems of distributors that operate under the name of a large-scale manufacturer, or sometimes a wholesaler. They have much in common with the vertical marketing systems that some large US manufacturers have introduced to organize their interfirm distribution channels. A third—the shihon keiretsu or capital keiretsu—are groupings based not on the flow of production materials and goods but on the flow of capital from a parent firm.

While Gerlach's description of the different types of keiretsu in Japanese industry is clear and categorical, in the complex world of reality the webs of the keiretsu do in fact frequently overlap, and it is possible to have keiretsu with dual centers, the one a manufacturing or trading center and the other a bank. It is also not unusual for the outer members of keiretsu to deal preferentially with each other as well as with the core company.

Such dominated networks are not unique to Japan, although they are a strong feature of the Japanese industrial system of production and distribution. In the UK Marks & Spencer's relationship with its suppliers has many of the characteristic features of the dominated network, including control over quality and supply in exchange for large annual order commitments.

Relationships within dominated networks typically take the form illustrated in Figure 8.2. There is often only limited networking between satellite companies, except in relation to the business of the dominant company. The dominant company may establish formal links with the satellite through a minority shareholding and/or board membership. But this is not always or even generally the case. The advantage of such networks from the viewpoint of the dominant company is that it can rely on regular quality supplies at a preagreed price without the need to put up the capital and management resources to create them directly. From the satellite's viewpoint, it can economize on sales and marketing expenditure and have the security of reliable orders and cash flow for its planning purposes, which removes many of the risks from its business. Of course at

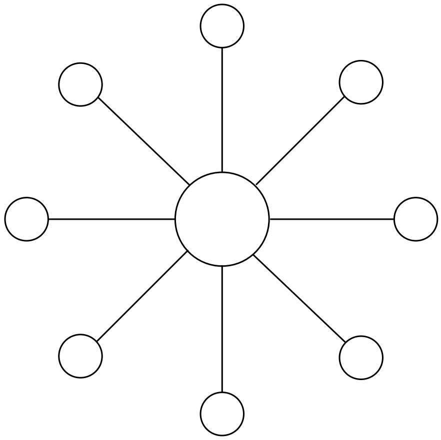

**Figure 8.2** Pattern of communication in a keiretsu.

the same time it also removes some of the autonomy, and if the satellite allows too great a percentage of its business to be with the dominant company it is at risk of ceding all independent bargaining power over such matters as price changes or product development.

## 8.4.2 The equal-partner network

Equal-partner networks are so named because, unlike in a dominated network, there is no single partner which sets up and controls the network's activities. However, this does not necessarily imply that all partners do in fact have equal power. In all equal-partner networks power relationships are varied and constantly shifting with the fortunes of members. The equal-partner network differs from the dominated network also in that it is not a substitute organizational form to the integrated firm. Rather it is the expression of a set of developed relationships between firms that form a substructure from which competitive organizational entities may emerge.

Figure 8.3 illustrates in a stylized fashion the nature of relationship and contacts between members in equal-partner networks in contrast to those in dominated networks illustrated in Figure 8.2. Equal-partner networks can be configured and reconfigured to meet changing market opportunities, and often with a different lead partner in the ascendant. This is both their strength and their weakness. While it implies great flexibility, and an ability to respond to changing often turbulent environments, an equal-partner network lacks the permanent brain and central nervous system that will ensure it combative ability against an organization that is so endowed. Any organization hoping to compete with vertically integrated companies, which possess production and sales capacity and strong identifying brand names, needs to convince the public of its enduring existence. It also requires a leadership capacity to plan and execute strategy, and information systems sensitive enough to convey what needs to be done and to ensure

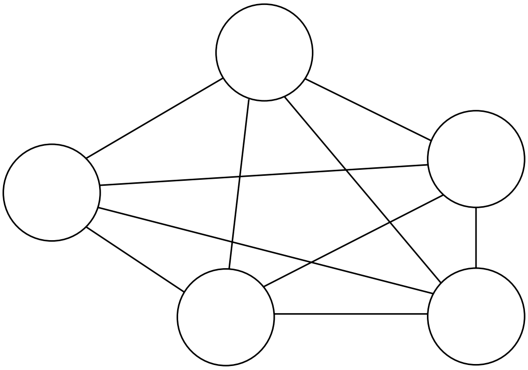

**Figure 8.3** The typical pattern of communication in an equal-partner network.

that it is done. This cannot easily be achieved via the loose linkages of an equal partner network, despite its other already identified advantageous qualities. For this reason an equal-partner network is more of the nature of a dense set of mutually aware capabilities than an actual organization form. Such networks may therefore often be in transitory forms that will develop into dominated networks, virtual corporations, or even integrated companies in due course. In economies where networks traditionally flourish like Silicon Valley, California, the emergence of new firms out of a deeply embedded network substructure does not disturb the basic network characteristics of the economy.

Gomes-Casseres (McQuade and Gomes-Casseres 1992; Gomes-Casseres 1994) provides an interesting example of competition between dominated networks and a much more equal-partner network in the RISC processor competition of the 1990s. Competition in this sector was launched by a successful design in 1985 on the part of MIPS Computer Systems. This technology offered a new architecture for computer operating systems, based on using simplified instruction sets for increased processing speed without increasing the size or density of components on the processor chips. Commercial success bred imitation, and by 1991, various RISC architectures were available, with Hewlett-Packard, Sun Microsystems, and IBM presenting the major competition for MIPS. MIPS, as a relatively small firm with engineering expertise in systems software and processor design, had been developing a network of chip manufacturers and distributors since 1987. By 1992, though, MIPS's network was matched by networks centered on Sun, H-P, and IBM. While MIPS had a critical first-mover edge in the marketplace for its architecture, its design focus made it vulnerable to strategic decisions by its partners, on which MIPS relied for production, use, and sales of chips based on its designs. Its main competitors, however, all produced at least a portion of their chips and sold computers and workstations directly in the market, using their strong brands, and incorporating their chips and architectures. In the face of intense competition, MIPS proved unable to manage a network in which they were not the leading firm, only the supplier of technology and had no established brand. When two equipment makers, DEC and Compaq, left to either pursue their own designs or to join other networks, MIPS's network collapsed, and MIPS itself was acquired by Silicon Graphics, one of its chip suppliers. The other major competitors, leading dominated networks, were able to continue their competition, as they had the market power, size, and brands to control their networks.

### 8.4.3 The effect of networks

The concept of the social embeddedness of networks has become of considerable interest to researchers of late. All make intuitively sensible points providing insights that might otherwise go unnoticed. For example Uzzi (1996) establishes from empirical research that high levels of embeddedness of a firm in a network leads to poor performance and so does low embeddedness. Moderate embeddedness is however helpful to performance. The reasoning runs as follows. Deeply embedded firms have their flexibility for strategic choice outside the network severely hampered and suffer for this in diminished performance. However, unembedded firms suffer from lack of the knowledge and capability enhancement that belonging to a network can bring. Moderate embeddedness, however, both preserves freedom and flexibility, and also provides access to wider knowledge. Gulati and Zajac (2000) take the concept of network embeddedness and hypothesize that being embedded in a particular network social structure conditions the alliances that firms form, and thus both limits and enables the development of those firms and alliances according to the business appropriateness of social networks that were formed originally for other than business purposes. However, they claim such alliances should have a better than average chance of success as the key qualities of trust and cultural congruity are likely to be present in alliances formed out of common social networks.

Thus, social networks can reduce the chance that firms with potential technological compatibility will fail in an alliance due to mismatched socialization. However, they seem to raise the potential for ‘relationship traps’, in which partners are selected due to social network membership, with no search external to the network for more appropriate ties. Corviello and Munro (1997) support this line when they claim that the incremental internationalization of small and medium-sized enterprises (SMEs) is often developed rather haphazardly (or more charitably emergently) on the basis of who they know internationally, that is, on the basis of their existing networks, however appropriate these potential partners may or may not be as rationally chosen partners for international development.

> The network perspective shows that international market development activities emerge from, and are shaped by an external web of formal and informal relationships. (Corviello and Munro 1997)

Networks can also be unpredictable factors in the lives and evolution of larger MNCs, as Gauri (1992) shows. He describes how MNCs develop networks both at the center and regionally as their international activities mature. It may be then that the demands of the local network conflict with those of the center. In this case, Gauri suggests, the needs of the local network are likely to prevail, and the center will find great difficulty in enforcing its will. The center may be behaving rationally according to a predetermined strategy, while the regional center is operating organically and in an evolutionary manner. This may in fact be to the advantage of the MNC in long-term developmental terms.

Kogut (2000) writing in favor of networks, stresses that a particular network can benefit firm performance in proportion to the range and quality of the information it provides, and by the impetus to development created through being part of an evolving network full of dynamic activity. Afuah (2000), looking on the other side of the coin, finds that performance is lowered if the capabilities in a network are pooled as a result of technological change with which the network has not kept pace. Gulati et al. (2000) support this view, stating that although networks provide a firm with access to information, resources, markets and technologies, they may also, if inappropriately constituted, lock firms into unproductive relationships. They conclude therefore that 'networks really do matter in terms of firm performance'.

Thus we may conclude, that being part of a high performing team raises your game, but being part of a losing network drags you down with it. The moral is to choose your network partners carefully. This is emphasized by Baum, Calabrese and Silverman (2000), whose research shows that the performance of start-ups can be substantially affected by the nature of the networks within which they choose to work. Baum et al.'s research on Canadian biotech start-ups confirms their hypotheses that early performance can be enhanced by (*a*) establishing alliances, (*b*) configuring them into an efficient network that provides access to diverse information and capabilities with minimum costs of redundancy, conflict and complexity, and (*c*) judiciously allying with potential rivals that provide a good chance of enhancing learning and low risk of intra-alliance rivalry.

Dyer and Nobeoka (2000) give further support to the importance of the quality of the networks in their research into Toyota's network of suppliers. Here they pinpoint the creation of a high performance knowledge-sharing network as the keystone to high productivity for the members of the network. Toyota, they claim, has achieved this by creating a strong network identity, with rules for participation and rules for entry into the network. In Toyota's world, it would seem, production knowledge is viewed as the property of the network. Thus Dyer and Nobeoka hold that by extension dynamic capabilities can create competitive advantage by extending beyond firm boundaries, and where this is achieved through members accepting and avoiding conflict as a result of clear coordinating rules, the network so created will be superior to a simple firm as an organism for creating and recombining knowledge due to the inevitably larger store of knowledge that resides in a network, in contrast to that in a firm alone. They stress however that networks should not have too many members performing similar roles, or there will be a high potential for conflict, and firms with inefficient webs of alliances do not prosper.

Network theory has become prominent of late as the basis for new organizational forms (Nohria and Eccles 1992; Castells 1996) and for the growth of cooperative strategy as a counterbalance to the self-sufficient philosophy underlying competitive strategy theories. At one level, however, networks have always been with us. Shortly after any individual starts up a business, or engages in any repeated endeavor, that person begins to build up a network out of the associates with whom he or she interacts. In the business world they will be suppliers, distributors, and perhaps to a lesser extent competitors and customers. He or she will always consider the degree to which they should outsource some of their potential activities, and the level to which they should deal directly with the customer or develop their sales through a network. In some areas—for example, northern Italy—this has traditionally led to strong specialization of activity amongst family firms, and therefore the network as the fundamental underpinning of business activity. In other areas, notably much of the USA, vertical integration has been more the norm until the 1990s, with cooperative networked activity therefore treated with some suspicion.

The degree of prominence networks have received has significantly increased in recent years. This is due largely to the globalization of markets and technologies, leading to the widespread growth of cooperative activity as a necessary strategy, if firms with limited financial strength, focused competencies, and limited 'global reach' are to be able to compete in global markets.

An attractive characteristic of many networks, then, is that they help members achieve increased global reach at low cost and with minimum time delay. They are flexible within their membership, and able to respond rapidly to changing environmental situations. In an increasingly turbulent world, they reduce uncertainty for their members. They enable synergies between members to be captured, and provide the conditions for the achievement of scale-and-scope economies through specialization. They are also good vehicles for the spreading of information and for all forms of market intelligence. Under conditions of trust between members, they may also reduce transaction costs, in contrast to vertically integrated companies with internally competitive cultures. But such costs are very difficult to assess in any situation, particularly *ex ante*.

However, networks, if they are to be contrasted with vertically integrated companies and with the arm's-length nature of the pure-markets form, do not score well on all counts. In dominated networks, the risks for the dominant partner are of unlicensed technology leakage, of poor quality assurance, and of a possible diffusion of internal feelings of identity and motivation in the outlying companies. There is also the difficulty of communicating tacit knowledge, and of achieving a sufficient level of coordination between members in different companies to compete successfully with the systems of integrated companies—the 'singing from several hymn sheets' problem. For the smaller companies in the dominated network, there are the problems of feeling too dominated, and thus of loss of autonomy and motivation, of lack of promotion opportunities, of insecurity, and of the difficulty in recruiting high-quality personnel to small companies with limited prospects.

In equal-partner networks the primary problems relate to the lack of a brain and a central nervous system. By their nature they are loosely organized coalitions without a permanent acknowledged leader. Major investment in such networks is difficult to organize, and there is the perpetual tension between trust and the risk of prisoner's-dilemma defection by partners—that is, the potential creation of competitors as a result of too much misplaced trust. There is also the difficulty for a network of driving consistently towards a vision of the future, in the way a successful vertically integrated company can and does.

The global economy of the future will undoubtedly see a growth of networks in the search for reduced uncertainty in the face of the increasing turbulence of world economic activity resulting from the globalization of technologies and markets.

Cooperative strategy will become more prominent but can never replace competitive behavior in the ultimate market place, if pressures for efficiencies are to be maintained.

## 8.5 Summary

1. Networks arise in order to reduce uncertainty, provide flexibility, increase capacity, provide speed, access to new resources and information.
2. Network relationships are dominated by power and trust.
3. Strategic networks are replacing the integrated company in many industries; outsourcing features strongly in them.
4. Snow et al. identify three types of network; the internal network, the stable network and dynamic networks.
5. They also identify three types of network executive: the architect, the lead operator and the caretaker.
6. A dominated network is one where a lead firm with a brand name outsources to other firms on a regular basis many of its value chain activities.
7. An equal partner network is not a substitute for an integrated firm, but is rather a set of developed relationships between firms able to mount a project rapidly.
8. Business networks often arise out of social networks, and vice-versa.
9. The quality of a network significantly affects firm performance.
10. A network approach enables a firm to achieve increased global reach rapidly.

## 8.6 Questions for discussion

1. How does a network differ from an alliance?
2. What are the key characteristics of networks?
3. Why have networks become so popular of late?
4. What attitudes are necessary from executives if networks are to succeed?
5. What are the principal types of network?

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# 9 The virtual corporation[1]

## 9.1 What this chapter covers

Definitions and descriptions of virtual organization vary considerably and this chapter starts by identifying the features that are common to this new organizational form. It then describes different forms of virtual organization and the conditions under which such organizations emerge listing the benefits to be achieved from virtual corporations and their limitations. It goes on to describe how to manage the virtual corporation, emphasizing the economic, technological, and organizational factors that need to be considered, and highlighting the need for well-developed teamwork in virtual corporations. Perhaps counterintuitively it notes that research shows avoiding conflict can have a negative effect on team performance. The important role of IT in the management of a virtual corporation is also stressed.

## 9.2 The virtual corporation

Just as network theory and the strategic alliance became the popular phrases to describe the growing intraorganizational forms of the 1990s, it seems likely that the 'virtual corporation' will fill that role in the first decade of the new millennium. The virtual corporation differs from the strategic alliance in that it places its emphasis, not primarily on how two or more firms can work together to their mutual advantage, but on how one firm can be created with flexible boundaries and ownership aided by the facilities provided by electronic data exchange and communication. As Nagel and Dove (1991) put it: 'A virtual company is created by selecting organizational resources from different companies and synthesizing them into a single electronic business entity.'

There is one crucial difference between strategic alliances and the virtual corporation beyond the electronic aspect of the latter. The strategic alliance is generally created to bring about organizational learning. Many commentators highlight the point that successful alliances are not composed of partners involved in skill substitution—that is, one partner produces and leaves the selling to the other. They are concerned to learn from each other, and thus strengthen the areas in which they are weak. This does not apply to the

[1] Some of this chapter is taken from Chapter 9 of John Child, *Organization: Contemporary Principles and Practice*, Oxford: Blackwell 2005.

virtual corporation. In this intraorganizational form, companies each provide different functions, and are linked electronically. Organizational learning is not a basic objective of the exercise, but rather the creation of a flexible organization of companies, each carrying out one or more functions in order to deliver a competitive product to the customer.

Mowshowitz (1994), however, attempts a deeper and more conceptual view of the way in which the virtual corporation differs from earlier organizational forms. He points to the nonincremental changes in society in history (echoes of punctuated equilibrium!). Thus the factory system developed rapidly in the nineteenth century when, owing to the advantages of the steam engine as a source of power, great productivity could be achieved, thereby separating the means of production from other social interaction, in a way that the earlier handicraft workshop did not.

He believes the virtual organization will have similar dramatic results, bringing equally great social transformation in its wake. He states:

> The essence of the virtual organization is the management of goal-orientated activity in a way that is independent of the means for its realization. This implies a logical separation between the conception and planning of an activity, on the one hand, and its implementation on the other.

There is, therefore, no problem, as there is in the traditional organization, with allowing extraneous matters such as company loyalty or human relationships to enter the equation of how best to realize abstract goals in concrete terms. The concept of infinite switching capacity, which is central to Mowshowitz's virtual-corporation concept, allows such realization to be achieved from the best combination of inputs, despite their spatial separation. Electronic communication overcomes the problem of the spatial separation of inputs. He adopts the concept of meta-management as central to operating the virtual corporation effectively. Meta-management involves the following steps:

1. an analysis of the inputs needed from outside sources, independent of the examination of particular suppliers
2. tracking and analysis of potential suppliers
3. revising and improving the allocation procedure
4. updating the requirement-supplier table.

He then identifies the three pillars of virtual organization as:

1. Standardization of interaction. Thus suppliers can be coupled and decoupled with ease to meet changing objectives, and the perceived optimal means of achieving them.
2. Commoditization of information. This is necessary to facilitate switching and thus realize the flexibility necessary for the new form of organization. 'By reducing dependency on the human being as the bearer of knowledge and skill, it is possible to increase the flexibility of decision-making and control to unprecedented levels. Knowledge is a basic factor of production, and if it can be supplied by computer-based artifacts, it can be manipulated and combined with other factors of production in ways that are not possible with human labourers' (Mowshowitz 1994: 281).
3. Abstractification of property. Thus a house is made abstract in the form of its title deeds. Abstract property rights, as Mowshowitz observes, simplify the preservation of

> wealth over time, and its movement over space. Since switching means functions may be carried out anywhere in the world, the problems of currency and interest-rate risk need to be controlled through such abstract instruments as currency hedging, and the use of currency futures and option contracts.

Moving back into the traditional mainstream of organization theory, Mowshowitz (1994) claims that the virtual organization is consistent with the contingency-theory approach of Lawrence and Lorsch (1967). The contingencies are, however, not wholly environmental, but are more concerned with the elements that managers can use to craft organizational solutions to meet specific objectives.

Perceived in this way, the virtual corporation has such dehumanizing aspects that it invites rejoinders, notably from Walsham (1994), who notes the absence in the concept of any reference to the contribution of the culture of organizations, or to the need for meaning and a sense of identity in a person's working life. He claims that 'it can be suggested that a human being acting as a "whole person" is likely to be more economically productive than one enfeebled by the adoption of an amoral role subservient to powerful interests' (1994: 291).

This is reminiscent of the arguments of Taylorists, who would, in the interests of efficiency, break a task down to its component parts, deskill it, and dehumanize the operative. This is in contrast to the more modern ideas of those like Skinner (1978), who would organize a task to meet the needs of the whole person. This may be the key constraining factor in the growth of the virtual corporation—that is, efficiency may be reduced, rather than increased, if the human interest and motivating factors are removed from the day's work. If so, the Mowshowitz vision will require considerable modification before it can hope to become a dominant organizational paradigm.

The Walsham rejoinder to Mowshowitz does, however, give pause for thought to the conclusion that efficiency without motivation necessarily leads to greater productivity, than that achieved through a lower level of efficiency coupled with the high motivation achieved from working in a committed dedicated team. So the dominance of the dehumanized virtual corporation is by no means assured.

It is interesting to note the tension that is ever present in a discussion of cooperative strategy between, on the one hand, the identification of the human qualities of compromise, forbearance, consensus development, and trust as keys to success, with, on the other, the dehumanized virtual corporation with its elimination of loyalty, human eccentricities, or even culture as extraneous to efficiency needs. Yet they are two sides of the same coin of cooperation between independent companies in the pursuit of the satisfaction of an economic need.

Harrington (1991) draws attention to a distinction between perceptual organization and physical organization that may attenuate the harshness of Mowshowitz's vision to some degree. Using this distinction, Harrington claims that an organization needs only to be logically perceived as one to become one. The organization thus has virtual (logical) qualities, and physical existence in its traditional form. The virtual and physical aspects of a firm coexist, and interact with each other. Power, culture communication, knowledge perception, and self are seen by Harrington as virtual characteristics, whilst resources, management, personnel, organization structure, information systems, and production are seen as epitomes of the physical organization. The virtual characteristics are less clearly bounded, and are more dominant in some types of business than in others. An advertising agency may perceive itself to be single entity, even though most of its contributors may be self-employed. The organization itself is shaped by the interaction of its virtual and physical parts. Information technology unbalances the firm towards virtuality, which can limit or increase effectiveness, according to how its introduction is handled.

The Harrington concept is more human than the Mowshowitz idea. However, if we are concerned with efficiency and effectiveness of organizational forms, it may be helpful, in assessing the validity of the Mowshowitz twenty-first century vision, to measure it against the identification by Child (1987) of the three key characteristics an organizational form needs if it is to flourish. The three great strategic challenges faced by a corporation in the turbulent, global economy of the current and immediate future are, according to Child, demand risk, innovation risk, and efficiency risk.

By 'demand risk' he means the risk that capacity will have been created to produce and sell in a market that then fluctuates widely, either booming or rapidly melting away. In such circumstances a virtual corporation, or at least one with a relatively limited fixed central core, and a large and flexible periphery, is in a better position to survive, and adjust to changed market conditions than a wholly integrated corporation. Mowshowitz's virtual corporation is then well suited to cope effectively with demand risk. The switching function ensures this.

By 'innovation risk' Child refers to the risk of falling behind rivals in the race for the new generation of products. There are mixed arguments for the virtual corporation here. Child advances the view that a specialized core, buying in parts outside that specialization, helps innovation by concentrating the specialists on developing new products and technologies related to their area of core competence. Chesbrough and Teece (1994), however, champion the integrated firm in areas of systemic technological innovation, since they argue that only such a corporation will have the will and the funds to risk such major R&D programmes. They relegate the virtual corporation to a position of being able to deal effectively only with what they term autonomous innovations—that is, those that involve far less than a whole system. Chesbrough and Teece would question the ability of the Mowshowitz virtual organization to cope with systemic innovation as effectively as the more traditional integrated corporation. However, we are in the domain of theory, as there is currently little more than anecdotal evidence to support either argument.

By 'efficiency risk' Child alludes to the ever-changing nature of costs as technologies change. Here the virtual corporation would seem to have an advantage over the vertically integrated hierarchy, as virtual companies, coupled on the basis of specialization, are likely to be well equipped to achieve optimal scale economies, and consequently to contribute low-cost parts to aid the production of an aggregatively low-cost product.

Child (1987) also stresses that coordination within such virtual corporations can be achieved only through attention to what Boisot (1998) calls the increased codification and diffusion of information, by means of the increasingly sophisticated channels of modern information technology.

> IT has, in short, changed the economic cost–benefit balance in favour of greatly enlarging the information processing capabilities of organizations. Additionally it has expanded the options for

the codification and diffusion of information. The availability of these options makes a significant contribution towards the viability of externalizing transactions. (Child 1987: 43)

Warner and Witzel (2004: 18) echo the view that virtuality involves a mental leap which allows for a highly fluid and boundary-transcending form of collective activity:

in virtual organizations the solid physical realities of bricks and mortar, offices and production plants, colleagues and customers met face-to-face, are to some extent—sometimes to a large extent—dissolved and replaced by virtual forms. Solid bricks become fine networks. Instead of managing within organizations that enclose us and envelope us, we are part of an organization that is fluid, flexible and to a large part invisible, and can be called into existence only by active mental effort on our part. In virtual space, we place less emphasis on our five physical senses, and much more on our inner knowledge and imagination.

New forms of technology are seen as the most significant facilitators of virtual organization. Indeed, as we have noted one definition of virtual organization is that it is a repertoire of variably connectable modules built on an electronic information network. It is, however, possible to have organized activity based on modules or groups that are flexibly connected without the assistance of modern information and communications technology (ICT). The clan mode of organizing come close to this description and has been functioning in societies like China and Southern Italy for many centuries. Nonetheless, ICT has opened up a huge range of new possibilities and extended the potential scope of organizing in a virtual manner to the global level.

Certain phrases are commonly used to identify the virtual organization—lack of physical structure, reliance on ICT, fluidity and mobility, the transcending of conventional boundaries, networks, and flexibility. Definitions of the virtual organization tend to emphasize one or more of these characteristics and therefore vary considerably. Some stress the role of information and technology, regarding the virtual organization as one that organizes information and technology rather than people. Others stress the networking aspects, applying the idea of virtuality to webs of partnerships between individuals or firms that come together to achieve a task or make a product. Dell (2000: 185), for example, defines 'virtual integration' as 'the idea of interweaving distinct businesses so that our partners are treated as if they're inside our company'. A further variant is the idea of flexible workforces that are brought together to perform a given need and then disband. In all these respects, virtual organization is seen as an attempt to avoid the rigid hierarchies and boundaries that often characterize conventional organizations.

Virtual organization takes the notion of the network organization to a higher level. While companies within a network may still act as different entities towards the external environment, the virtual organization is seen as a single entity from the outside, within which the companies inside act much more in concert. A highly developed network for coordination, normally using ICT, is required to achieve this. A significant level of mutual trust focused on an acceptance of common business goals is also needed.

Faced by this wide range of interpretations, Warner and Witzel suggest that it is useful to note the features that nearly all virtual organizations have in common. Box 9.1. summarizes the ones they identify.

**Box 9.1 Common features of virtual organizations**

- Lack of physical structure: Virtual organizations have a lower physical presence than their conventional counterparts. They have fewer tangible assets such as office buildings and warehouses, and those they do have are often geographically dispersed. Some have suggested that in the future, firms may be structured in virtual reality formats with computer links taking the place of physical infrastructure and firms existing only in cyberspace.
- Reliance on communications technology: Modern ICT plays a vital role in enabling virtual organization, and many see it as being at the heart of the virtual organization. Whereas conventional organizations use physical structures to provide their framework, virtual organizations use networks of communication supported by the Internet and other systems. However, technology is an enabler of virtual organization rather than the organization itself.
- Mobile work: The use of communications networks rather than buildings and tangible assets means that it is now less important where work is physically located. As a result, departments and teams no longer have to work in close contact with each other. Project teams can be—and in sectors such as publishing, routinely are—assembled from persons in different countries or on different continents to work together without ever coming into physical contact.
- Hybrid forms: Because virtual organizations often involve collaboration between individuals or firms, they have been referred to as hybrids—networks, consortia or webs working together within a loose framework to achieve a mutual goal. Such hybrids can be short-term such as consortia with a limited life bringing players together to undertake risky research and development projects, or they can be longer-term such as virtual supply chains.
- Boundaryless and inclusive: This characteristic is associated with the way that virtual organizations are not confined to legal entities. They can encompass suppliers and distributors working in tight relationships with producers, and bring customers into the production process through the concept of relationship marketing. Online financial services are a highly developed example of this latter phenomenon.
- Flexible and responsive: Virtual organizations are, in principle, very responsive and flexible. They should be amenable to rapid assembly from a variety of disparate elements, used to achieve a certain business goal and then dismantled. Much in practice, however, will depend on the people involved: whether they can negotiate mutually satisfactory arrangements quickly, and whether managers and employees are willing to work flexibly.

*Source*: Warner and Witzel (2004: Chapter 1).

To appreciate the difference between the integrated hierarchical company and the virtual corporation, it may be useful to look at both organizational forms and contrast them on a number of criteria. Table 9.1 attempts such a comparison on six basic dimensions.

**Table 9.1** A comparison of integrated and virtual corporations

| Organizational dimensions | Integrated corporation | Virtual corporation |
|---|---|---|
| Organization structure | Formal and flexible | Flexible network, flat |
| Decisions | Ultimately by fiat | By discussion and consensus |
| Culture | Recognizable, encouraging employees to identify | Pluralist, linked by overlapping agendas |
| Boundaries | Clear 'us and them' | Variable |
| Management | High overheads | Minimal overheads |
| Power | From the board ex officio | Through possession of competencies in demand<br>Being the brand company |

The basic differences are of an autocracy and a democracy, if one takes an analogy from the political sphere. In the autocratic hierarchically organized company, employees are paid salaries, and therefore are implicitly bound to accept the orders of those in authority over them, even if they disagree with them. Considerable resources are expended in constructing a governance framework based on motivating devices, sanctions, communications systems, job descriptions, organigrams, and layers of middle management that are neither the board of directors nor 'front-line troops'. A culture is established that encourages all employees to 'sing to the same hymn sheet' and identify with the corporations in all possible ways.

Virtual corporations are quite different. Their culture is pluralist and task orientated. Decisions are necessarily consensual, and overheads are minimal. Furthermore the boundaries of the corporation are as narrow or as wide as the personal networks of each member. Core competencies are similarly flexible, as new members can always be brought on board without difficulty. It is the flexible boundary issue in fact that provides perhaps the most attractive feature of the virtual corporation. However, it is important to emphasize that the difference between cooperation and competition is not, as is sometimes suggested, necessarily highly correlated with ownership and the boundaries of the firm. As Jarillo (1993) suggests, there may be competition inside a firm and cooperation outside it, as illustrated in Figure 9.1. Thus, under common ownership (the firm), there may be cooperation (e.g. the vertically integrated company united by a common vision and culture), or competition (e.g. many functionally hostile bureaucracies). Similarly, in conditions without common ownership there may be cooperation (e.g. the virtual corporation), or competition (e.g. the market).

There are, of course, limitations and disadvantages too with the virtual corporation: difficulties in achieving scale-or-scope economies, difficulties of tacit knowledge transmission, problems with proprietary information leakage, and difficulty in financing critical mass level R&D, difficulties in maintaining commitment, and so forth.

Virtual corporations may be realized in a largely incremental way. Thus a firm may start out by performing some activities itself and subcontracting others. As it grows and establishes trust and commitment relationships with its subcontractors, it may establish single-source relationships not unlike those of the Japanese keiretsu, where a high degree

| | *Cooperative approach* | *Noncooperative approach* |
|---|---|---|
| *Common ownership* | Vertically integrated company<br>Shared goals | Bureaucracy<br>Frequently adversarial relationships |
| *No common ownership* | Virtual corporation<br>Belief that 'we are stronger together' | Market<br>Arm's length relationships |

**Figure 9.1** Competition and cooperation do not depend on ownership patterns.
*Source*: Adapted from Jarillo (1993).

of operational interdependence is developed between firms at different stages of the value chain of activities, but with little if any common ownership.

The next stage in this electronic age may be the development of a strategic network between the operators, and then ultimately probably the establishment of a corporate identity through some form of joint ownership of profit streams. The virtual corporation has arrived, and may be followed as required by lesser or greater levels of integration, and by the development of a variable repertoire of configurations to meet changing market needs.

Rayport and Sviokla (1996) extend the concept of virtuality from the corporation to the value chain that depicts graphically the activities carried out by the corporation (Porter 1985). The physical value chain (PVC), as they differentiate it, has typical primary activities of inbound logistics, operations, outbound logistics, marketing and sales, and after-sales service. These activities are supported by activities such as technology development, human-resource functions, the firm's infrastructure, and procurement. The PVC incurs costs, sometimes very high costs, as activities move from one linkage in the chain to another, and the most efficiently configured PVC takes advantage of what economies of scale and scope exist in the technologies and process of the firm. Rayport and Sviokla depict a virtual value chain (VVC) that exists in the age of the microchip alongside the PVC. It needs to be managed separately from the PVC, but in concert with it. It does not require the realization of scale-and-scope economies to achieve cost efficiency. Often an activity may be moved from the PVC to the VVC with advantage; thus Ford used to conduct product design by gathering an engineering team in a specific location and charging it with the job of designing a car. This can now be done by a virtual team in different parts of the world operating through CAD/CAM, e-mail, and teleconferencing.

Creating value in the VVC involves five sequential activities: gathering, organizing, selecting, synthesizing, and distributing information. If these five activities are applied to each activity in the PVC, then a value matrix is created that can transform the operations of the company, and thus even the 'rules of the game' of the industry.

Boeing, for example, has been able to develop a teardrop-shaped aero engine in virtual form, tested it virtually in a wind tunnel, and determined the best design at almost zero cost. Rayport and Sviokla talk of shifting activities from the market place to the 'market space'. As they say: 'Managers must therefore consciously focus on the principles that guide value creation and extraction across two value chains (PVC and VVC) separately and in combination' (1996: 34).

## 9.3 Characteristics of the virtual corporation

We might develop a concept of the virtual corporation based on three premises:

1. Few companies are excellent at all functions. Greater value can, therefore, be created if each company concentrates on performing only the functions that it does best, and relies on cooperating partners to carry out the other functions, rather than by attempting to do all things internally within a fully integrated company.
2. The globalized trading world is increasingly volatile and turbulent. In order to survive, companies need to link together flexibly, and be immediately ready to effect ICT-based architectural transformations to meet changing conditions.
3. Cooperative attitudes even between competitors, and the existence of increasingly sophisticated electronic software, make points 1 and 2 possible.

Fortune Magazine (1994) endorses this characterization, seeing the virtual corporation as dependent upon six prime characteristics:

1. A repertoire of variably connectable modules built around an electronic information network.
2. Flexible workforces able to be expanded or contracted to meet changing needs. The 'shamrock' (Handy 1989) pattern may well be an appropriate one here, with a small central core and several groups of self-employed workers selling their time as required.
3. Outsourcing but to cooperating firms with strong and regular relationships as in the Japanese keiretsu.
4. A web of strategic partnerships.
5. A clear understanding amongst all participating units of the current central objectives of the virtual corporation. In the absence of such an understanding there is a high risk that the corporation will lack the will and purpose to compete successfully with more integrated corporations.
6. An enabling environment in which employees are expected to work out for themselves the best way of operating, and then to get things done. This is in contrast to the traditional system of working according to orders conveyed with the aid of operations manuals, organigrams, and job descriptions.

Such a corporation would be unlikely to work effectively in the pre-electronic age, as failures of communication and computation would lead to unacceptable inefficiencies and misunderstandings within the virtual network. However, there are nowadays a wide range of software packages and systems in existence able to provide the electronic systems for the virtual corporation.

### 9.3.1 Forms of virtual organization

It is important to recognize that there can be different degrees and different forms of virtuality in organization.

Some organizations may organize certain activities on a virtual basis while organizing others in a conventional manner. For example, the operations inside supermarkets are physical and tangible. By contrast, their links with many suppliers are often virtual through the use of automated reordering systems. In addition, specialist programmers working from their homes maintain the software for these and other systems. Very few companies, however, are suited to complete virtuality throughout all their activities. They may have to maintain a physical connection with their customers and they may also still be producing tangible goods.

The exact mix of virtual and tangible aspects in an organization depends on the nature of its product or service, and the way it adds value in relation to the needs of customers and suppliers. It is useful here to distinguish between the mix of virtual and tangible organizational assets and the extent to which these are managed in a virtual or tangible manner.

The most comprehensively virtual organization is found when both its assets and management system are highly virtual. Many financial service firms fall into this category. They are trading a largely virtual commodity—financial instruments and currencies—across dispersed networks of offices around the world, managing the transactions through various communication technologies. Other cases illustrate the management of virtual assets in a nonvirtual way. These are often found in knowledge industries, where intellectual property is created or processed through project teams, teaching programme teams, or publishing houses. There is always the potential for the management and coordination of such virtual assets to be managed in a more virtual manner. There is, for instance, growing interest in the use of virtual global teams for research and development.

Another form in which both assets and management are highly virtual is found with companies that take outsourcing to its limits. When a company outsources all the activities in its value chain except for its strategic core, and coordinates these in a virtual manner, it can be large in trading terms but very small in terms of fixed assets and permanent staff. For instance, the fashion accessories company Topsy Tail had revenues of about $80 million in 1998, but only three employees. It never even touches its products through the entire supply chain. It contracts with various injection-moulding companies to manufacture its goods; it uses design agencies to create its packaging; and it distributes and sells its products through a network of independent fulfilment houses, distributors, and sales representatives (Malone and Laubacher 1998).

The traditional way to manage tangible assets has been in a non-virtual way. This uses the conventional form of organization in which most people and assets are physically concentrated into factories and offices, and are managed through hierarchies. It is in fact difficult for technical reasons to envisage anything other than a non-virtual configuration and management of integrated process production, unless such processes can be completely automated.

Tangible assets can be managed in a partly virtual manner when the value chain can be separated into stages. Global virtual supply chains, as are common in the automobile and computer industries come into this category. Dell Computers provides a case-in-point and is often held up as an example of a highly successful virtual value chain network.

> Microprocessors and other semiconductors may pass through as many as four or five different production facilities—often in as many countries—as they move down the value chain through the various processes of etching, masking and so on to finished status. The physical production plants are controlled 'virtually' from the corporation or supply chain headquarters. (Warner and Witzel 2004: 6)

### 9.3.2 Conditions for the viability of a virtual organization

Certain conditions are necessary for a potentially beneficial set of links between people and units to be converted into a viable virtual organization. First and foremost, like any organization a virtual organization requires management. Warner and Witzel (2003) suggest that four managerial tasks will assume greater importance in a virtual organization: communication, assessment, learning, and valuation. First, managing communication clearly presents a particular challenge in the planning, coordination, and control of activities that are no longer located centrally under one roof. This means ensuring that the flows of information and knowledge are efficient, relevant and timely, so as to link all the elements of the organization to one another as well as to suppliers and customers. Second, because a virtual organization is composed of various quasi-independent units, it is necessary to make frequent assessments of how they are meeting the organization's goals and how they need to lock together. The form and structure of a virtual network is potentially flexible, which is why it requires regular assessment and, often, regular adjustment. Third, a virtual organization usually relies heavily on knowledge assets rather than on tangible physical assets (Boisot 1998). This stock of knowledge assets requires replenishing through activities such as training and education, research and development, and searching the environment for new relevant knowledge. Fourth, there needs to be a frequent reassessment of knowledge assets in terms of their value to the virtual organization. The more that virtuality is seen as a way of acquiring flexibility in the light of changing customer or client requirements, the more frequently the contribution to that end of different people and units in the virtual system, and the knowledge they provide, has to be reassessed.

The continuing significance of management in a virtual organization stems from the fact that such an organization requires both operational and strategic direction. At the operation level, it is necessary to put together a set of competent value-chain performers that are able to deliver required output on time and to specification. This is the central nervous system of the virtual organization, as providing communications and processes to assure necessary standards of quality and delivery. While having such a system is an obviously necessary condition, it is not sufficient. For a virtual organization also requires strategic direction. It requires a brain as well as a central nervous system. The brain is a center that provides strategic direction and makes difficult choices according to a consistent vision, including whom to add and whom to discard from the collective network.

In practice, a virtual organization is likely to be led, even dominated, by a company at its center possessing the brand name that is a mark of quality and market appeal. That lead company is also likely to serve as the central information systems 'commander', taking responsibility for designing and maintaining a common information standard across the virtual network. This applies both to management systems such as accounting and to technical systems. Regarding the latter, it is especially vital that a common standard is adopted when the work performed at different stages in the value-chain such as design, development, production engineering, component assembly, and software systems has to interface according to precise technical specifications.

### 9.3.3 Potential benefits of virtual organization

While the operation of virtual organization is greatly facilitated by the development of ICT, other factors encourage managements actually to adopt it, namely its potential benefits. The potential benefits of virtual organization lie in the fact that it facilitates:

1. efficient coordination across boundaries of time and space;
2. the reduction of costs by eliminating mediated transactions;
3. a more flexible combination of activities, and
4. the simplification of management.

The use of ICT-based systems opens the door to efficient coordination across boundaries of time and space. Email systems overcome the need to synchronize communication across time zones, and to ensure that the other party is immediately available, as is necessary for telephone conversations. Moreover, they readily overcome limitations of geographical space by permitting the simultaneous distribution of information across a network of recipients in dispersed locations. Other systems, like video-conferencing, effectively eliminate spatial distance by creating the virtuality of a single space between people who are at a considerable distance. It is possible to hold meetings between people located thousands of miles from each other, and also to deliver services such as education simultaneously and interactively to different groups located far away from one another. Online financial services reduce the units costs borne by banks as well as being readily available at times outside the normal working day that suit many customers.

This aspect of virtuality clearly can provide considerable benefits for the organization of related activities across physical distances, such as with a global supply chain. The savings in time, cost, travel fatigue and so forth can be considerable. They offer the benefits both of reduced cost and faster speed of response. Organizing in a virtual mode therefore offers a constructive response to the coordinative and control requirements that follow from the trend toward the networking of business on a global scale.

A related benefit of a virtual organization lies in the way it can reduce costs by eliminating mediated transactions. In conventional modes of organization, the imperfections inherent in transacting in a mediated way through, for example, the intervention of staff placing orders for supplies, or requesting a technical specialist to visit a site in person to provide assistance, generate costs associated with waiting times because the physical and organizational distance between transacting parties creates delays. Components and parts have to wait in the form of inventory; people have to wait until personal assistance becomes available. By transacting in a virtual mode, it is often possible to reduce if not eliminate waiting costs such as these, as well as the costs of managerial intervention. Supplies can now be ordered automatically through electronic order placing guided by a stock check and reorder system. Technical advice can often be given speedily on the basis of an electronic representation of the problem parameters, either through applying an expert system or through electronic communication with technical staff working at their distant location—which may be their home.

Another set of potential benefits from virtual organization stems from the way that it permits a more flexible combination of activities that form a value chain. By providing an alternative means of managing linked activities to placing them under a unified hierarchical structure, virtual organization allows for their coordinated disaggregation, often spread between different firms. With virtual modes of management, it becomes easier to separate stages of production and other activities in the value chain, while retaining a basis for coordinating them effectively. The speedy communication of information through common protocols within a virtual system permits the disaggregated activities to be recombined in a variety of ways to meet the needs of the specific situation. This approach promises considerable economic benefits:

1. It permits a firm to specialize on those activities for which it enjoys a relative advantage based on its core competencies and/or specific location. The firm can then focus its efforts on enhancing this core advantage so as to maintain the basis for its competitive position.
2. Similarly, the firm can select the most suitable partners with which to join to form a complete value chain. The partners should also benefit from the ability to focus on their core competencies.
3. Partnerships within a network are bound together by contracts that can be subject to periodic review and renewal, and that include provisions for contingencies. Such arrangements should permit greater flexibility in adjusting to changing market demand compared to a mode of organization in which all activities are integrated within a single company.
4. When a company focuses its staff down to a small central core and constructs a virtual organization to take care of other value-chain activities, it can use flexible employment arrangements to permit the workforce to be expanded or contracted as needs change. This kind of arrangement is neither new nor confined to virtual organizations. Virtuality, however, can offer an extra degree of loose coupling which provides more flexibility in adjusting employment compared with a conventional organization. The extra loose coupling comes through the spatial dispersion of work units and flexible employment arrangements such as home-based contract work.
5. The use of communications networks rather than a physical concentration of people and equipment opens up much greater choice in the location of work. People and

> their activities can now be located in the least-cost places, which is one of the prime reasons why outsourcing has become so attractive to firms. Even staff working in the core organization do not need to be located in central offices; many can work at home or in their local community. This can dramatically reduce costs; for example the overhead per capita cost of home working can be under one-third that of working in a city center office.

A number of the potential benefits offered by virtual organization are associated with a reduction in the need for managerial intervention. Partly by automating much information processing on the basis of shared protocols, and partly by facilitating direct communications between anyone in the network, it is natural to devolve initiative within a virtual organization, and this saves on management time and effort. As a result, the use of virtuality should permit a simplification in management and a corresponding reduction in administrative overheads.

In offering these potential benefits, virtual organization speaks to the needs that most companies face given the changes in their competitive environment as a consequence of the business revolution. Companies face pressures to offer increased value along with lower costs. Virtual organization promises to reduce costs in several ways, not least by offering a viable way of managing outsourcing to lower cost sources of supply. Companies also need to respond more rapidly to changes in order to preserve their competitive advantage. The flexibility offered by virtual organization should assist this capacity for rapid response.

Virtual organization can also benefit small companies by combining their advantages with those of large companies. Independent but closely linked companies can cooperate within a virtual organization to achieve their common business goals in an efficient way. Their relatively small size helps them to be highly innovative and to react swiftly to changing market demands. On the other hand, their combination into a virtual organization allows them to act as a single large company and to benefit from their aggregated market power.

### 9.3.4 Limitations of virtual organization

There are, of course, limitations and disadvantages too with the virtual corporation: difficulties in achieving scale-or-scope economies, difficulty in transferring tacit knowledge, problems with proprietary information leakage, difficulty in financing critical mass level R&D, and difficulties in maintaining commitment.

There are concerns about the limitations of virtual organization, especially in terms of its capacity to stimulate learning and innovation, and the vulnerability that may arise from dependence on partners.

Unlike strategic alliances between different firms, many of which are intended to transfer knowledge or bring about organizational learning, learning is not a fundamental objective of virtual organization. Rather, the main intention is to create a flexible organization of companies in order to allow each to specialize on its area of excellence so as to deliver a product competitively to the customer. One limitation of virtual organization therefore concerns its capacity to promote learning and innovation except within the confines of each firm in the network.

It may prove difficult to develop systemic innovation involving the commitment of large R&D funds to highly integrated projects within a virtual organization, because such investment requires there to be stability in the relations between partners over a period of years. The essentially flexible nature of virtual organization is likely to militate against this degree of stability, or at least present a high risk that it will not endure. The problem can be avoided if the lead firm in a virtual network can undertake the necessary R&D itself. If the product in question comprises relatively discrete units that can be assembled together in different configurations, as is the case with the microprocessor, disk drives, monitor, keyboard, and speakers in a PC system, then the responsibility for innovation in such component units can largely be left to their producers. In this situation, a virtual relationship between them and the lead company designing and assembling the PC need not be problematic on these grounds.

A further limitation of the virtual organization lies in its restricted ability to communicate and share tacit knowledge. The virtual organization functions through arms-length relationships, despite the fact that its supporting technology can compress distances of time and space. This presents a barrier to the sharing of uncodified, ill-formed ideas and knowledge, especially when the willingness to share them depends on the people concerned knowing and trusting each other well. This implies that the processes required to achieve the initial creative stages of innovation may not be well served by organizing virtually. Later stages of innovation, when it is primarily a question of working out how to produce a well-specified new product or service, or a codified new technique, are more amenable to coordination and control on a virtual basis.

The risk of vulnerability when working within a virtual network is illustrated by a well-known example where an innovation partnership operating in a virtual fashion actually worked against the long-term interests of the lead company. When IBM, although far from being a virtual corporation itself, decided to develop and make its PC in a virtual manner, it coupled its hardware with Microsoft software and an Intel microprocessor. This gave Microsoft and Intel the impetus to grow from small beginnings to become larger than IBM itself. The company missed the opportunity to make the microprocessor and develop the software in-house, which it certainly had the resources to do. Instead, it effectively gave away some of its core competencies. It made a mistake in entering into a virtual partnership and not doing in-house the things that it was both good at and which had strategic importance.

## 9.4 Managing the virtual organization

All firms comprise a mixture of virtual and physical components, using both tangible and intangible assets. The question is how to decide on an appropriate combination between the two. This question can be addressed by reference to the combination of economic, technological, and organizational requirements that a business faces:

## 9.4.1 Economic factors

### 9.4.1.1 Relationships with customers

How important is it to maintain personal face-to-face contact with customers? Do customers expect a high level of personal contact or not? If the product is standardized and an established brand, there will not normally be any need for customers to have personal contact with the producer, and the relationship can take a virtual form. In other cases, the transference of customer provision to a virtual mode is technically possible, but may hinder the provision of other linked services that customers prefer to receive through a more personal mode of delivery. For example, banks were concerned about losing touch with their customers once they introduced automated teller machines (ATMs). British banks have found that the quality of their relationship to customers declined after switching to call centers, so that one major bank is now making telephone access to local branch staff a feature in attracting new customers. Products like soft furnishings, where many customers want to make a personal firsthand choice between alternatives, might have only a limited appeal if offered solely through mail order or over the Internet.

### 9.4.1.2 Relationships with suppliers

Virtual supplier relationships also depend on the nature of the goods or services being supplied. In manufacturing, components and parts require physical shipment and may be sourced very locally so as to facilitate just-in-time delivery. This shipment clearly cannot be done on a virtual basis, although the accompanying information processing—of components/parts specifications and their delivery schedule—can be. Normally, the organization of supplies, and indeed a whole supply chain, can be accomplished on a virtual basis. Services that consist of information provision like booking airline flights, are increasingly being provided through the Internet. Other support services, such as consultancy and media promotion have to be tailored to the needs of a particular firm as they require personal interaction between the supplier and members of the organization, and cannot be conducted on a virtual basis. When the supply of goods or services can be provided and transacted on a virtual basis, considerable savings of cost and time are normally available through the elimination of 'middlemen' such as wholesalers and travel agents.

## 9.4.2 Technological factors

If a firm undertakes advanced research and/or design work, the need to promote creativity and share tacit knowledge through group work may limit the extent to which this can successfully be carried out on a virtual basis. This is despite the keen interest now being shown in virtual teams. Managers may have to assess the trade-off between (*a*) optimizing the processes conducive to creativity, and (*b*) optimizing the availability and cost of creative resources, especially when these are spread across different regions and time zones. The first component of the trade-off speaks in favor of working in a non-virtual mode with teams of people who are in close physical proximity, whereas the second component speaks in favor of bringing together the most appropriate, but dispersed, people through a virtual system.

Other areas of work can operate, and be managed, quite well on a virtual basis. Sales teams are often physically dispersed and work through virtual links. They can be brought together periodically through sales conferences in order to share experiences and discuss possible improvements on a face-to-face basis.

### 9.4.3 **Organizational factors**

In addition to the work of different units within an organization, such as design and sales, consideration must also be given to relations between them, and those between management and employees. If employees are frequently faced with new problems that they have to solve quickly, then managers have to organize in ways that facilitate intensive and creative interaction between their constituent units and the people concerned. Virtual information processing systems may assist, but there will also be a need for interpersonal discussion and interaction. When the organization's work is relatively routine then a greater use of virtual methods may be possible.

In addition to these primarily 'horizontal' relationships within a firm, consideration has also to be given to the vertical aspect—the relationship between management and employees. One of the problems that frequently arise when organizations adopt virtual modes is a loss of control and motivation. Control may not be too much of a problem if the quantity and quality of what people produce can readily be measured or assessed. Even so, people working at a distance from their organization can feel cut off and develop a demotivating sense of being neglected by management. Therefore, if virtual arrangements are to replace physical and social proximity between managers and employees, this will probably have to be compensated for with mechanisms that ensure the relationship remain sufficiently tight.

Warner and Witzel (2004) ask how different the task of managing a virtual organization is, and suggest that it has affinities with the general management of conventional organizations. General managers are not expected to get closely involved with operational control and coordination, though in practice some do (Mintzberg 1972), and in a virtual organization IT-based systems are expected to provide a considerable amount of the operational coordination that is required.

The traditional approach to identifying the specific activities of general management has derived from the following seven sets of tasks first identified by the French management theorist Henri Fayol (1949), and generally known by the acronym POSDCORB:

- Planning
- Organizing
- Staffing
- Directing
- Coordinating
- Reporting
- Budgeting

Planning in the sense of strategy formulation and implementation remains very important, as does 'reporting' (i.e. control) and coordination across the whole range of value-chain activities and functions. People in a virtual organization may be almost its only asset, and HRM issues are therefore especially important. How HRM tasks are dealt with within a virtual organization will depend on how it is constituted. If it is a network between organized partners, such as distinct firms, then many HRM matters can be managed within those organizations. If, however, the virtual organization consists of contract staff working by themselves in scattered units, HRM matters will have to become the responsibility of the virtual organization's central management. Other tasks such as organizing work, directing and budgeting are likely to be less salient in a virtual organization than in a conventional one.

The nature of a virtual organization means that its management process has to be characterized above all by:

1. guidance and motivation of the organization through a vision that is articulated through strategy and communicated effectively to its members;
2. a strong focus on information processing and knowledge management;
3. an emphasis on the coordination of others, and
4. the constant reinforcement of skills and willingness to cooperate among staff.

The last requirement stems from a recognition that, while a virtual organization depends on advanced technology to facilitate its processes, its distinctive competitive edge depends primarily on its network of people and how this functions. One aspect of this is to give priority to the development of their relevant skills, appreciating that these skills must include the ability to work together within a virtual format. It is therefore vital to manage the staff of a virtual organization in a manner that promotes their willingness to trust each other, and consequently to communicate openly in ways which enhance the potential competitive advantages of a virtual organization in respect of learning and flexible adaptation.

A further issue that arises with virtual networks, outsourcing and alliances is what to centralize into the lead firm and what to leave to the partners. Drawing on research in telecommuting, globally-coordinated product planning, and supply chain integration, Fritz and Manheim (1998) identify what they term the 'critical processes' that have to be managed in virtual organizations. These are the management of people, relationships, work, knowledge, and technology. They argue that the effective management of these processes in a virtual organization can be a source of major business benefits such as shorter time to market, a superior response to competitors' moves, more effective management of integrated supply chains, and the better use of staff with flexible work schedules. The key difference between managing the processes in a conventional organization and a virtual organization lies in the very low incidence of face-to-face contacts in the latter.

The managers of virtual organizations therefore need to make special provisions for nurturing and supporting relationships between the people within the network and between those people and themselves. Essentially, these provisions are intended to offset the impersonality and sense of psychological distance that can otherwise reduce the quality of relationships and even lead to a sense of alienation among staff. For example, there can be arrangements to bring physically scattered staff together in periodic regional gatherings. These would combine the functions of discussing work-related issues with social events intended to help people who normally communicate only remotely to bond together personally. Managers themselves should be prepared to make personal visits to other partner organizations within a virtual network. There is evidence from studies of strategic alliances that such visits contribute importantly to building trust among the partners, and that this in turn assists them to optimize on their partnership through mutual learning, and a spirit of cooperation in adapting to changing requirements. In between these interpersonal events and visits, news and other information can be distributed regularly throughout the virtual organization through its electronic channels.

### 9.4.4 Work coordination

In a virtual organization, the management of the work itself focuses on the two processes of coordination and control. The coordination of activities within a virtual organization becomes more complex because goals and priorities have to be communicated to people in a variety of different locations. Local needs and circumstances have also to be communicated back to managers. In a conventional work environment, managers can often achieve this coordination speedily and effectively through face-to-face interactions, either informally or through scheduled meetings. In a virtual organization, electronic protocols have to substitute and rules be implemented to make this effective—for instance, an instruction that all staff must check their email boxes at least once a day. When the units of a virtual organization are distributed globally, special support is needed to assist their working together.

In virtual organizations the approach to control has to shift from attention to how work is done and toward the outcomes of that work. Initiative is generally highly devolved in virtual organizations, because to work effectively in geographically dispersed locations, workers must have the autonomy to make important decisions on how to perform their work—for example, how to respond immediately to specific client requests. This means that managers have to develop new approaches toward evaluating and monitoring the performance of remote workers.

Within a physically compact organization, a great deal of knowledge can be shared and created through direct interaction between people. In a virtual organization, the sharing even of explicit knowledge can become difficult. Data can be transmitted and distributed without undue problems, but the reasoning and understanding that distinguishes knowledge from mere data or information poses a greater problem. Making sure that people get access to the information they need to perform their job is a critical and more complex issue when they are not located in the same place. The design of appropriate systems to coordinate the sharing of both structured knowledge and less structured opinions is important in the virtual corporation.

### 9.4.5 Technology management

Information technology clearly plays a vital role in virtual organizations. The technology is required to support virtual working in a number of modalities:

1. structured, as in the use of systems for managing and reporting structured tasks such as sending purchase orders as EDI messages in a supply chain;
2. semi-structured, as in the use of Workflow Management systems; for example, sending invoices for payment that may entail several levels of review in both the purchasing and selling units within a virtual network;
3. unstructured, which could use Groupware and email to cope with distances and/or nonsynchronized work schedules (Fritz and Manheim 1998).

The need to service a number of interaction and transaction modalities, means that an IT strategy for supporting the processes within a virtual organization has to take account of the entire range of interactions in an integrated manner. Managers also need to give attention in their IT policy to supporting the totality of virtual work, including personal interactions as well as purely business matters.

### 9.4.6 Virtual teamwork

Teamwork is a powerful organizational tool for coordinating interdependent activities. The activities may be aimed at solving problems creatively as in a project team charged with effecting a new development. The kind of team is likely to have a life span governed by that of the project. The application of the virtual approach to teams can help to overcome some of the limitations of the traditional face-to-face team (Eom and Lee 1999). With the use of ICTs such as email, video conferencing, telewriting systems, multimedia email and group support systems, a virtual team can communicate and proceed with its work without the necessity of gathering together in one physical place.

With the use of virtual teams, it is possible to mobilize the contributions of a large number of people. This extended participation draws on a wider range of contributions and spreads the sense of ownership and commitment toward a particular project. For example, the NCR Corporation created a virtual task force of over 1,000 people at seventeen locations to develop a new-generation computer system. Applying high-speed telecommunication networks and information systems technologies, the virtual task force team completed the project on budget and ahead of schedule (Lipnack and Stamps 1997).

When the membership of teams is restricted to a small number of people, those left out can readily feel estranged and devalued. Friction can easily arise between the two sets of people. Even if they are motivated to contribute to the team's work or to respond to its ideas, the outsiders are handicapped by not knowing who is involved or what the team is doing. One of the arguments for restricting access to teamwork is that there may be a need for information security. Paradoxically, when the need for security arises, the electronic storage and circulation of information allows for control because it allows the flow of such information to be tracked.

There is increasing interest in the use of global virtual teams. Many technology-based firms are spreading out their research facilities globally in the search for highly trained scientific and technical personnel. A global virtual team is a group of geographically and temporally dispersed individuals who are assembled via the use of ICT to accomplish an organizational task. The technologies are now available to provide the possibilities for working on this global basis to take place. The challenge is how to organize and manage global teamwork effectively. Virtual teams, established to overcome space and time barriers, cannot necessarily rely on traditional social cues and behavioral mechanisms. New ways have to be found to coordinate them and to resolve conflicts between their members (Montoya-Weiss et al. 2001).

An experiment carried out with thirty-five five-person teams composed of graduate students located in the United States and Japan throws some light on how to manage these requirements (Montoya-Weiss et al. 2001). It found that:

1. Avoiding conflict had a negative effect on team performance. However, this negative impact was reduced by the use of Lotus Notes to provide a temporal coordinating mechanism that revealed team members' initial positions, imposed progress-setting tasks such as required reviews, and set time limits for specific tasks.
2. Behavior that tried to accommodate conflict within the team through thoughtless agreement with what another member was saying did not contribute anything to performance. Since this behavior focused more on maintaining harmony than on negotiating integrative optimal solutions, application of the temporal coordination mechanism to such behavior did not help.
3. When conflict within the teams was resolved through domination by one party or by collaborative behavior, team performance benefited. Handling conflict through compromise led to poorer team performance, though this negative effect was reduced through the use of the temporal coordination mechanisms. These mechanisms did not have any moderating effect on the domination and conflict and collaboration styles.

This pioneering experimental research suggests that an IT-based mechanism to coordinate global virtual team members' contributions across space and time barriers can assist team performance under certain conditions. By providing a structure to the team process, and perhaps by encouraging transparency within the team, the IT mechanism can reduce the otherwise negative effects of behavior that lead to suboptimal performance by muting issues and opinions rather than expressing them openly and forcefully.

One of the conditions for virtual teams to work successfully is that their members have to trust each other. Ishaya and Macaulay (1999) examined the role of trust among the members of two experimental virtual teams. They concluded that there were three main levels of trust in these teams. The first two concerned technology and media, namely the mechanism and software used for collaboration. If these failed, trust could not readily develop among team members. The third level of trust concerns the interactions between the team members, i.e. the 'social' level. The researchers found that with virtual communication trust could be jeopardized because people could hide behind the relative anonymity of the technology. For example, people continued to criticize one another for a longer period, and to say things they would not normally have said in face-to-face communication.

**Table 9.2** Dimensions and protocols of social trust in virtual teams

| Dimensions | Characteristics of each dimension | Protocols |
|---|---|---|
| Integrity | Honesty, truthfulness, loyalty, faithfulness, and commitment | Being honest |
| | | Being straightforward |
| | | Keeping promises |
| | | Being faithful and truthful |
| | | Responding in good time |
| | | Being reliable |
| Ability | Interpersonal knowledge, skills, and experiences, competence | Demonstrating personal knowledge |
| | | Demonstrating individual & group skills |
| | | Sharing individual experiences |
| | | Demonstrating personal competence |
| Openness | Willingness to share ideas and information freely | Informing team members |
| | | Sharing ideas freely |
| | | Sharing information freely |
| | | Giving positive feedback |
| | | Apologizing publicly |
| Benevolence | Wish to do good, goodwill, and generosity | Being helpful and supportive to others |
| | | Being friendly to others |
| | | Being kind and courteous |
| | | Being considerate to others |
| | | Empathizing with others |
| | | Praising people for their good work |
| | | Being humble |
| Expectations | Potential gains/losses, reliability, consistency, and judgement | Being open in one's expectations |
| | | Being prepared to compromise on one's expectations |
| | | Being fair in expectations |
| | | Being consistent in personal expectations |

*Source*: Adapted from Ishaya and Macaulay (1999: Table 2, p. 146).

Ishaya and Macaulay suggest that, in order to help build social trust in a virtual team, certain communication protocols or conventions need to be established by which each team member would have to abide. These relate to the five dimensions of integrity, ability, openness, benevolence, and expectations. Each dimension has certain defining characteristics, which the protocols states in specific terms, as the Table above indicates.

## 9.5 An appraisal of the virtual corporation

To be a successful virtual corporation it is not sufficient to be able to put together a competent set of value-chain activity performers, able to deliver the required output on time to specification. More than this is required for an opportunistic linking to be converted into a virtual corporation.

First, it is necessary to have a brand name under which to trade, that comes to be accepted as a mark of quality. Speed and flexibility are the next essential elements that the virtual corporation needs to pitch against the integrated corporation's established physical presence and proven competencies. It also needs a brain and a central nervous system. It is, therefore, difficult to conceive of a successful competitive virtual corporation that is not dominated by one brand-name company at its center. As in networks, the dominated network is likely to succeed when in competition with the less directed equal-partner network.

This information architecture, as it has come to be called, normally includes a data highway to link partners, private access for partners to access key data and applications software, the ability to monitor integrity and security, and an appropriate set of communication tools. Given these characteristics, the virtual corporation should be in a position to compete successfully against integrated corporations in many industry segments.

The virtual approach is not a solution to all situations. It has certain inherent weaknesses that are more important in some situations than in others. For example, if an industry is dominated by virtual corporations, it is unlikely to achieve major *systemic* innovation. This probably requires an integrated firm to take a risk and commit large R&D funds to developing a new technology. It then needs to exercise its market power to change the 'rules of the game' in its industry, as IBM did back in the 1960s with its 360 modular computer. This is very difficult for a virtual corporation to do, as it lacks sufficient legitimacy or reputation.

| | Autonomous | Systemic |
|---|---|---|
| Capabilities exist in-house | Multidivisional | Integrated |
| Capabilities exist outside | Virtual corporation | Alliance |
| Capabilities must be created | Alliance, integrated | Integrated |

*Types of innovation*

**Figure 9.2** Autonomous and systemic innovations require different handling.

*Source*: Adapted from Chesbrough and Teece (1994).

Chesbrough and Teece (1994) developed a matrix shown in Figure 9.2 in which they differentiate between autonomous innovations and the more major systemic ones. They suggest that for systemic innovations (e.g. compact discs as opposed to vinyl records) integrated companies are generally the more appropriate forms. However, they suggest that, with *autonomous* innovations within a technological paradigm, virtual corporations are much more appropriate. Systemic change costs more in resources up-front, and needs the driving force of an existing major player to see it through. A loosely knit coalition with resources belonging to the different partners would find this major activity difficult to achieve.

If the communication of tacit knowledge, or the existence of very effective and efficient internal systems, is the key to success, a virtual corporation is unlikely to compete successfully against an integrated company with similar competencies in every other way. Similarly, if there is a need for a high level of high-tech interdependence, an integrated company is more likely to be able to achieve this than a virtual corporation.

Thus, integrated corporations are likely to remain the dominant form of organization where internal coordination is key, where innovation is systemic, where there is a need to establish an industry standard, where tacit knowledge needs to be communicated, and where the major growth opportunities are the extension of existing activities into neighbouring markets.

In certain circumstances, however, virtual corporations are likely to outperform integrated corporations. These are in markets that do not exhibit the characteristics described in the previous section, where considerable turbulence leads to the need for speed of response, robustness, and flexibility, and of course where the onset of globalization demands resources not available to a single firm. In these circumstances the virtual corporation is likely to exist alongside the integrated corporations over the coming decades as the naturally selected winner in certain markets, and not in others. For many of the reasons outlined above, it may never come to replace the integrated form, and indeed may often exist on the interface between a number of integrated corporations involving parts of them in variable configurations.

The virtual corporation is often thought of as outsourcing, with electronic information controls and communication. In this sense the growth of the fashion for configurations around key competencies with outsourcing has led to the corresponding growth of virtual-corporation theory. Virtual corporations are indeed all about putting together a variable configuration company from existing companies with excellent specific skills. No inter-company learning is necessarily involved.

It may be very possible to set up a virtual corporation by identifying a strategically vital center, outsourcing everything else, and linking the whole by IT packages, with the central core representing the brain, owning the brand name, and maintaining the motivation even amongst the outlier partners by sophisticated relationship development. It is quite another matter, however, to slim down an existing integrated corporation and transform it into a virtual corporation. The demotivation resulting from being cast into the outer periphery, or from fear that one will be the next to go, makes such a transformation fraught with human difficulty and unlikely to lead to a happy and thus competitively successful company.

## 9.6 Summary

1. A virtual organization might be considered the ultimate new organizational form because it is not bound by the legal and physical structures that define a conventional organization.
2. It is a highly developed type of networked organization, comprising different units or companies that act in concert through an advanced level of coordination often using electronic means to substitute for face to face activity.
3. Although virtual organizations vary considerably, they have a number of common features:
   - lack of physical structure
   - reliance on communications technology
   - mobile work
   - hybrid form
   - inclusivity across boundaries
   - flexibility and responsiveness.
4. Different forms of virtual organization are characterized by varying mixes of virtual and tangible assets and activities. The most comprehensively virtual organization has both assets and management systems that are highly virtual, as is the case of firms trading financial instruments and currencies.
5. The use of virtual organization offers potential benefits including efficient coordination across time–space boundaries, a significant reduction in costs, more flexible combinations of activities, and a simplification of management.
6. Certain conditions are required, for a virtual organization to be successful and the form has a number of limitations. It may, for example, have a limited capacity to promote innovation and share tacit knowledge.
7. A number of key questions therefore have to be asked about virtual organization: when to use it in preference to conventional forms of organization; whether virtual organization has to be managed in a different way; and how the virtual approach can be applied to teamwork.
8. The possibility of virtual teamwork on a global basis is attracting considerable interest, research uncovering some of the requirements for global virtual teams to operate successfully.

## 9.7 Questions for discussion

1. What are the key characteristics of a virtual organization? How does it differ from (*a*) a conventional organization? (*b*) a networked organization?
2. What are the main potential economic benefits of a virtual organization?
3. Discuss the key considerations for management in setting a balance between conventional and virtual organizational forms.
4. What are the key differences between managing a conventional organization and a virtual organization?

5. Compare and contrast the virtual organization with an outsourcing organization.

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# PART III MANAGING COOPERATION

Alliances, once established, have to be managed. The alliance process models mentioned in the Introduction to Part II recognize that there is a stage or stages that continue beyond the 'signing ceremony' setting up the JV, alliance, or partnership (Tallman 2000; Zajac and Olson 1993). Tallman discusses managing the cooperative venture at some length, to include a discussion of alliance failure, while Zajac and Olsen consider 'reconfiguration' to be an essential step in venture development.

Part III deals with what happens when the dust has settled and the alliance partners start to work together. Managing an alliance presents more of a challenge than a unitary organization. It must accomplish the creation and development of a viable new enterprise, usually with a heterogeneous mix of staff provided by the partners, plus others newly recruited. It involves maintaining good relations with several principals, and fostering their cooperation. It also has to take account of a wide range of external groups, some of which, like a host government, may be partial to the interests of one partner rather than another.

The chapters in this part of the book focus on different aspects of alliance management. Following an examination of general management, the subsequent chapters look at questions concerning control, corporate governance, fostering learning, HRM, managing cultural differences, and managing cooperation in transitional economies.

Chapter 10 considers the critical and difficult role of general management in contributing to the success of cooperation, how the role can be performed, and the qualities required of an alliance general manager (AGM).

Chapter 11 reviews the different forms of control partners can exercise in alliances, noting that tight control is by definition impossible in cooperative activity, but that this should not lead to the total abnegation of all control, especially over strategic decisions.

Chapter 12 further develops the theme of control in alliances by addressing the neglected question of their governance. It focuses on partners' preferences for alliance governance policies in the light of the risks they face.

Chapter 13 discusses the role of organizational learning in all its aspects as a primary driver in cooperative activity. It analyzes the technical, systemic, and strategic aspects of organizational learning and considers how these apply to strategic alliances. The different forms of learning are also discussed, including opportunity learning, technology transfer, and tacit learning. Attention is given to the mechanisms and policies that help promote and transmit learning within alliances.

Chapter 14 looks at alliances from a human-resources viewpoint. It shows how much more difficult it is to establish a coherent HRM policy when there are at least two companies involved with different cultures and missions. The chapter also considers the contribution that a well-thought-out HRM policy can make to achieving the strategic and knowledge-acquisition intentions that partners may have towards cooperation.

Chapter 15 turns to the question of culture and highlights how difficult and critically important are company and national cultural issues in enabling an alliance to work effectively. It explores the difficulties that can arise because new partners have given inadequate attention in the pre-alliance phase to attempting to understand the other partner's culture and ways of behaving.

Chapter 16 discusses how alliance management can be addressed in one increasingly important context, namely emerging economies. It discusses the context for alliances in several significant emerging economies and regions, and considers issues arising in alliances between companies based in developed parts of the world and those from emerging economies. This chapter therefore applies some of the implications of Chapters 10 to 15 to an increasingly important part of the world economy.

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# 10 General management

## 10.1 What this chapter covers

This chapter begins by discussing the importance of alliance general management. It then compares the job of the alliance general manager (AGM) with the equivalent role in unitary companies. This points up the particular conditions for alliance success that general managers have to foster. Given the presence of two or more alliance partners or parent companies, general managers are likely to experience considerable role conflict and role ambiguity. As a condition for alliance success, general managers have to take an active part in handling relations between partners, in addition to other external relations and the internal organization of the alliance. The tasks and conditions that AGMs face naturally leads on to the qualities they require, and the chapter closes by reviewing these.

## 10.2 Alliance management—a vital but neglected task

Despite the increasing popularity of strategic alliances as an interorganizational form, developed in large measure to meet the needs of globalizing markets and technologies, the record of running successful alliances is somewhat mixed (see Chapter 17). The dissolution rate for JVs is reported to be about 50 percent, which is almost as high as that for mergers and acquisitions in new industries (Park and Ungson 1997). Porter (1987) found that no more than half the alliances he identified were successful by any reasonable criteria. Management consultants Coopers & Lybrand, and McKinsey, in separate studies came to similar conclusions (Bleeke and Ernst 1993).

One reason for failure lies in the disparity between the concern that the top management of companies shows in the formation of alliances and the attention it pays to managing them once they are established. As Kanter (1994: 96) has commented from her research into a variety of international alliances:

> too often, top executives devote more time to screening potential partners in financial terms than to managing the partnership in human terms. They tout the future benefits of the alliance to their shareholders but don't help their managers create those benefits. They worry more about controlling the relationship than about nurturing it.

This disparity is also evident among writers on the subject. They have generally given more attention to the reasons for the creation of alliances than to their management.

Most, if they deal with the question of alliance management at all, content themselves with laying out a few basic ground rules (Killing 1983; Kanter 1989; Lynch 1990; Collins and Doorley 1991; Spekman and Sawnhey 1991; Bronder and Pritzl 1992; Lorange and Roos 1992; Urban and Vendemini 1992). As Frayne and Geringer (1995: 86) note, 'the academic and practitioner literatures have not focused on the role and required skills of the IJVGM [international joint venture general manager]'.

The quality of alliance management is a vital requirement for their success. Some, like Harrigan (1986), have argued that 'alliances fail because operating managers do not make them work, not because contracts are poorly written'. Inkpen and Crossan (1995) conclude that, when strategic alliances fail to capitalize on their opportunities for mutual learning, the fault lies primarily in the attitudes of their senior managers. Niederkofler (1991: 238) has argued that:

> a major cause for cooperative failure is managerial behaviour. In nature, cooperation differs fundamentally from competition. Whereas competitive processes are well understood and practised daily, the key success factors in cooperative processes are widely ignored.

Faulkner (1993) assessed the extent to which features of alliance management were associated with long-term success in sixty-seven ISAs. Success was assessed by reference to five criteria:

1. The achievement of agreed alliance objectives in quantifiable terms.
2. The achievement of spin-off benefits.
3. High morale amongst alliance members.
4. A good alliance reputation in the partner companies.
5. A good alliance reputation in the industry at large.

The commitment of partners to the alliance, their positive attitudes towards it, and congruent partner goals all discriminated strongly between successful and less successful alliances as Table 10.1 shows. This chapter will indicate how alliance management can foster these beneficial attributes.

Yoshino and Rangan (1995) were able from their case studies of global strategic alliances to identify a number of 'critical tasks' for alliance management. One task they call

**Table 10.1** Significance of partner commitment and cooperation to the success of alliances

| Feature | Level of significance* (%) |
|---|---|
| Commitment by partner top management | 99.9 |
| Mutual trust between partners | 99.9 |
| Sensitivity to partner's culture | 99.9 |
| Congruent partner goals | 93.0 |

*Level of significance indicates the likelihood, based on a Chi square test, that the association between the named feature and alliance success did not arise by chance.

'establishing the right tone'. This is largely concerned with building trust between the partners through encouraging personal relationships between their staff, who have to work together for the alliance to succeed: senior managers, functional managers, engineers, and technical staff. A second key activity that a general manager can perform is to monitor the contributions that the partners are making to the alliance and to initiate appropriate corrective action if these are found to be insufficient or unsatisfactory. These contributions can range from the tangible and relatively easy to monitor, such as supplies of components, to more difficult cases, such as the quality of staff and information offered by a partner. A third task is to be aware of strategic reassessments by the partners and their implication for the alliance. They may offer opportunities for alliance general management to propose new activities for the alliance that will contribute to its long-term development.

As will be discussed in the next chapter, appointments to head up an alliance unit, especially a joint venture, provide partner companies with an important mechanism of control over that unit. Most joint ventures are separately managed business units and inevitably many powers have to be delegated to their general managers. General managers are in a position to implement policies and to influence, if not actually make, key decisions for the venture. The general manager often has the right to decide on who should fill other senior appointments within the venture (Wang et al. 1998). If a general manager is appointed directly from one of the partners, the social network that he or she already has with colleagues in that company facilitates communication with it, giving that partner a control advantage (Robson et al. 2003). For these reasons, the right to appoint an alliance general manager can be a major objective for a company when it negotiates to form a new alliance, especially if it is concerned that otherwise the alliance's management may not be of adequate quality and that its investments in the alliance would therefore be put at risk.

## 10.3 General management roles

General management is a rather amorphous term, which can be identified more precisely by referring to the roles it covers than to the various positions that may carry the name. General management has responsibility for a whole organizational unit, covering the range of functional, product, or geographical activities the unit carries out. There are long, medium, and short-run aspects to this responsibility. For the long run, general managers are expected to establish goals, set the direction of their companies, decide which business to be in, and ensure adequate resource provision including investment. For the medium term, they have to determine the effective allocation of resources. In the short run, they have to ensure that human, financial, and material resources are used efficiently (Kotter 1982).

In a large, multidivisional, and multifunctional company, several positions can come into the category of general management. These include the CEO (who may be called executive chairperson, president, or managing director), divisional general managers (who may be termed divisional or regional vice-presidents), and multifunctional heads.

In some cases, the scope of a business development manager's job may be that of general management vis-à-vis a range of new ventures for which he or she is responsible. The managers placed in charge of cooperative ventures also occupy a general-management position in respect of those ventures, even though they may report to regional or product divisional managers.

Within this domain of responsibility, a general manager normally has to carry out several key and overlapping roles. First, as a decision-maker, he or she is responsible to the board of directors or corporate head office for seeing that the decisions necessary for policy implementation have been carried out. The decisions that a general manager takes encompass the initiation of change, the allocation of resources, negotiation with groups within and outside the organization, and handling disturbances. Second, the general manager needs to be an internal integrator, aiming to ensure that the collective effort is coherent. In this role, he or she manages both vertical and horizontal relationships. The former are relations with subordinates, with a view to motivating and supervising them. The latter are interpersonal and intergroup relationships across the organization, in which the general manager forms teams and ensures activities are appropriately linked across the organization. A third role is one of external integrator, between the organization and its context. This requires the general manager to act as a networker overseeing the boundary conditions of the organization, and it includes fostering key connections, negotiating opportunities, managing the expectations of stakeholders, and preserving the organization's freedom of action. In performing these three roles, general managers also have a special responsibility for a fourth role; that of information manager. He or she plays a particularly important part in receiving and disseminating information of a strategic nature, and is expected to inform others on behalf of the organization as a whole.

These roles have to be performed by the general managers of any organization, and that includes the strategic alliance as well as a unitary firm. In the case of alliances, additional requirements arise because their general managers are beholden to two or more partners and because they will normally have to create the conditions for effective cooperation between staff who are likely to hail from different organizational and (in the case of an international alliance) societal cultures. The extra requirements placed upon alliance general management are, therefore, particularly taxing and crucial for organizational success.

Frayne and Geringer (1995) interviewed parent company executives and JV general managers involved in forming and managing forty-two developed country and sixty-two developing country IJVs. They found that 88 percent of the IJVGMs and 86 percent of parent company executives thought that the skills required of an IJVGM were different from the general manager skills required for similar positions in the parent companies' wholly-owned subsidiaries. Most of the respondents also thought that the requirements of the IJVGM role were more challenging than those of general managers in non-JV businesses. Frayne and Geringer (1995: 87) note five particular challenges associated with the role of IJVGM:

1. The presence of multiple parent companies.
2. The existence of divided loyalties.

3. The need for operational independence despite often limited preparation and support.
4. Responsibility which exceeds authority.
5. Pressure for rapid action.

The additional difficulties likely to face AGMs, especially international ones, are summarized in Table 10.2. This contrasts the four general-management roles as they are found within a single, national firm with the additional difficulties likely to attend the performance of the same roles within an IJV.

It is evident from Table 10.2 that there are two features of alliance general management that add significantly to its difficulty. The first, and most salient, stems from the presence of multiple principals in the form of the two or more parent/partner companies. If there are just two partners, their demands are likely to be direct and forceful, and potentially conflicting, unless one clearly dominates. When there are more partners, each with a smaller stake, the pressure that each can exercise over the AGM will be reduced, but the demands they place on the alliance will tend to be more diverse. When faced with demands from parent companies that are inconsistent or that conflict with the best interests of the alliance as a business in its own right, an AGM will experience the dilemma of conflicting loyalties.

In addition to the partners, AGMs may find themselves having to take account of the expectations of multiple groups, such as governmental agencies and community organizations, in the context where the venture is located. The expectations of these local groups do not necessarily coincide with those of either or all partners, and this sets up further potentially conflicting pressures on an AGM. In the case of an international alliance, these conflicting pressures will typically be contained within the net of relationships illustrated by Figure 10.1.

The second source of difficulty arises from the cultural heterogeneity that has to be managed within the alliance. This heterogeneity is a product of the parents' different corporate cultures, and it increases in the case of international alliances, when a mix of national cultures is also present. It is an important requirement of AGMs that they achieve sufficient 'cultural fit' for their unit to operate effectively. The more that the alliance partners have different structures, modes of operation, and cultural attitudes, the more challenging is the situation facing the general manager.

Two concepts—role conflict and role ambiguity—are useful for analyzing these aspects of the AGM's role (Shenkar and Zeira 1992). *Role conflict* arises when the priorities of one alliance partner conflict with those of another, which means that the alliance general manager faces conflicting simultaneous demands from those partners. It can also arise when the expectations of groups in the alliance's environment, such as governmental agencies, do not agree with those of the alliance management or its parent companies. Cultural heterogeneity within the alliance adds to role conflict because it presents the general manager with conflicting expectations about the values that should inform the alliance and the manner in which it should be managed.

*Role ambiguity* arises when the general management of an alliance is unclear about the expectations that various key groups have of it—the partners, the various employee

**Table 10.2** General management roles in unitary companies and IJVs

| | General manager of unitary company | General manager of an IJV |
|---|---|---|
| Decision-maker | | |
| *Innovator* | Initiates change | This role takes on the added complication that it is necessary to convince the parent companies as well as the IJV's own board |
| *Resource allocator* | Decides where efforts and energies will be directed | Very difficult, owing to multiple sets of resources and expectations. Becomes easier to perform if the IJV has some autonomy |
| *Negotiator* | Deals with situations involving negotiations on behalf of the company | Perhaps the primary skill required of the IJV general manager. Can be more difficult if the GM is an expatriate |
| *Disturbance handler* | Takes charge when crises arise and the firm is threatened | Influences and pressures from parent companies and the IJV board of directors can complicate the decision |
| Internal integrator | | |
| *Leader* | Manages relationships with subordinates, motivating and supervising them | The general manager may find it more difficult to motivate and supervise staff of another nationality and/or coming from another partner's organization, owing to different values, ethics, and acquired practices |
| *Teambuilder* | Forms teams and ensures that activities are appropriately linked across the organization | Has to overcome potential barriers to teamwork between staff arising from different organizational or national cultures |
| External integrator | | |
| *Figurehead* | Represents the firm on ceremonial and other official occasions | In some host countries, protocol and legal requirements may necessitate a greater emphasis on this role |
| *Networker* | Interacts with managers, officials, and members of other groups outside the firm | This is likely to be a very prominent role. The presence of several partners complicates the network with which the IJV general manager has to interact. In many contexts, it is particularly important to interact with government officials. There may be problems if the GM is an expatriate and does not have good external connections |
| Information manager | | |
| *Monitoring* | Receives and collects key information, usually of an informal nature, both inside and outside the firm | It may be more difficult for an IJV general manager to pick up information from internal staff and external sources who do not share the same language or identity |
| *Disseminator* | Ensures information is transmitted to members of the firm | Again, communication breakdown may arise because of language and cultural (interpretative) differences. More effort will be required to explain what is communicated, clarify misunderstandings and teach members of the IJV about the partners' protocols |
| *Spokesman* | Informs external persons about, and on behalf of, the firm | Similar factors can add to the difficulties of this general management role |

*Source*: Adapted and extended from Beamish (1988), Schaan and Beamish (1988).

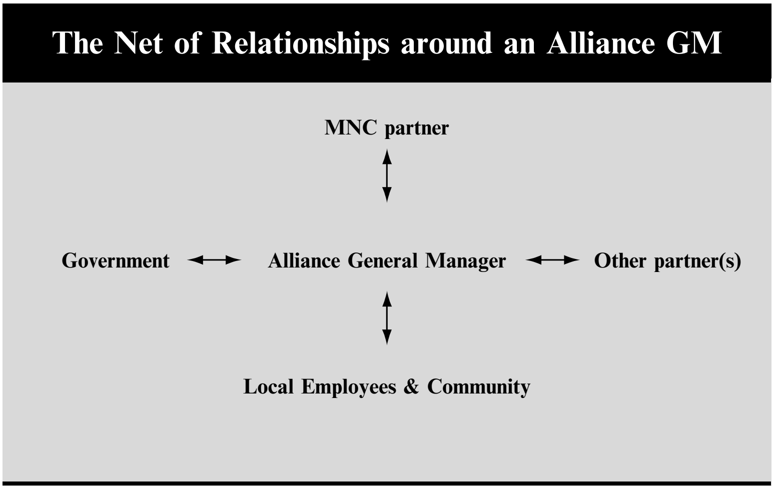


**Figure 10.1** Typical net of relationships of an alliance general manager.

groups in the alliance, and institutions of the country where the alliance's operations are located. Role ambiguity for alliance general management therefore stems from the lack of clarity about what is expected of it, whereas role conflict arises from differences in the expectations that are placed upon it. Frayne and Geringer's (1995) findings illustrate the extent to which AGMs may be subject to role ambiguity. They found that in as many as 42 percent of the IJVs studied, it was reported that the parent companies did not employ any specific criteria for evaluating the performance of the general managers. The general managers were often given no clear indication of how they were expected to run the JV.

It is likely that AGMs will experience higher levels of role conflict when there are a few but active alliance partners, who differ markedly in the objectives they have for the alliance and in their defining corporate characteristics such as size and ownership. One would similarly expect that having a larger number of partners, especially if they are culturally diverse, would increase the role ambiguity experienced by alliance general managers. Shenkar and Zeira (1992) found among IJVs in Israel that having fewer parent companies was associated with greater role conflict, while divergence between the parent companies' national cultures gave rise to role ambiguity.

The factors we have identified as predictors of role conflict and ambiguity are characteristic of the situations in which AGMs may find themselves working. This leaves open the important possibility that managers with more experience of handling such situations will not perceive the conflict and ambiguity inherent in them to be so much of a problem. They may, indeed, even be able to turn situations of this kind to their advantage by negotiating between the parents to secure greater autonomy for the venture under their charge, and perhaps to encourage competition among the parents in their provision of resources to it. Shenkar and Zeira in fact found that JV general managers with longer tenure in their jobs suffered less from role conflict and ambiguity, while better-educated general managers also tended to report less ambiguity in their roles. Those who were permitted, or had negotiated, greater autonomy for themselves also experienced less ambiguity about their roles.

Nevertheless, the conditions giving rise to role conflict and ambiguity are ones that could threaten the breakdown of an alliance, if not handled skillfully. Role conflict often reflects the presence of a competitive undertone to a partnership, and this clearly contributes to the high failure rate of alliances. Both role conflict and role ambiguity can generate stress, dissatisfaction, and difficulties in decision-making for AGMs. Severe role conflict, due to incompatible demands from the partners, could make the general manager role an impossible one to fulfil. Role ambiguity is more likely to present opportunities for general managers to formulate their own policies for the alliance, especially if the ambiguity arises from the partners' lack of clear policy or disinterest, and if the general manager has the requisite skills, experience, and standing to chart his or her own course.

There are in effect two main primary requirements in managing an alliance successfully. The first is to ensure that the expectations of the partners are reconciled and incorporated into the strategy for the alliance. The more the partners' expectations are met, the less onerous is likely to be the control that they place upon alliance management. Meeting the expectations of alliance partners therefore involves a combination of securing their consensus on the alliance's strategic objectives as well as maintaining the partners' continuing support in achieving them. This first requirement is essentially one of managing cooperation between the alliance and its partner companies and, as far as possible, managing the relations between the partners themselves insofar as these impinge on the operation of the alliance unit.

While the management of relationships between the alliance and its partners will always form an important part of alliance general management, the autonomy that general managers are granted to lead the alliance is likely to vary according to how that alliance is constituted. In a JV, the board of directors should, in principle, establish its strategic objectives, leaving the general manager free to decide how to achieve them so long as he or she is supported with adequate capital and other resources. By contrast, in collaborations without a JV form to focus managerial attention, the running of the alliance is carried out through partner company initiation and monitoring of joint projects. The principles of project management then hold, but with the additional difficulty that the designated project manager has the problem of managing personnel from different home companies over whom he or she does not have ultimate responsibility. The management of such projects has then to be carried out with extra sensitivity. In less formal alliances, such as many consortia or information-sharing arrangements, parent inputs may primarily be resources provided on a non-contractual basis. The management of such alliances then may well be handled directly by partner staff.

The circumstances that generate role conflict and other special difficulties for alliance general management lend a certain delicacy, even fragility, to the process of cooperation between organizations. This means that AGMs need to have a special concern for the conditions required to nurture and develop the cooperative relationship in which they play a pivotal part.

The second primary requirement in managing alliances is to install measures that promote the alliance's internal effectiveness as an ongoing operation. These include establishing appropriate organizational arrangements, providing leadership to achieve cooperation and motivation among employees, and ensuring appropriate information flows within the alliance. Although these activities are part of the role of any general manager, in alliances the ease with which they can be performed adequately is conditional on the quality of cooperation between the partner companies.

## 10.4 Generating and maintaining cooperation

There are two particularly significant facets to the role of AGMs in generating and maintaining cooperation:

1. Contributing to the quality of cooperation between alliance partners. This entails reconciling, as far as possible, their expectations of the alliance, and encouraging a climate of trust to develop between the partners including their nominated personnel who are working in the alliance;
2. Managing the relationship between the alliance and its parent companies. This provides it with the support and autonomy required for its success.

### 10.4.1 Contributing to the cooperation between alliance partners

There is wide agreement that, for an alliance to be effective, the long-term goals and objectives of the partners should not conflict (Spekman and Sawhney 1991). It is not necessary that the objectives dovetail exactly; clearly those of Honda and Rover in their successful alliance did not. Their objectives must not, however, actually conflict and they must possess an attractive degree of complementarity otherwise the alliance will have difficulty in developing consensus for a particular course of action. Even if some partner goals diverge in the short term, they must be able to perceive considerable mutual benefit from cooperation over the long term.

The attitude of partners towards the cooperation between them is critical to its success. A positive attitude is demonstrated by:

1. a sensitive attitude to national and corporate cultural differences (i.e. the willingness to undertake mutual sense-making);
2. strong commitment by top- and lower-level management in the partner companies, and
3. mutual trust.

Kanter (1989) identifies the critical nature of corporate and national cultural sensitivity between the partners; Anderson and Narus (1990) point to strong top- and middle-management commitment as a key factor for alliance success, and Lynch (1990) emphasizes the need for mutual trust. Inkpen and Crossan (1995) found that, when top managers in partner companies did not understand or commit themselves to their alliances, their companies failed to realize the potential learning benefits that cooperation offered.

Olf and Earley's (2000) discussion of interpersonal exchange relationships in international strategic alliances serves to recall that the relations between alliance partners and their AGM are normally those between a small cluster of people. This cluster may only comprise three individuals—the persons responsible for the alliance in each of two partner companies and the AGM. In forming their alliance, partners are engaging in exchange relations through which their respective contributions and associated risk-taking are 'traded' for expected benefits and returns. Among such a small group of key actors, there is clearly scope for each to have considerable influence in constructively reconciling the expectations of the partners and promoting good understanding in general. Because of his or her full-time engagement in the alliance, it usually falls to the general manager to take the lead in fostering this process.

Yan and Gray (1996) found in their study of ninety Sino-US manufacturing EJVs that a better quality of cooperation between the partners was associated with superior venture performance. Given the cross-sectional nature of their study, the researchers were not able to ascertain how much of this association was due to the constructive effect of good cooperation rather than the reverse causality, namely that a successful alliance will leave the partners well satisfied and thus enhance the quality of relations between them. Nevertheless, common sense suggests that good relations are of themselves essential to the success of a working partnership.

Simonin (2002) argues that knowing how to collaborate effectively through strategic alliances is a source of competitive advantage and a competence that can be learned. He found from a study of large and mid-sized US companies engaged in ISAs that part of what he calls 'collaborative know-how' starts with laying a solid foundation for collaboration through careful partner selection and negotiation of the terms of the alliance. Subsequently, a major component of such know-how consists of 'managing and monitoring' ongoing alliance activities. This falls squarely within the purview of its general management. Simonin distinguishes eight aspects of managing and monitoring:

1. building trust with the partner
2. resolving conflicts
3. managing alliance–parent company relations
4. logistics and resource transfer
5. renegotiating initial agreements with partner(s)
6. cross-cultural training
7. staffing
8. technological assessment.

His analysis draws attention to the importance in the AGM's role of ensuring that the key relationships mentioned are well managed, that there are mechanisms for resolving the conflicts which will almost inevitably arise, and that there are provisions for developing alliance competence including its capacity to learn (see Chapter 13).

### 10.4.2 Processes of managing cooperation

It is easier to state the need for cooperation between alliance partners and alliance staff than it is to achieve it. In this respect, Ring's studies (1996) of six international alliances throw valuable light on the formal and informal processes through which cooperative strategies develop and can be sustained. He identifies three formal processes: negotiational, transactional, and administrative. Negotiational processes tend to be particularly significant during the formation of an alliance, but they can persist during the life of an alliance when the cooperation between partners has advanced to an operational stage. Transactional processes involve the partners in making commitments to action and in settling the terms on which the alliance will operate. Administrative processes are concerned with managing the execution of partners' commitments in order to maintain the alliance as an operating organization. The general manager of an alliance can contribute most to the success of transactional and administrative processes during its operational phase, and also to continuing negotiations post-formation. However, we argue below that ideally the founding general manager should also be involved in the negotiations that precede alliance formation, so as to share in the initial relationship-building that takes place at that stage and also to provide for continuity from formation through to implementation.

The successful accomplishment of these three formal processes depends on achieving a series of informal processes: sense-making, understanding, and committing. Sense-making processes help individuals view and align their own preferences in relation to the others involved in a cooperative relationship. Understanding is a process whereby the parties to a cooperative relationship reach a shared understanding of the context in which their alliance operates. Committing is an informal process that produces psychological contracts between the cooperating individuals, in which they come to accept unwritten and largely nonverbalized expectations and assumptions about each other's prerogatives and obligations.

Ring found that the intensity of these processes, and the time needed to take them to an outcome which could support effective cooperation, varies considerably between different cases. For example, where cooperative strategies are based on kinship or other close social ties (that is, on an already established network), there is less need to rely heavily on sense-making and understanding processes; in larger, more complex alliances, such as research consortia or IJVs, sense-making, understanding, and committing processes will generally be more intensive for everyone involved and are likely to take much more time to conclude (Ring 1996: 12). In other words, the more 'embedded' the prospective partners are in a shared social context, the less intense the informal processes required for them to advance through the negotiational, transactional, and administrative phases are likely to be, and the cooperation will be established on a viable basis in shorter time.

By contrast, where the proposed alliance is between organizations coming from two cultures with different assumptions about how to conduct business relations, each phase (and especially negotiation) is likely to require intense effort and considerable patience to achieve the necessary sense-making, understanding, and commitment. This kind of challenge arises in the formation and operation of alliances between companies from cultures with explicit procedures for conducting business, such as the USA, and those from cultures where the rules of business transacting are much more implicit and grounded in the quality of interpersonal relationships—such as China and Japan. It is also likely to arise in the case of alliances between organizations within the same country, but coming from sectors that have very different values and traditions, such as private and public sector organizations.

Ring's analysis draws attention to the formal and informal processes that the creators and managers of cooperative ventures have to bring to a positive conclusion if the cooperation is to succeed. It indicates that the foundations for effective collaboration have to be laid down at the formation stage, including an understanding and personal acceptance of the cooperation by those who will work within it. In other words, it is vital to regard the formation and operation of an alliance as interdependent stages in one and the same continuing process. It should be the task of alliance general management to ensure that there is continuity between these stages so that the conditions for cooperation develop without unnecessary setbacks. It is for this reason very helpful for the first general manager of an alliance to be chosen from one of the leading players in the formation process, who will be aware of the sense-making and understanding reached during the negotiation process and can carry this forward enjoying the respect of both partners.

The fact that this recommendation is often not followed is one aspect of the problem that the human-resource preparation for alliances is often left until a so-called 'implementation' stage, which is too late (Drouin 2001). Frayne and Geringer (1995: 93) found another manifestation of insufficient human-resource preparation for AGMs. Less than one-quarter of the IJV general managers they interviewed had received any specialized training or other preparation for their JV assignment, despite the fact that less than 10 percent of them had any prior IJV experience.

Such prior preparation is essential, given the demands of the AGM role. Mohr and Spekman (1994) found from a study of 140 personal-computer manufacturers and dealers that the successful management of alliances depends on processes which are comparable to those Ring has identified. The management of these processes is very demanding. In regard to negotiation between partners, Mohr and Spekman draw attention to the benefits of constructive conflict-resolution processes such as joint problem-solving rather than attempts either to dominate or to smooth over problems. They also recommend the creation of commitment, interdependence, and trust, which is promoted by participation, information-sharing, and a high quality of communications. They conclude that all these processes serve better to align partners' expectations, goals, and objectives. The processes emphasized by Mohr and Spekman have a clear affinity with the sense-making, understanding, and committing processes identified by Ring as necessary conditions for cooperation to develop and thrive.

### 10.4.3 Managing the relationship between the alliance and its parent companies

A great deal of what has already been said concerns the contribution that an AGM can make towards the understanding and support that partner/parent companies have toward their alliance. However, a specific issue arises particularly in the case of JVs. This concerns the extent to which AGMs should strive to increase the autonomy of their venture units vis-à-vis their parent companies.

A JV is established in order to contribute to achieving the objectives of its founding partner companies. At the same time, if the JV is intended to perform according to normal business criteria, its success in those terms may well require that its management has the freedom to formulate strategies that are relevant to its specific location and competitive situation, together with policies to implement these. This contrast points to the possible tension between what have been called 'goal' and 'system' criteria for alliance performance (see Chapter 17). It indicates the conflict an AGM may face between his or her role as defined in terms of parent company criteria and those defined in terms of acting as the manager of a successful business. In particular, it raises the question of how much autonomy from its parent companies is appropriate for their JV to have.

Frayne and Geringer (1995: 90) found that newly appointed IJVGMs 'typically have little in the way of guidelines . . . to help them into their new jobs' and that 'the IJVGM is an outsider to at least one of the parent firms'. They often received ambiguous indications of what they were expected to achieve and inadequate support. This means that such general managers 'often must be exceedingly entrepreneurial in order for the venture—and the IJVGM—to perform effectively' (Frayne and Geringer 1995: 91). When JV general managers do behave entrepreneurially, there may come a point when this brings them into conflict with one or more of the parent companies which is concerned that it is losing control over its JV. Lyles and Reger (1993) illustrates how exactly this situation arose in the case of a European-based IJV called EIM.

Assuming that it is necessary for the success of a JV for its general manager to be able to exercise upward influence with the parent companies, Lyles and Reger's study is useful in indicating the ways in which this may be done. In the EIM case, the most successful methods of exercising upward influence used by its general manager were the following, listed in order of their effectiveness in gaining alliance autonomy:

1. direct entrepreneurial leadership by the JV's GM, largely reflecting his personal style and high reputation;
2. securing support for the venture directly from third parties, especially through licensing and influencing parent company stakeholders;
3. obtaining resources for the venture independently;
4. developing the venture's own distinct strategies (even to the point of competing with the major parent in some markets);
5. developing informal relationships with the parent companies involving persuasion, trust-building, and even playing parent off against each other.

The risk that attaches to such autonomy-promoting actions by a JV is also illustrated by events in the case. Despite EIM's success as a business, it was progressively reintegrated into the dominant parent company's own organization once the entrepreneurial general manager reached retirement. Indeed, that parent eventually bought out EIM entirely. It was evidently hard for the parent company to tolerate a high level of autonomy on the part of its JV affiliate.

## 10.5 Organization and alliance success

Faulkner (1993) found that clear well-thought-out organizational arrangements, and the dissemination of information within the alliance, were associated with alliance success.

Others have proposed that certain principles should underpin organizational arrangements if frictions and other problems are to be avoided, and that their explicit adoption is important to a smoothly functioning alliance. Collins and Doorley (1991) emphasize the establishment of a clear dispute resolution mechanism. Lorange and Probst (1987) stress the importance of giving a JV managing director clear authority. Faulkner (1995) suggests the importance of choosing the most appropriate organizational form. Taucher (1988) argues that partners will feel much more comfortable with each other if they have an agreed exit formula if things go wrong; and Kanter (1989) mentions the importance of a good information dissemination system with the partner companies and the alliance itself.

This suggests that clear organizational arrangements need to be set up in an alliance if it is to be managed effectively notably:

1. the establishment of clear dispute-resolution mechanisms;
2. in a JV alliance, clear authority vested in the chief executive;
3. a divorce mechanism agreed at the outset;
4. processes for wide dissemination of information within the alliance.

Ten case studies that Faulkner (1993) conducted illustrate these features in more detail. The cases comprised four JVs (ICI Pharma set up by ICI Pharmaceuticals and Sumitomo, EVC set up by ICI and Enichem of Italy, Dowty–Sema, and 'Eurobrek' which is a fictitious name to disguise the identity of a JV set up by a European and an American breakfast-food company); five collaborations (Imperial–Wintermans, Courtaulds–Nippon, Rover–Honda, Royal Bank of Scotland–Banco Santander, and ICL–Fujitsu); and one consortium organized by Cable & Wireless.

When initially surveyed by means of a questionnaire, most alliances claimed to have a good dispute-resolution mechanism, yet the case studies provide evidence that puts this into question. In general, the alliances claiming good dispute-resolution mechanisms are those with JVs. Only Rover–Honda and RBS–Banco Santander among the collaborations studied made such claims. Of course dispute systems are easier to set up in JVs, since they have clear hierarchies with a chief executive at the apex reporting to a Board of Directors. In those circumstances day-to-day disputes can be resolved in the normal way as within other companies. Where disputes arise between JV personnel and partner-company personnel, they can be resolved ultimately at JV board level, which almost always contains representatives of the partner companies, as well as of the JV management.

The collaborations, ICL–Fujitsu, Imperial–Wintermans, and Courtaulds–Nippon Paint admitted to less than adequate dispute-resolution mechanisms, and the collaborative form is inevitably the one with the greatest ambiguity in the area of resolving disputes. Yet Imperial–Wintermans and Courtaulds–Nippon Paint collaborations adopted a form of the 'gateway' system, which gives a degree of focus to the contacts between the companies, and Fujitsu seconded a small number of senior personnel to ICL headquarters in Putney to take care of such relationships. The mission of the gateway executives is boundary-spanning (Killing 1988; Niederkofler 1991). The gateway is normally personified in a senior executive in each company who directly manages the interfaces between the companies, and hence by implication the disputes, or is at least kept informed of all such contacts. As the senior gatekeeper executive for Banco Santander pointed out, the gateway system is a good one, but the ultimate aim must be for it to wither away, as relationships between the partner companies become closer.

Niederkofler (1991: 251) has argued that: 'By limiting the actual amount of cooperation, by a careful selection of appropriate boundary spanners, and by stepping up the involvement with the partner as the firms get to know each other, the effects of organizational incompatibilities may be moderated.' Thus, boundary-spanning is a critical aspect of alliances, particularly collaborations, and the skill with which it is carried out seems to have considerable impact on the success of the alliance.

The case studies of global strategic alliances undertaken by Yoshino and Rangan (1995) point to the value of parent companies designating responsibility for such affiliates to specific corporate managers. They comment: 'Our research suggests that firms which make the most effective use of alliances tend to assign responsibility for their management to a specific manager or group' (1995: 123). Similarly, Dyer et al. (2001) recommend from their study of 1,572 alliances that partner companies appoint 'alliance managers' at a senior level within their structures to coordinate all the company's alliance-related activity, capitalize on their company's experience with alliances, and provide them with sufficient support.

One of the problems that AGMs may experience is that their responsibility, in terms of results they are expected to achieve, exceeds the authority they are granted. Among Faulkner's case studies of JVs, there was mixed experience on the question of the clarity of authority in the hands of their general managers. Managers in the Dowty–Sema alliance admitted that such authority was not granted; consequently an inordinate amount of time was spent in meetings in which both partners argued for action clearly in the interest of their respective companies but not necessarily in the interests of the JV, or the efficient pursuance of the project. The result was that projects, although successful in their outcome from a physical performance viewpoint, were frequently unprofitable.

The other JVs claimed that their Managing Directors had clear authority. However, such claimed authority was of no avail to the Managing Director of EVC in his quest for greater independence to choose where to buy raw material, or the Managing Director of Eurobrek, should he have wished to run his own sales force. Of the other alliances with separate JV companies, the C&W consortium was run as a Japanese company, so consensus rather than clear authority is the dominant culture, and the same was the case in ICI Pharma.

A further condition requiring an appropriate organizational system is that of managing the information flows between the partner companies and ensuring that information on the alliance is adequately disseminated to them. The purpose is to stimulate interest in the alliance, to encourage support for it, and to encourage the diffusion of the knowledge that can always be gained through close exposure to another company, and the absorption of know-how, embedded knowledge, and routines from the partner.

The management of information, however, has a double edge to it. A degree of information-sharing is essential for the viability of an alliance and its capacity to realize both the economies and learning potentials of cooperation. On the other hand, alliances can become conduits for the flow of commercially valuable information from one partner to another. This is, paradoxically, more likely to happen when managers and staff from one partner come to trust and feel comfortable with their counterparts from another company. AGMs have to handle this paradox in a balanced and constructive manner.

Of the alliances that Faulkner investigated, all except ICI Pharma claimed that information on the alliance was either acceptably or well disseminated in the partner companies. The importance of this would of course vary with the degree to which the alliance involved core activities of the partner companies or only peripheral activities (Lorange and Roos 1992). In most of the alliances, core activities were involved. However, in certain cases this was not so. Eurobrek involved only a very small part of both its partner owners. EVC involved a relatively small part of ICI, but a core part of Enichem. The Imperial–Wintermans alliance was only for cigars, which were central to Wintermans, but peripheral to Imperial, and the RBS–Banco Santander collaboration affected only a small part of the staff of both basically national banks.

Where a noncore activity is involved for a partner, unless there is a greater onus on that partner to ensure wide information dissemination, there is a risk that the alliance will become of decreasing interest to the rest of his company. It is noteworthy that Rover managers claimed that much of the benefit they received from the Honda alliance has been through information dissemination within Rover, and the consequent organizational learning that took place.

Clear and appropriate organizational arrangements are intended to ease the process of managing both internal and external alliance relationships. The two are highly interdependent and equally important. Yoshino and Rangan (1995), for instance, point out that middle managers and technical specialists often view alliances either as peripheral to their core activities or even detrimental to their firm's interests when the alliance is with a competitor. They recommend on the basis of their case studies that AGMs should approach internal relationships as enthusiastic champions for the alliance, rather than as representatives for one of the partner firms, maintain open communications and links at all levels, and seek in this way to promote mutual understanding and realistic expectations of what the other partner(s) can do for the alliance.

## 10.6 Alliance management qualities

A great deal is expected of an AGM under conditions which could become quite frustrating if full support is not forthcoming from one or more of the partners. Yet, although various surveys and writings identify the abilities and skills required of 'international' or 'global' managers (e.g. Barham and Oates 1991; Lane and Distefano 1994), less attention has been given to the desirable profile of alliance managers. In the case of international cooperative ventures, the two roles overlap and the skills of international management will be relevant. The two roles also share a need to effect cooperation between diverse, and potentially antipathetical, groups. Other desirable abilities and skills can be inferred from our review of the general-management role.

It is widely agreed that a fundamental attribute for effective international managers is to possess the broader strategic awareness that is necessary for operating on a global scale, or within an international network. The parallel for alliance managers, even those with responsibility for purely domestic alliances, is that they have to understand and accept the strategic rationale for the alliance and the business objectives the partners place upon it. Yoshino and Rangan (1995: 143) comment that:

> If the mission of an alliance is to be closely aligned with a firm's business strategy, the manager must be in a position not only to understand the firm's strategy but also to have a voice in its formulation and implementation. To manage effectively an alliance that involves multiple projects and therefore competing priorities, the manager must be intimately acquainted with company strategy.

International and alliance managers must also be willing to work towards a set of objectives that is both defined and realized through meaningful relationships with others. Hence further requirements for success in both roles are the ability to communicate effectively and to be flexible in relating with others. These requirements point to relevant personal skills and sensitivities. They imply that, whatever training is offered, certain kinds of people are better suited to the demands of the job than are others. In the case of international managers, the relevant personal skills which have been identified include adaptability, the ability to function in fluid conditions and to cope with ambiguity and personal stress, the capacity to work in and manage teams with diverse memberships, personal self-reliance, relationship and negotiating skills, and the capacity to communicate in more than one language. All of these, except in some circumstances the last, are also necessary for an AGM. Several sensitivities have been identified as requisites for international managers: sensitivity to different cultures, awareness of their own cultural background, and openness to learning from new situations and diverse points of view. Again, these requirements also apply to AGMs, although the cultural diversity may be organizational rather than national.

Alliance managers have to work with large numbers of people over whom they have no direct authority, especially when the alliance takes the form of a collaboration or consortium. They have to possess a capacity to build trust among people, many of whom may be on secondment and will therefore tend to retain their identification with their own parent organizations and career paths (Child and Rodrigues 1996). This clearly places a premium on personal flexibility and finely tuned interpersonal skills.

This chapter has emphasized that the success of alliances requires the development of sound relationships between partners and their staff, coupled with a strategic sense of how the alliance can meet partner objectives. The skills needed for alliance management are quite similar to those for international management, especially when the two spheres overlap; namely, to cope with the exigencies of working with diverse social groups (in this case the partners) and to promote constructive cross-cultural relations. The main characteristic which the management of an alliance requires in greater measure is an understanding of the organizational arrangements required to avoid frictions and other problems in a situation which is not merely one of trading (as can be the case in international business) but one in which a hybrid organization has to be managed in its own right and on a continuing basis. An ability to manage the relationship between alliance partners in ways that permit their cooperation to flourish requires particular skills and self-confidence, which generally develop with experience.

The pressures bearing on alliance managers can be severe, as we have seen, especially when they are working in unfamiliar environments. Quite a number are unable to stand the pressure and the cost is high both to the individual who has failed in a highly exposed position and to the alliance itself, which may be placed under severe strain as a result. In the case of international alliances, the purely financial cost of extricating a failed general manager can easily run to $1 million. It is therefore vital to select people who are acceptable to all the alliance partners, and who have characteristics suited to the demands of the role.

It is equally important to prepare people to undertake the position of an AGM. Several pertinent questions need to be asked. Do they already have experience of working with staff from the other partner(s)? Have they been adequately briefed about the cultural and sociopolitical background of the location to which they are being sent? Has attention been paid to how well their family circumstances fit with their appointment, and have the views of their family been solicited? Has there been a discussion of what they are expected to achieve as general manager and how success in these terms will advance their career? Has this discussion included the question of how they will be reintegrated into the parent organization from which they have come?

## 10.7 Summary

1. The general management of alliances is more challenging than that of unitary firms, because it involves maintaining active cooperation between two or more partner companies.
2. In addition, many alliances today are international in scope and this means that their general managers may find themselves having to take account of the expectations of various groups, such as governmental regulators and community organizations, in an unfamiliar national environment.
3. The importance of managing both external relationships concerning the partners and internal relationships within the alliance itself is indicated by the factors that are associated with alliance success. Positive partner attitudes, especially trust and commitment, are the major external factors, while clear organizational arrangements and the management of information flows are important internal factors.
4. The key to the development of a successful alliance lies in developing a close relationship between the partners, characterized by flexibility,

mutual trust, and committed attitudes towards each other. Given positive attitudes, frictional problems can normally be resolved. However, in the absence of a flexible and trusting relationship, any problem encountered places the alliance in jeopardy.

5. An AGM can do much to facilitate the development of this relationship through helping the partners to make sense of the alliance in terms of their own expectations, and to reach a shared understanding of the context in which it operates.
6. Good internal organizational arrangements, especially in relation to information dissemination, and dispute resolution—for example, the establishment of gateways—enable the inevitable and difficult challenge of managing an enterprise by consensus to be carried out with a good chance of success.
7. The essence of a successful alliance must be to learn from one's partner, and not just to use the partner's skills to substitute for one's own deficiencies. Adoption by both partners of a learning philosophy, but within a situation in which personal and intercompany bonding has taken place, is a likely sign of an enduring alliance.
8. Managing the relationship between the partners, to foster both their strategic and their personal motives for cooperation, is therefore the key to a successful alliance, and a top priority for its general management.

## 10.8 Questions for discussion

1. In what ways does the role of the AGM differ from that of a general manager heading a unitary firm?
2. Can role conflict and role ambiguity provide opportunities for an AGM in addition to the stress they may generate?
3. In what ways might the responsibilities of AGMs exceed their effective authority? Can anything be done to avoid this situation?
4. What are the main contributions that a general manager can make to the success of an alliance?
5. What qualities are likely to be required in persons who are appointed to be AGMs?

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# 11 Control

## 11.1 What this chapter covers

This chapter focuses on the nature and basis of control in alliances and the options available. It begins by discussing why control is such an important issue for strategic alliances. The attributes and dimensions of control are then identified. Distinctions are drawn between strategic and operational control as well as between control in JVs and collaborations. Equity share, bargaining power, and resource provision are seen to provide foundations for partner control in alliances. This leads to the long-debated issue of whether dominant control in the hands of a leading partner is conducive to better management and performance. Research suggests that there is no simple relationship between alliance control and performance. Evidence from Sino-foreign JVs exposes the complexity of the relationship between alliance control and performance, and also offers useful policy guidelines. The same evidence also indicated a relationship between control, trust, and performance, and the chapter closes on the subject of control and trust.

## 11.2 Control as an issue

Control is a central aspect of management, and essential in any system that holds managers accountable for their actions and decisions. It may be defined as a process whereby management or other groups are able to initiate and regulate the conduct of activities such that their results accord with the goals and expectations held by those groups. In the language of agency theory, control is one of the means whereby principals endeavor to ensure that their agents are acting in their best interests. In the case of alliances, the principals are the collaborating partners, or the parent companies of a JV.

Control is widely regarded as critical for the successful management and performance of strategic alliances. It might appear strange that it generates so much concern in the case of organizations founded on collaboration. This is because the formation of an alliance requires each partner to share some control, which introduces an additional dimension of uncertainty. As Geringer and Hébert (1989: 236) have put it rather graphically with reference to IJVs, ‘although each partner must, by definition, relinquish some control over an IJV’s activities, such a move is often accompanied by great consternation’.

In a strategic alliance, the collaboration between partners is balanced against the potentially competitive aspects of their relationship, and each partner seeks to reconcile the alliance's activities with its own strategy and pattern of operations. Insufficient control over an alliance can limit a partner's ability to protect as well as efficiently utilize the resources it provides to the alliance, and to achieve the goals it has set for the alliance. It is particularly critical for a partner to control the core technology and know-how that it provides, which is proprietary, unique, and hard to duplicate under normal competitive conditions.

The general problem of how corporate owners can exercise sufficient control over the direction of their companies has become widely recognized, following the seminal study by Berle and Means (1932). It is one of the key challenges of corporate governance. It raises questions concerning the rights of smaller versus dominant stockholders and how managers can be held accountable, as the agents of business owners. Although these questions have been addressed mainly to unitary enterprises, comparable issues arise in strategic alliances, albeit in a rather different form.

The partners in strategic alliances are also in the position of owners. In the case of EJVs, their ownership is legally vested in the equity they have contributed. However, partners resource some kinds of alliance on a nonequity basis, and even in EJVs, equity alone would constitute a narrow definition of the contributions which partners provide in an essentially ownership role. Because partners normally establish strategic alliances to exploit complementarities between themselves, they will supply those alliances with a range of resources, skills, and knowledge. These are assets with an intrinsic value that are in the possession of partner firms, and they amount to ownership inputs with implied property rights. They may be provided on the basis of contracts, but they need not be. The partners face the problem of protecting the integrity and use of the resources they supply in these ways, and they therefore have a motive for seeking a certain level of control over their alliance. Research has shown (Mjoen and Tallman 1997) that ownership rights do not necessarily translate directly into control of an alliance, and even less into control over the specific resource inputs that one or the other partner might wish to protect.

Alliance partners may face several threats to the integrity of the resources they provide. An alliance can give another partner privileged access to its core competencies, bringing with it various risks such as strengthening a future potential competitor, facilitating a partner's intervention in critical decisions, and possibly diluting the company's distinctive image as a technology leader. There is the danger that proprietary technology and know-how will 'leak' to another partner and its wider affiliates, and hence undermine the competitive advantage that the supplying partner enjoys through possession of that technology. This is a particularly acute problem in countries that have not yet established an effective system for the protection of intellectual and commercial property rights.

Hamel (1991) has illustrated how a shift in technological advantage took place in alliances between Japanese and Western partners because of the superior ability of the Japanese to learn from their partners within the process of collaboration. He points out that the formation of an alliance may be viewed as an alternative to other modes of skill acquisition such as acquisition, licensing from a partner, or developing the needed skills through internal efforts. This clearly sounds a warning for alliance partners either to match the learning abilities of their partners and/or to ensure that they retain sufficient control over their core competencies.

The need for control over an alliance in order to safeguard integrity can take other forms as well. In some countries financial probity can be a problem, which is a major reason why many multinational companies insist on appointing the chief financial officer when they establish JVs with local partners. Another difficulty concerns the counterfeiting or illicit marketing of high-reputation international brands, sometimes aided or even undertaken by an alliance partner. A French wine-maker in China, for example, discovered that its JV partner was secretly bottling wine from inferior grapes and selling it under the JV's brand label, the quality of which was guaranteed by the French partner.

A partner will also be concerned with how the resources it provides to a strategic alliance are used. It seeks to obtain a rate of return from those resources which compares with their alternative applications elsewhere. A poor use of the resources could also threaten the good name of its products in other market places, if as a result their quality suffers and they are provided with inferior after-sales support. Alliances between partners from developed and developing countries are often not marriages of equals so far as skills and competencies are concerned, and this can provide a strong incentive for the more advanced partner to seek control over the alliance's operations (Meier et al. 1995).

A further reason why a partner may seek to secure control over the management of a strategic alliance stems from the fear that a shared system of management may lead to a lack of cohesion and unity that would threaten the alliance's performance. The sharing of ownership and contributions to an alliance between its partners always carries the risk of segmenting control in a way that could lead to problems of integration. If this arises, it threatens not only the operating efficiency of an alliance but also, as we note in Chapter 13, the achievement of mutual learning between the partners as well. Killing (1983) argued that the risk of confusion and fragmented efforts would be reduced the more that one parent company assumed a dominant managerial role. On the other hand, when partners can provide truly complementary inputs to an alliance, dominance by one partner may work against the value of the other partners' inputs being recognized and so inhibit the full sharing of their benefits within the alliance. The empirical evidence on the impact of dominance versus shared control on alliance performance is at present very mixed. The argument in favor of dominant control is, nevertheless, widely held among business people and managers who are engaged in alliances.

The reasons why control is an issue in strategic alliances stem from problems that may arise in relations both between the partners and between the partners and their agents who are actually managing the alliances. We noted in Chapter 6 that the appropriateness of alliance partners can be defined by reference to the fit between their strategic objectives and the fit between their organizational and national cultures. It is extremely difficult to achieve these fits. This means that, while alliances depend very importantly on trust between the partners, that trust is not likely to be absolute. Partners' objectives are not likely completely to coincide and their working relationship can be disturbed by cultural misunderstandings. For these reasons, control will be an issue between alliance partners concerned with the extent to which each of them can influence the alliance so that it meets their objectives and cultural preferences. They have to work out an acceptable solution to this problem, which ideally should reflect the levels of involvement they seek to have in the alliance and the distinctive competencies they bring to it.

Another aspect of control is concerned with ensuring that the managers of an alliance are held accountable for its performance to its owners. This is present in any organization and is not unique to alliances. It can, however, be complicated in a strategic alliance by the presence of multiple partners, who may seek to introduce different performance priorities into the alliance and to reflect these in different control and information-reporting systems. In China, for example, until the mid-1990s, the higher authorities of state-owned alliance partners insisted that alliances continue to produce accounts according to standards inherited from the days of a socialist economy, which had to coexist with accounts produced to the international standards required by the foreign partner.

Control is clearly a big issue for alliances and this chapter focuses on the nature and basis of control in alliances and the options available. It also reviews evidence on the relationship between alliance control and performance. Chapter 12 then locates the control issue within the wider frame of alliance corporate governance; an issue that has to date received remarkably little attention. It discusses the preferences that alliance partners are likely to have for alternative control and governance strategies in the light of the risks they face.

## 11.3 The nature of alliance control

Control in strategic alliances refers to the process by which the partners influence, to varying degrees, the behavior and output of the other partners and the managers of the alliance itself. Their influence may be exercised on the basis of a number of attributes including:

- *power*, such as the command of resources that are key for the alliance's success;
- *authority*, such as the rights deriving from majority equity share;
- *expertise*, such as the possession of specialized expertise relevant to the alliance's operations, and
- *rewards*, such as the ability to deliver good returns to other, less active, partners and to offer favorable compensation to alliance staff (cf. French and Raven 1960).

Geringer and Hébert (1989) identify three dimensions of control in IJVs that in principle apply to all alliances. These are the extent of control exercised over a JV, the focus of that control, and the mechanisms by which control is exercised. A further useful distinction is between two levels of control: strategic and operational.

### 11.3.1 Extent of control

Most of the studies that have examined its extent have thought of control as being dependent upon the centralization or location of the decision-making process. One of the important contributions of this perspective is that it regards control as a continuous variable. In other words, parents can exercise different degrees of control over their alliance rather than having either total control or no control. One of the pioneering studies adopting this perspective was that undertaken by Killing (1983) in thirty-seven JVs. He argued that JVs are intrinsically more difficult to manage because of the way they are constituted, with a small number of powerful parents who are liable to disagree on many issues. He observed that some joint ventures were easier to manage than others, and this was when one parent, or set of parents, was willing to adopt a passive role, leaving the other dominant parent to run the venture. Killing concluded that, the more a JV can be run as if it has only one parent, the simpler will be its management task and the better its performance.

Killing assessed the extent of parent-company control over a JV by examining its degree of influence on nine areas of decision-making. He enquired whether each decision was made by:

(*a*) the joint-venture manager alone, (*b*) by one parent alone, (*c*) by the other parent alone, (*d*) by the JV general manager with input from the first parent, or (*e*) with input from the second parent, or (*f*) with input from both parents. This enabled Killing to classify the thirty-seven JVs into three categories:

- dominant-partner JVs, where only one of the parent companies plays a dominant role in decision-making.
- shared-management JVs, where each parent plays an active role.
- independent JVs, where neither parent plays a dominant role and the JV general manager enjoys extensive decision-making autonomy.

Child et al. (1997) assessed the relative extent of parent companies' control over the management of Sino-foreign JVs by reference to the influence each was perceived to exercise in thirteen areas of JV management, including decisions of both a strategic and an operational nature. They found that this method distinguished between the extent of control exercised by the partners. It also emerged that the distribution of each partner's level of control generally varied across different areas of management.

Research of this kind on the extent of alliance control recognizes several features which are of practical significance. One is that control applies to a range of activities and decisions. The implication is that it is possible for partners to achieve comparable levels of control over a strategic alliance on the basis of different dominance profiles. A dominance profile represents the set of alliance activities over which the partner has predominant influence. In one case it may suit an alliance partner to exercise dominance over activities related to technology, but in another case a partner may seek to exercise dominance over market-related activities. Depending on factors such as the partner's key competencies and the criticality of such activities for the sector in which the alliance is operating, each profile may furnish the basis for a similar extent of overall control.

Another implication is that the extent of each partner's control over an alliance has to be assessed in its own right. The relationship between them with respect to control is not likely to be either simply zero sum or wholly convergent. The balance between these two extremes will alter if an alliance matures on the basis of growing mutual confidence and trust between the partners. In the event that this happens, and a shared management based on a heightened sense of common purpose emerges, then the ability of one partner to extend its control over an alliance should be experienced as an improvement, or at least not as a threat, by the other partner.

Consideration of the extent of control also draws attention to the danger of over-control. The attempt to exercise more control than is necessary will not only incur additional direct costs; it could have negative consequences. If one parent tries to exert too much control within an alliance, this may threaten the quality of its relations with its partners. As Schaan (1988: 5) put it, 'in order to ensure the success of a joint venture, managers seek to strike a subtle balance between the desire and need to control the venture on the one hand, and the need to maintain harmonious relations with the partner(s) on the other hand'. Moreover, if parents either singly or together try to control their alliances too much, this may inhibit the flexibility which the latter need in order to develop within their own competitive environments (Bleeke and Ernst 1993). So, as Ohmae (1993: 42) argues, 'Managers must overcome the popular conception that total control increases chances of success.'

### 11.3.2 Focus of control

The realization that control in alliances does not have to be an all-or-nothing phenomenon has drawn attention to the possibility that parents may seek to focus their control on specific activities, decisions, or processes which they perceive to be crucial for the alliance's performance or for the achievement of their own strategic objectives (Geringer and Hébert 1989). Schaan (1983) explored this possibility in a study of ten IJVs located in Mexico. He explicitly defined control as 'the process through which a parent company ensures that the way a JV is managed conforms to its own interest' (1983: 57), and he demonstrated that parent companies tended to seek control over 'strategically important activities' rather than over the whole JV. Geringer's (1988) study of ninety developed-country JVs supported Schaan's finding that control had a focus dimension, in that parents may choose to exercise control over a relatively wide or narrow range of the JV's activities. Geringer and Hébert (1989: 240) conclude that 'these findings support the notion of parent firms' parsimonious and contingent usage of resources for controlling international joint ventures'. Mjoen and Tallman (1997) find similar results for a group of Norwegian IJVs.

The research conducted on Sino-foreign EJVs by Child et al. (1997) also found that foreign- and local-partner control was focused to some extent on those areas of JV activity in which they enjoyed competence advantages. The areas in which foreign partners had the greatest competence advantage and exercised the greatest control—technology, quality maintenance, and marketing—are particularly critical for bringing the performance of Chinese JVs up to internationally competitive standards and for extending the JVs' market penetration within China. Areas in which the Chinese partners had relative competence advantages, such as personnel and welfare, were ones in which their influence was higher than average. However, in a developing country situation like China it is the foreign partners who normally bring most of the technology and expertise to alliances, and this leads to an overall imbalance between levels of foreign and Chinese control.

The implication of the focus dimension to control is that it is effective for alliance parents to exercise control selectively over those activities and decisions the parent regards as critical. The criticality of some alliance activities is likely to be greater than that of others. The resource deficiency of many developing countries in technology and marketing systems should lead a foreign parent to consider these among the key items for it to supply and control in order to achieve viability for an alliance. In view of the problem of corruption, the foreign partner may also feel it necessary to control the alliance's financial management. This selective approach becomes more sensible in view of the transaction costs of exercising control. The costs of managing some areas of alliance activity may be less for one partner, because of its acquired competence and familiarity in so doing, than for another partner.

Choi and Beamish (2004) draw together considerations of control extent and focus in their framework for depicting the broad choices available to JV partners. They take the case of JVs between multinational and local company partners. Their framework is shown in Figure 11.1, the four options being:

1. Each JV partner controls those areas of JV activity and decision-making in which it has advantages, such as technology and know-how specific to itself (firm-specific advantages).
2. Both partners share control over all JV activities.
3. The multinational partner assumes a dominant control over all areas of JV activity.
4. The local partner assumes a dominant control over all areas of JV activity.

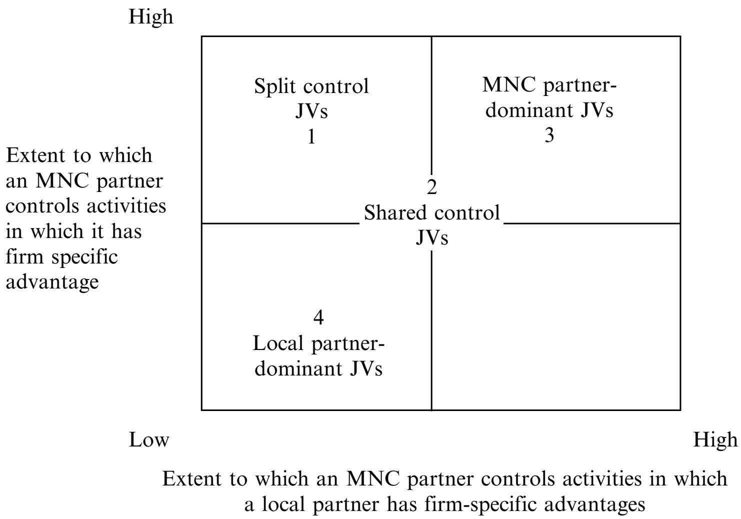


**Figure 11.1** Four ways of dividing control between joint venture partners.

*Source*: Adapted from Choi & Beamish (2004, Fig, 205).

### 11.3.3 Control mechanisms

In order to achieve effective managerial control, the parent companies of EJVs frequently rely upon a majority equity shareholding. There is evidence to indicate that equity share does in practice convey considerable control leverage (e.g. Tomlinson 1970; Stopford and Wells 1972; Lecraw 1984; Child et al. 1997; Child 2002), and that the senior managers of parent companies also believe this. Schaan (1988: 4), for example, quotes the vice president of a large electronics firm as saying with reference to JVs that 'We like to have full control over our operations. We always have majority ownership.' The Dowty–Sema JV illustrates how problems can arise when neither partner has a majority of equity (see Box 11.1).

There can, however, be three limitations to relying on equity holding as a control mechanism. The first, and most obvious, is that it may not be available. Several forms of cooperation do not involve the creation of equity and the legal rights that accompany it, and even in an equity arrangement, majority equity share is not always an available option. The second is that the decisions of a JV's board of directors cannot be expected to reflect a majority equity position without any qualification. The third is that majority equity share may not be an effective means of control at the operational level where the protection of core knowledge and its effective use come into play.

The option of implementing wholly-owned or dominant ownership ventures is often constrained by the increasing scale and risk which accompanies many projects. External constraints may be placed on control by host-government policies that, as in many

**Box 11.1 Control in the Dowty–Sema JV**

Dowty–Sema was a JV set up by the two eponymous companies in 1982 to provide command and control systems for the British navy. The Ministry of Defence (MOD) was the client. Dowty provided the hardware and Sema provided the software. The venture was 50:50 in terms of equity, and the venture company was largely a 'shop window' for tendering, in that the 100-odd staff were all assigned to the payrolls of one parent or the other, dependent on their function. Software engineers were assigned to Sema and hardware engineers to Dowty.

Control was exercised in the following way. A project was divided up between the two companies and 90 percent of it was carried out in the parent companies, leaving only 10 percent, principally project management, for the venture company to do. Dowty controlled contract negotiation and administration and Sema controlled finance. Each parent appointed its own project teams, and an element of competition and tension developed between them. The board membership was 50 percent from each partner. At first there were joint Managing Directors, but later one single Managing Director was appointed. Difficult decisions led to very lengthy meetings by a committee of the board. The venture grew to £50 million sales but unclear control meant that deadlines were missed and the venture made no profit.

*Source*: Faulkner (1995).

emerging economies, promote local-partner equity participation in order to encourage technology transfer, the development of expertise, or market access. Moreover, in China and some other emerging countries, most local JV partners are state enterprises that report to higher governmental authorities. This means, as Nolan (1995: 9) comments with reference to one of Coca-Cola's JVs, that the state is 'an important shadow figure' on its board of directors. There is also the fact that some forms of alliance are not founded upon equity participation in the first place, or they take the form of consortia in which equity is too dispersed among a larger number of shareholders for any one of them to exercise much control through that route.

If the alliance is a JV, meetings of its Board of Directors will normally decide on policy issues such as the venture's business plans, overall performance, and key appointments. As Schaan (1988) points out, in the absence of safeguards built into the JV contract to protect minority interests, majority equity holding ultimately confers control over the issues which a board covers. The frequency with which the board meets and the scope of its agenda therefore bear upon its effectiveness as a control mechanism for the majority partner. However, control through the board is necessarily qualified. If exercised too frequently and in a domineering manner, it is likely to lead to significant ill will and the eventual breakdown of the alliance. Board meetings also provide a channel for keeping minority partners adequately informed and for allowing their views on policy to be expressed. They have the opportunity to discuss and negotiate issues that are placed before the board. The ability of minority partners to influence the management of the alliance will be enhanced if they appoint as their board representatives people who have a good understanding of the alliance's operational and strategic situation, good negotiating skills, and empathy for the partner's culture. Indeed, minority parents may be able to negotiate the inclusion in a JV contract of the right to veto board decisions that are important to their interests.

Where it is available as an option, majority equity ownership can provide for control over alliance policy, but it cannot guarantee operational control. This is because considerable reliance often has to be placed upon another partner's managers and staff for the implementation of policy. This is especially true of alliances whose operations are located in the other partner's country. A lack of operational control, as we have noted, can have serious consequences for the integrity and use of resources provided to the alliance.

These considerations have led to an interest in mechanisms for control over alliances other than equity share. The appointment of key alliance managers to run the operation or manage critical functions such as marketing or R&D can be an important means for a partner to maintain operational control. This is particularly true in cases where the partner is geographically remote or is a minority equity-holder. Formal contractual agreements can be made which set out certain rights to the partner relating to technology (e.g. licensing) or management (e.g. key appointments, management systems, and services). Managers in partner companies can enhance their control over an alliance by structuring the relationships the alliance has with the partner company. These include the reporting relationships upwards from the alliance to a parent company, formalizing its planning and approval processes for capital budgeting and resource allocation, and laying down procedures and routines for the alliance to follow. The provision of HRM programmes and systems for the alliance, for selection, training and development, career advancement, and compensation, can both help to control the quality of the alliance's staff and help to lay down an organizational culture which is consistent with the partner's own (Frayne and Geringer 1990). Generally, multinational companies are interested in promoting corporate culture to improve the control, as well as the integration, of their foreign affiliates (Edstrom and Galbraith 1977, Milliman et al. 1991).

In addition to these relatively formal methods to improve operational control over an alliance, a number of important informal mechanisms are also available. One is the maintenance of regular personal relations with the alliance's senior managers. The partner company can assign an executive with sufficient time and resources both to monitor the alliance's progress and to support this with the necessary personal contact. Personal relations between partner and alliance functional and technical staff are also important, especially if a partner is relying on its superiority in technical and other competencies as a means of guaranteeing participation in the management of the alliance's day-to-day operations. Technical, advisory, and managerial inputs offered to an alliance on a continuing noncontractual basis, and accompanied by the maintenance of close relations between the parent and its alliance, can have a considerable potential for enhancing operational control.

Schaan (1983) distinguished negative from positive control mechanisms. Negative mechanisms are used by a parent company to stop an alliance from implementing certain activities or decisions. These include laying down a requirement for approval of specific decisions by the parent or the alliance board, particularly of items such as capital expenditure plans and budgets, and nominations of senior appointees. A parent may also insist on its approval before projects are discussed with another parent. The other mechanisms we have listed are generally positive in nature because they are used to encourage and promote certain behaviors. Schaan found that negative control depended principally on formal agreements approved by parents and an alliance's board of directors or management committee. Contracts, for example, can lay down restrictions on an alliance's use of technology and brand names, as well as its suppliers and market access. Positive control was most often exercised through staffing, participation in the planning process, reporting relationships, and informal mechanisms.

Bjørn (1997), in a study of the interfaces in Danish companies between headquarters and foreign subsidiaries, advances a typology of control and coordination mechanisms that helps to categorize the different mechanisms we have discussed. Table 11.1 adapts and selects the most relevant examples from Bjørn's typology.

The use of different mechanisms for controlling alliances is in practice likely to reflect a number of considerations. One is the extent to which the performance achieved in an area of activity carried out by the alliance can be assessed through direct measures. If an activity has a measurable output, such as cases of beverage shipped per week or the percentages of rejects, then control can be exercised through formal monitoring systems. This control could be quite tightly administered, if so desired, in the sense of frequent and precise reporting. If, on the other hand, the outputs or consequences of an alliance's activities are not amenable to such precise definition, as is the case with much HRM and marketing work, then it is appropriate to employ a mode of control that is primarily based on behavioral assessments of how the activity is being carried out (Ouchi 1978).

**Table 11.1** A typology of control mechanisms

| Control mechanism | What the mechanism does | Examples |
|---|---|---|
| Input control | Facilitates action on grounds of controlled conditions | Transfer prices, distribution of resources, information management, training and personnel development |
| Behavioral control | Specifies the correct way to do the work | Policies, plans, specification of methods, rules, direct supervision |
| Output control | Specifies intended results, monitors and rewards their achievement | Targets, budgets, reporting of results, performance-related pay |
| Value socialization | Defines and creates common values | Organizational cultures expressed through belief systems, rituals, traditions |
| Adaptation socialization | Makes people familiar with each other's values and practices | Skills standardization, peer pressure, culture sensitivity programmes |
| Personal involvement | Signals what partner managers think is important | Visits and participation by managers, spoken communication |
| Hierarchical structure | Emphasizes and supports partner and alliance goals | Boards of directors, appointment of managers, reporting lines |
| Lateral structure | Influences people to interact across formal boundaries | 'Gatekeepers' between partners, cross-partner teams |

Control in this case is likely to be more personal, less formal, and less frequently conducted.

A second consideration is whether the way in which an alliance performs a certain activity has a direct bearing upon a parent company's overall international operations and standing. Interfaces with other parts of the parent's global operations are likely to be carefully planned, particularly when they constitute an integral part of a global sourcing, production, or marketing network. Similarly, an alliance's activities relating to core technical competencies and core products, such as the quality it achieves for those products, are likely to be very closely controlled by the parent company.

Third, a parent company's cultural preferences may well be expressed in the modes of control it prefers to install for an alliance in which it is involved. Contrasts of American and Japanese approaches to management would, for example, suggest that the former prefers to rely upon formal mechanisms of control including performance-contingent employment contracts, whereas the latter relies rather more on developing motivation and identity with the parent through the promotion of cultural symbols and practices (Hickson and Pugh 1995). It has indeed been found in previous studies of IJVs in China and Hungary that American, German, and Japanese foreign owners prefer to introduce different management philosophies, of which control is an important element (Child et al. 1994; Child and Yan 2001).

### 11.3.4 **Levels of control**

There are two levels of control in alliances: *strategic control* and *operational control*. Strategic control is control over the means and methods on which the whole conduct and future direction of an alliance depends. These include its capital, the form of assets in which the capital is embodied, and its strategic dispositions such as the markets or areas of need to be served, the communities and labor markets in which the organization is located, its external relations with suppliers, competing organizations, and government agencies. This is the level of control that those concerned about effective corporate governance normally have in mind.

The ability that partners have to exercise power within their alliances derives primarily from control at this strategic level. For this level of control allows them to deploy the capital and technology they provide to the alliance, as well as to decide on its market strategies. The second level of control, operational control, is over the work done within an alliance. The ability to exercise control within an organization at the operational level is largely dependent on, and certainly facilitated by, control at the strategic level. Nevertheless, operational control can over time steer many strategic decisions because it impacts on the strategy that the alliance is realistically capable of pursuing and because a succession of operational decisions eventually build up into larger strategic ones. The situation can therefore arise in which one alliance partner does not have the formal ultimate authority to determine its strategy, due to a minority ownership, but where in practice its technical or other expertise relevant to managing the alliance's operations can heavily influence strategic decision-making. Robins et al. (2002) suggest that performance satisfaction in long-lasting alliances is tied to partners' accepting control of the appropriate strategic aspects of the venture—those applying to their asset strengths—but allowing the alliance managers freedom in operational decisions.

## 11.4 Control in collaborations

The discussion so far has confined itself to the issue of how to exercise control without stifling performance in JVs, as it is in this area that the research has largely been conducted. However, it must be remembered that typically of any sample about a quarter of alliances will be collaborations—that is, alliances in which a separate company is not created. Rover–Honda and the RBS–Banco Santander are the alliances to which we keep returning in this book as examples of this genre. There was no Rover–Honda company and there is no RSB–Banco Santander company. Control of collaborations has therefore two major focal dimensions:

1. The 'gatekeeper' role established on both sides to ensure accurate communication between the two companies. For this to be successful, a friendly and forbearing attitude between the two gatekeepers is vital. They must grow to enjoy each other's company, and be able to take a viewpoint that extends beyond the narrow short-term self-interest of their employer, if they are to carry out their role successfully. Gatekeepers play a vital role in controlling an alliance in the sense of monitoring its implementation, guiding it towards fruitful areas of joint activity and keeping partner top managers informed of progress (see Box 11.2).

**Box 11.2 The gatekeeper role in the collaboration between the Royal Bank of Scotland and the Banco Santander**

The two gatekeepers for this collaboration are both senior and experienced executives. One is an Assistant Director of the RBS formally reporting to its Managing Director of Corporate Banking. The other is the Banco Santander's Director for the Alliance with the Royal Bank, and he reports formally to the Santander Managing Director. In practice, however, both men have the freedom to cross any organizational lines within their banks. They have a special responsibility for facilitating the collaboration between the two banks. They do this through two main activities. One is representing the alliance to the partners' top management. The other is facilitating the implementation of the collaboration within the two banks' ongoing activities. They meet in person about every two months.

They prepare reports for, and informally brief, the top-level group which oversees the collaboration, aptly named the Surveillance Committee. The two banks' chief executives are members of this committee, as are at least two other executive directors. It meets at least every six weeks. The Surveillance Committee tends to concentrate on broad policy issues and initiatives concerning the two banks. The two gatekeepers have the job of working together to implement the collaboration on a continuing basis within the policy guidelines. Their coordinated reports to the Committee keep the top managers of both banks well informed about the progress, and therefore the value, of the collaboration.

José Saavedra, the Banco Santander's Alliance Director described the operational side of the gatekeeper role:

> This job is partly a banker's job and partly a diplomat's job. Because we don't have any authority over anyone, on either side, but we've got to make things happen through persuasion . . . What we try to do, we take the head of, say, Advances, Santander, and the head of Advances, Royal Bank, we put them together, we shake them, and we hope something happens. But it's difficult. Because, on both sides, the perception is 'well, we've got things to do, we are very busy'. But we make sure they talk at least once a year.

The persuasion has to appeal to bottom-line results that can arise from active collaboration. He instanced the successful programme to second Royal Bank staff to Santander branches in Spain, where there is a customer base of British tourists and expatriates:

> On the secondee programme, for instance, clearly I present myself to the branch network management as an ally. I say, I can give you someone, a human resource, who will help build up your profits cost-effectively. You will pay so much and you will earn a multiple of that. And they love it. . . . And that's my job, effectively—to find areas where I can say that to as many people as possible.

*Source*: John Child, personal interview.

2. The leaders of the joint company project teams upon which the economic success of the alliance depends have a role of equal importance to that of the gatekeeper.

The dimensions of control that Geringer and Hébert (1989) have identified for JVs apply mutatis mutandis to collaborations as well. However, some of the differences should be noted. The philosophy behind the extent of control should be that of flexibility and a resolution not to seek to overcontrol. In a collaboration, the focus of control must be on not unintentionally transferring proprietary information beyond that agreed. The major mechanisms of control are the project plans, their Gantt charts, appointments to the project teams, and the monitoring of progress on the projects, and the provision of finance and other key resources to the alliance. The agendas of the gatekeepers also provide a mechanism for control of the development of the alliance, as do the members of the supervisory committee that should be set up to oversee the overall maturing of the alliance.

It should be noted, however, that the collaboration form of alliance does not allow access to certain mechanisms that are available to JV alliances. There is no JV company and therefore no formal permanent management structure, board of directors, or equity holdings by the partner companies. These provide important control mechanisms to the JV as described earlier. Despite these control limitations, if similar philosophies are adopted, the collaboration may be controlled just as successfully as the JV, although the risk of overcontrol is perhaps rather less in this inherently more flexible alliance form.

## 11.5 Foundations for control

Rather more attention has been given in literature and research to the reasons for the formation of strategic alliances than to how they are managed once they have been established. As a result, there is relatively little evidence on control in strategic alliances, or on the factors that provide for control, despite its importance for partner companies. Indeed, among the available research studies, there is also the complication that some have examined control in alliances between partners from developed countries, while others have investigated control in alliances between developed and developing country partners. The distinction between these two situations has to be borne in mind because they may produce contrasting findings with different practical implications (Beamish 1988).

The main theories on the subject of control identify three main factors that provide bases for control in strategic alliances. These factors are often related to one another. The first is *majority equity shareholding*, which obviously applies to those alliances that can have an equity basis—namely, JVs and consortia. A majority equity shareholding provides the legal voting rights to determine the venture's policies through its board of directors unless specific restrictions are placed on those powers.

The second factor has been identified as an alliance partner's *bargaining power*. This is assumed to derive from the availability of alternative partners, the importance of the alliance for the partner's own strategy, and the partner's commitment of resources to the alliance. A partner possessing bargaining power may be able to negotiate to have a larger equity share when a JV is being formed.

A partner's ability or willingness to commit key resources to an alliance links to the third factor that, it is argued, can provide a lever for control. This is the advantage a partner has over others in its *ability to provide resources* that are critical to the alliance's success (Pfeffer and Salancik 1978). The provision of such resources may bring with it the justification for installing the partner's managerial and technical systems, and for the nomination of staff to run these, which are themselves further levers for exercising control. Resource provision also relates to formal ownership in two respects. First, equity ownership is itself constituted through the provision of resources that are valued as equity, such as cash, land, plant and technology. Secondly, equity shareholding has a legal status with formal rights and in this respect it parallels the contractual provisions under which resources may be provided to an alliance, whether it be equity based or not. These contracts often include legally defined rights accruing to the resource-providing partners, as in technology-transfer agreements. These rights may include fees and royalties as well as the imposition of restrictions on the use of the resources.

Equity share has been a focus of attention in most studies of alliance control. A number of studies have found that, while many multinational corporations, especially those of US parentage, seek to acquire a majority equity holding in their overseas ventures, this may be dependent upon prior factors which contribute to their bargaining power. Lecraw (1984), for example, found among 153 ASEAN region affiliates of 'transnational' corporations (TNCs), that as the bargaining power of the TNCs increased relative to the bargaining power of the host country, and as their desire for a high level of equity ownership increased, so the percent equity ownership they held in their affiliates increased. TNC bargaining power was assessed in terms of their technology advantage, their size and capital intensity, their advertising intensity, and the dependence on their subsidiaries for accessing export markets. The bargaining power of the host country was assessed with reference to the attractiveness of its local market, the degree to which it controlled access to that market, and the availability to the host country of proprietary assets from sources other than the TNC. Blodgett (1991) analyzed data on 279 two-party EJVs between USA and a variety of developed- and developing-country foreign partners. She concluded that the possession of valued technology appears to give considerable bargaining power to a JV partner leading to its acquisition of more equity share, particularly once that partner gains familiarity with the local market and environment and so relies less on its local associate for such knowledge. On the other hand, host-government persuasion could reverse the process, enabling the local partner to increase its equity ownership.

A pioneering study into the control effects of equity ownership was conducted by Killing (1983), who examined thirty-seven EJVs, of which thirty-five were alliances between developed-country partners. He distinguished between JVs with dominant parents, those with shared management, and independent ventures, using the criteria mentioned earlier in this chapter. He concluded that ownership and dominance are not necessarily related. He found four cases where a dominant JV parent had only a shared equity stake. As explanation, Killing offered the interpretation given by an experienced and successful JV general manager—namely, in any alliance that depends on the goodwill and cooperation of both partners for its success, the majority owner cannot force issues by taking them to a vote. '"You can only do something like that once," he stated, "the second time you try and force it you'll lose your joint venture"' (Killing 1983: 21). Nevertheless, all of the parent companies that had a more than 50 percent equity share were classified by Killing as dominant parents. A reasonable conclusion from this pioneering study would be that a majority equity share goes a long way towards providing the partner with a basis for dominant control over a JV, but that it is also possible for a nonmajority shareholder to develop a strong position through the other mechanisms of control we have identified.

Glaister (1995) examined the same issues in a study of control in ninety-four UK JV with partners from western Europe, USA, and Japan. Of these, sixty-five were EJVs and twenty-nine were non EJVs involving formal long-term cooperation agreements between the partners. In other words, they were what we have called collaboration. Glaister found that most of the nonequity cooperative alliances operated on a basis of shared control. Their management teams tended to be drawn equally from both partners, both partners tended to have the right to veto decisions made by the JV management, and management-control systems tended to be derived from both partners.

In the case of the EJVs, those UK partners which owned at least a half share of them not only possessed the control advantages associated with being the majority equity-holder, but had also in most cases been able to build upon this advantage by deriving several other mechanisms of control. These included appointing the JV's general manager, sourcing the JV's management team, providing its accounting, planning, and control systems, and being the more active partner in its general management and in all the main management functions except R&D and marketing. When the foreign partner held a majority equity share, it was similarly able in many cases to introduce much the same pattern of additional control mechanisms.

Schaan's (1988) conclusion that a JV partner can secure control even while owning a minority equity share therefore appeared difficult to realize in this sample. This may well be due to the contrast between in the nature of the partnership in Glaister and Schaan's studies. Whereas Glaister investigated JVs between developed-country partners, Schaan's conclusions were drawn from JVs between companies from developed and developing countries. In this latter case, alliances depend quite highly on the developed-country partner for technical and managerial skills, thus providing it with a substantial alternative basis for exercising control, even if it has a minority equity holding. By contrast, alliance partners from highly developed countries will tend to be more balanced in their managerial, and even technological, competencies and they are therefore less likely to be able to use these to derive further control advantages unless they enjoy the right to do so which flows from a majority equity share.

Further light is shed on the developing country alliance by recent studies of JVs formed between Chinese enterprises and foreign partners from developed countries. Yan and Gray (1994*a*, 1994*b*, 1996) conducted a qualitative study of partner bargaining power and control in four Sino–US equity manufacturing JVs and a complementary qualitative study in ninety such ventures. They assessed parent-company bargaining power during negotiations to form the JVs in terms of two dimensions: the alternatives each partner possessed when negotiating the venture and the strategic importance of the JV to each partner. Equity share and the relative provision by parent companies of non-capital resources were taken as measures of bargaining power during the operational life of the JV. Parent-company control over the JVs was assessed indirectly with reference to the composition of their boards of directors (as a measure of strategic control), the nomination of the general and deputy general managers and the decision-power distance between them (as a measure of control over operational issues), and similarities between

JV and parent-company organizational structures and operational procedures (as a measure of structural control).

Yan and Gray found that their four case studies supported the predicted relationship between the level of a parent company's bargaining power and its control over the management of a JV. Their survey did not, however, provide any support for a link between bargaining power during JV negotiation and the subsequent level of control exercised by the parent companies. Equity share strongly predicted the amount of control a parent company exercised over the JV's strategy and, to a lesser extent, its level of operational control. The more that one parent company provided non-capital resources relative to the other(s), the greater tended to be the operational control it exercised.

An investigation into sixty-seven Sino–foreign EJVs located in the electronics and fast-moving consumer goods sectors, throws further light on the bases for control over such alliances (Child et al. 1997; Child and Yan 1999). The investigators examined three categories of ownership input to the JV: capital resources (equity) and two forms of non-capital resources—namely, those provided on the basis of contracts and those provided on a non-contractual basis. They also examined the role of JV board composition and the staffing of senior positions in the JVs. They assessed control primarily in terms of the level of influence that the Chinese and the foreign-parent companies (and their representatives) were reported to exercise over thirteen JV activities and decisions.

The investigation identified four significant bases for control in the JVs. Majority equity share provided for dominant control over key policy decisions, including a JV's strategic priorities, reinvestment policy, and profit distribution. As expected, the right to a majority on the JV board secures control over alliance policy. Majority equity share also bolsters a parent company's influence over key managerial appointments in a JV—namely, its general manager and the heads of major functions.

The nomination of the general manager and the heads of certain functions increases a foreign parent's control over a wide range of JV decisions. These appointments are by no means wholly determined by equity share, and can therefore be negotiated separately. The right to appoint to given management posts can be specified in the JV contract. As well as having a foreign general manager, heading up finance enhances foreign influence in the large majority of JVs. Many foreign parent companies saw it as essential to have their own financial manager in the JVs in order to ensure accurate reporting according to their own accounting conventions. In the electronics and fast-moving consumer-goods sectors, technology and marketing are respectively key competencies. Managing these functions therefore contributed importantly to the overall direction of the JVs.

Legal contracts are intended primarily to provide security for foreign technology, to guard against leakage, to guarantee standards, and to secure an income stream from royalties. They are also used to protect brands. Providing resources under contract can therefore assist foreign control over certain key parameters, though the enforcement of contracts remains a problem in China. It did not, however, appear to affect the balance of influence within management, except in the area of technology development.

Noncontractual support is provided without any contract or fee, and includes product know-how, production technology, marketing assistance, management systems, and training. The provision of noncontractual support by Chinese JV parent companies on an ongoing basis adds appreciably to the influence they possess in many areas of JV management. Whereas equity share impacts most on the strategic influence available to a JV parent company, the provision of noncontractual support impacts most on the influence it has over operational activities—purchasing, production, quality, and sales/distribution. An exception was that when Chinese parents assisted with the management of external governmental relationships, this tended to enhance their influence over the JV's strategic decision-making as well. The level of noncontractual support provided by parent companies was to a large extent independent of their equity shares, and it is therefore an important lever for control in its own right.

A majority equity share was in most cases reflected in an equivalent majority on the joint venture board, but not necessarily so. Some JVs, for example, have a foreign majority share but a board with equally divided membership. Moreover, equity share was a stronger predictor of the level of control than was the ratio of board members, suggesting that its leverage on control works through other channels in addition to the board. One such channel is provided by senior managerial appointments.

The great majority (79 percent) of the sixty-seven Sino–foreign JVs investigated by Child et al. (1997) had a foreign general manager, and, of the five major functions, on average almost two (1.8) were headed by foreign managers. The roles which were mostly

**Box 11.3 Policies to enhance control in the management of Chinese ventures**

1. Acquire a majority equity share, and preferably a substantial majority such as 75 percent. This establishes the clear right to control the JV's policy as a whole (strategic control).
2. However, do not rely so highly on the legal rights embodied in equity and contracts as might be done in a Western context. Legal contracts tend to have a negative connotation in China. It is unwise to insist too often on the assertion of these rights, since this is readily interpreted as offensive and damaging of mutual respect by Chinese partners.
3. Involve foreign staff both in heading key functions and in the provision of continuing noncontractual support. This is, of course, costly, but it significantly increases the ability to determine the quality of the JV management process. It also creates active personal links within the parent company that enable its senior management to learn from the experience of operating in a relatively unfamiliar and difficult environment.
4. Focus control on areas that are both key for the business and where foreign expertise and experience are paramount. In China these are generally finance, technology, and marketing, though the development of human resources also needs considerable attention and support.
5. Above all, use the rights and powers of ownership to manage relationships. It is essential to approach these in a nonconfrontational manner. In China this is a condition for accepting the contribution and authority of foreign management. Also recognize the importance of sending high-profile corporate personnel to China. This is interpreted as a positive gesture, and it can do a great deal to remove constraints on JV management.

*Source*: Adapted from Child (1995).

occupied by Chinese nationals—deputy general manager and head of personnel/HRM—are ones for which foreign JVs partners do not necessarily possess superior competencies. Nevertheless, it is surprising to find so many JVs in which several functional areas, in addition to general management, were headed by non-Chinese appointees in view of the high costs of expatriate managers in China. It emerged that the greater the equity share and the provision of noncontractual resources by a foreign parent company, the more key appointments were likely to be held by managers from that parent. JVs still at an early stage of development were also more likely to have foreign managers or foreign parent nominees in charge of production, finance, and marketing.

These conclusions are broadly comparable with those of Yan and Gray (1996) for US–China JVs, regarding the impact of resource provision by parent companies upon their levels of JV control. Yan and Gray found that the equity share held by a parent is a stronger predictor of strategic control than is noncapital resource provision, while they found that non-capital resourcing is more predictive of operational control. However, Yan and Gray assessed strategic and operational control in terms of respectively the parent companies' ratio of JV board members and the nomination of the JV's general and deputy general managers. This tends to obscure the very germane question of whether such appointments themselves provide important bases for JV control in addition to the provision of financial and material resources.

These connections suggest that the parent companies were taking a focused approach to alliance control. They appointed managers to enhance their control in areas of importance to them. The occupancy of senior JV positions did, in fact, add to the relevant parent company's control over the JV, over and above the impact of equity share. In other words, there is support for Schaan's argument that the determination of a JV's management structure can provide alliance partners with a lever for control in addition to its ownership commitment. Because senior appointments are not entirely dependent on equity and other resource commitment, the implication is that they can to some extent be negotiated in their own right.

A number of practical implications can be drawn from this research, which, although located in China, is likely to apply to foreign cooperative ventures in many other emerging economies as well (see Box 11.3). Overall, they indicate the significant impact that non-capital resourcing can have on the control of alliance operations.

Another lesson to be drawn from the research just reviewed lies in the distinction between a partner's strategic control over an alliance and its control in operational areas of the alliance. The two levels of control are clearly not the same, and this offers the prospect of a reconciliation between the desire to promote harmonious relationships between partners and the need to control an alliance's operations to achieve the necessary level of competitive performance and return on resource investments. If there is broad compatibility between the partners' objectives, then it should be possible for control, in the sense of influence, to be shared at the strategic level, even if one partner clearly enjoys greater operational competencies and should therefore exercise the greater control at that level. The proposition, in other words, is that cooperation between firms will usually work best if they each perceive that they have a sufficient voice over the strategic direction it will take. Within an agreed set of long-term goals and priorities, it may then be quite acceptable to all concerned for one partner to take the lead in controlling certain operational areas in which it clearly enjoys superior expertise, experience, or knowledge.

## 11.6 Control and performance

Investigations into the effect of partner control on alliance performance have produced mixed results (Geringer and Hébert 1989, Choi and Beamish 2004). There are a number of likely reasons for this. The first arises from the fact that the assessment of alliance performance is far from straightforward and has not been consistent across different investigations. Some have assessed performance in terms of a 'goal' model—namely, how far partners think the alliance has met their objectives. One problem with this is that the partners' objectives can differ. Thus, in an alliance between developing- and developed-country partners, the former may evaluate the alliance's performance in terms of how far it has provided access to technology and foreign capital, whereas the latter may evaluate success in terms of its profitability and competitiveness. Other studies have assessed alliance performance in 'system' terms, with reference to how far the alliance is able to sustain and strengthen itself as an ongoing system by producing a return on the resources invested in it and by resourcing its growth (see Seashore and Yuchtman 1967).

A second problem stems from the difficulty of obtaining 'hard' performance data for alliances and the fact that assessments of profitability in particular can be distorted by factors such as transfer pricing between the alliance and its partner companies. An alternative approach has been to request the subjective assessments of partner or alliance managers, but these are likely to be qualified by the expectations which such managers hold and possibly by their desire to put a favorable interpretation on the alliance's performance (Geringer and Hébert 1991).

The practical consequence of these difficulties in assessing alliance performance is illustrated in the research that Child and Yan (2003) carried out on Sino–foreign JVs. They assessed JV performance with reference both to the goal model (JV managers' perceptions of how far Chinese and foreign-partner objectives had been attained) and to the systems model (subjective and hard data on JV profitability and growth). A mix of subjective (perceptual) and hard data were gathered for the assessment. However, while the perceptual indices were positively intercorrelated, there was only a limited correspondence between the subjective and 'objective' indicators: the indicators of profitability correlated, but those for growth did not.

Discrepant findings on whether and how alliance control has an impact on performance have also almost certainly arisen because different investigations have not focused on alliances of the same type, operating in comparable situations. In some circumstances greater control may afford benefits that outweigh the costs that are incurred, but in other situations the cost–benefit equation for control may be different. Contractor (1990) has argued that in industries where there is an additional return from global standardization of products and/or processes, multinational companies are likely to seek strict control over their cooperative ventures in order to achieve this standardization. This means that wholly owned subsidiaries will be their preferred mode of entry to new markets. By contrast, in industries with strong local-consumer preferences or a high level of economic nationalism, shared control through partnership with a local firm is preferable. Similarly, Anderson and Gatignon (1986) suggested that entry modes offering greater control would be more effective for highly proprietary products or processes.

Franko (1971), who studied the control–performance relationship in MNCs with IJVs, concluded that it depended upon the parent company's strategy. Their JVs were more stable (measured by the absence of liquidation or significant ownership change) when the MNC parents followed a diversification strategy and demanded less control over the venture than when the MNC's strategy emphasized product concentration (e.g. globalization) which usually relied on strong control. The implications of control for JV performance therefore appeared to be contingent upon the parent company's chosen strategy and structure.

Bleeke and Ernst (1993) argue that acquisitions in which one side in theory assumes total control over the other work well for core businesses and existing geographic areas where the acquiring company already possess relevant knowledge and experience. On the other hand, alliances with a degree of shared control are, they claim, more effective for edging into related businesses or new geographic areas. Much of this boils down to the adage that there is no point for a partner to try to control what it does not understand until it has had the opportunity to acquire the necessary knowledge, and there is no point either in trying to exert control if this will generate strong counterproductive reactions.

These considerations lay down the basis for a contingency approach to partner control and alliance performance, which is illustrated in Figure 11.2 (adapted from Bartlett 1986).

Although this approach needs to be clarified through further research, it points the way to the kind of judgment which companies need to make when establishing alliances.

This contingency analysis extends considerations of transaction costs in alliance management to take account of strategic factors, particularly global product strategy, as well. In the light of this more complex analysis, it is not surprising that the simple proposition advanced by Killing (1983)—alliances having dominant control by one partner will be more successful because they are easier to manage—has not been consistently supported. Killing found that ventures with 'dominant' parents 'significantly outperformed' those with shared management. This finding was based on two quite limited measures of JV performance that, nevertheless, provided a similar interpretation. These were the manager's own perception of his venture's performance and whether the venture had either failed through demise or undergone a major reorganization because of poor performance. Killing did, however, qualify his conclusions by arguing that a critical requirement for JV success is that partners who have required skills and knowledge should be able to exercise an appropriate level of control in those areas of competence. This means that in situations where, for example, one parent company has a special knowledge of technology, and the other a knowledge of the market, a shared management venture is the appropriate solution despite the likelihood that it will be more difficult to manage.

Killing's thesis on the performance advantages of dominant parents has received some further support, largely from studies of multinationals having alliances in developing countries. For example, a study was undertaken by A. T. Kearney International of

| *Returns to partner from global standardization of products* \ *Significance of specific local factors* | Low | High |
|---|---|---|
| High | Dominant control<br>*Consumer electronics* | Initially shared control, but attempt to move towards dominant control as partner learns<br>*Branded foods* |
| Low | Shared or dominant control depending on partner's management culture and attitude towards risk<br>*Cement* | Shared or limited control<br>*Construction* |

**Figure 11.2** A partner's choice of alliance control policy in the light of contingencies.

*Notes*: Illustrative sectors are shown in italics. Local factors include strong local consumer preferences, economic nationalism, or partner's unfamiliarity with context.

*Source*: Adapted from Bartlett (1986).

fifty-five large American and European multinational corporations operating in East Asia. This indicated that wholly owned subsidiaries accounted for almost 50 percent of the cases achieving a return on investment greater than their cost of capital, while 50:50 and minority JV and agent–partner arrangements made up more than 60 percent of the operations with a return below their cost of capital (Business Asia 1992). Hu and Chen (1994) found from a survey of 382 Hong Kong subsidiaries and ventures operating in China by 1986 that wholly owned subsidiaries were more likely to be successful than EJVs or those based on contractual agreements. This again suggests that sole management control has performance advantages. The results must, however, be treated with caution, since there were only twenty-seven wholly owned subsidiaries in the sample, and very indirect measures of performance were employed: duration of the alliance and total partner investment in it. Yan and Gray (1996), in their study of Sino–US JVs, assessed performance in terms of the extent to which JV general managers or deputy general managers perceived each parent company's strategic objectives to have been achieved. Path analysis suggested that, the higher the level of operational control a parent company exercises in the JV relative to its partner, the greater the extent to which that parent was perceived to be achieving its objectives. This finding appears to lend support to Killing's thesis that dominant control by one JV partner is associated with higher performance, but one should bear in mind that Yan and Gray's assessment was based on a goal model of performance rather than a direct measure of JV performance per se.

Other studies have failed to confirm Killing's findings. For instance, Janger (1980) used a classification scheme similar to Killing's in a study of 168 IJVs in both developed and developing countries. He did not, however, find that one type of JV tended to be more successful than another. Awadzi et al. (1986) failed to find any relationship between the extent of parent control and the performance of JVs. Bleeke and Ernst (1993) found among a sample of forty-nine cross-border alliances, chiefly, it appears, between partners from developed countries, that those with 50:50 ownership turned in a superior performance. Bleeke and Ernst considered that an alliance was successful if it passed two tests: both partners achieved their ingoing strategic objectives and both recovered their financial costs of capital. The reasoning they advance to account for their finding is particularly interesting because it stresses the benefits of strong management *within* an alliance rather than Killing's argument in favor of strong management *over* an alliance, as well as the virtues of developing trust between the partners:

> when ownership is even, it is more likely that the joint venture will be set up as a separate entity with its own strong management. But 50:50 ownership is important for another reason: It builds trust by ensuring that each partner is concerned about the other's success. (Bleeke and Ernst 1993: 28)

Beamish (1988) reviewed studies, including his own, on the control–performance link in developed- and developing-country alliances. Several of these investigations conclude that, when alliances are formed between developed- and less-developed-country partners, there tends to be an association between satisfactory performance and less dominant control by the foreign partner. The argument is that a sharing of control with local partners will lead to a greater contribution from them which can assist in coping with circumstances that are unfamiliar to the foreign partner, and therefore result in a higher return on investment. Beamish (1988: 21) concluded that 'What the literature seems to indicate is a different emphasis—in fact a weakening of the link—between dominant management control and good performance when study focus shifts from the developed countries to the less developed countries.' In a more recent investigation of seventy-one JVs between Korean and foreign multinational enterprise partners, Choi and Beamish (2004) found that 'split control', in which the JV partners chose activities to control that matched their respective complementary resources and strengths, was more closely related to positive assessments of the alliances' performance than were other control solutions. Three other control solutions were examined: shared control (i.e. not focused on areas of partner-specific advantage), multinational partner control dominance, and Korean-partner control dominance. The authors urge that more attention be paid in future investigations to the effects of split control solutions, by taking into account the distribution of partner control over different JV activities.

Osland and Cavusgil (1996) conducted interviews with forty-three managers and government officials representing eight Sino–US JVs. Noting that previous investigations provide conflicting results about the relative effects on performance of dominant, shared, and split control, they reported that a third variable—size of the JV measured in annual sales, equity, and expatriate personnel—affects the relationship between control and performance. They assessed performance in terms of partner satisfaction with goal attainment and with JV profitability. In each of the three small JVs, split control was satisfactory to both sides. However, when the American partners had committed more money and personnel to the JVs, it became desirable in their eyes to control more of their management functions. They were not satisfied with their JVs' performance unless they had dominant control in them.

Child and Yan (2003), drawing from the investigation of sixty-seven Sino–foreign JVs mentioned earlier, looked at both the possibility of a direct relationship between control and performance as well as the association that the degree of 'fit' between parent company resource-provision and control might have with performance. There was no consistent direct link between the relative level of control over the JVs held by the parent companies and assessments of their performance. Parent control only became a significant predictor of JV performance when the quality of resource-provision was taken into account. Specifically, a combination of good favorable JV resourcing and relatively greater local parent control was associated with superior JV performance. This suggests that, in an emerging economy like China, it is a positive move for JV performance to bring the local partner into its decision making process if and when the partners lay down an adequate resource base. On the whole, the JVs depended on the foreign parent for most of this resourcing. If their resource base is not very adequate, this appears to require compensation by additional foreign managerial intervention.

The findings of some more recent studies suggest that different configurations of alliance control and other factors need to be taken into account in order to understand its implications for performance, and that a failure to do so may account for many of the mixed results from previous investigations. A further, more detailed, study of twenty Sino–British EJVs certainly suggests as much (Child 2002). This study noted three significant configurations of parent ownership, management and control in JVs, and it concluded that different policies were conducive to superior JV performance in each of the three configurations.

### 11.6.1 Configurations of control and performance

Different configurations of ownership, control, and management appear to be viable under different circumstances. Alternative alliance forms appear to suit prevailing contingencies (Tallman and Shenkar 1994). The investigation of twenty EJVs between Chinese and UK partner companies identified alternative configurations in their organization, each of which was capable of supporting satisfactory performance. From the perspective of the UK (international/foreign) partners, these configurations could respectively be called the *surrogate subsidiary*, the *balanced partnership*, and the *junior partnership* (see Table 11.2).

*The surrogate subsidiary.* This configuration is based on the international partner holding a majority equity share in the JV. It is typically found in JVs that have a large value of invested capital. In such cases, the shortage of capital among local partner enterprises limits them to a smaller equity share in projects. Compared to the other two configurations, international partners with majority equity tend to be less insistent on contractual safeguards to any further resources they provide, since they perceive they can determine the use of these inputs and secure a due return on them through their overall control of the JV. This control is usually backed up with a heavy presence of expatriate managers and staff, especially as GMs and heads of the finance and technical functions.

International partners having a majority equity holding refer more decisions above the JV board to their corporate or regional levels than they do in the other two configurations.

**Table 11.2** Configurations of control and performance

| | Formative context | Investment and supporting resource (noncapital) | Management and control | Performance |
|---|---|---|---|---|
| Majority foreign equity share<br>Surrogate subsidiary | ➢ International partner is MNC with considerable international experience<br>➢ International partner seeks control and is willing to make a high capital investment<br>➢ Relatively large and more capital intensive JVs | ➢ High level of capital invested<br>➢ Moderate provision of support on contractual basis<br>➢ Extensive provision of support on noncontractual basis | ➢ Heavy presence of expatriates, especially general manager, finance and technical<br>➢ Foreign strategic control of JV via referral to parent company<br>➢ Foreign operational control of JV, especially finance, technical and international sales<br>➢ Direct managerial control makes control via contract less essential | Good<br>➢ Heavy support from International parent and active links to parent<br>➢ Local managers given active external role<br>Poor<br>➢ Product too expensive or sophisticated for Chinese market<br>➢ Little local manager contribution to marketing & other external activities |
| 50% equity<br>Balanced partnership | ➢ Fewer foreign parents are MNCs<br>➢ Some JVs are in sectors where foreign majority equity is not acceptable<br>➢ Relatively small JVs with lower capital intensity | ➢ Limited level of capital invested<br>➢ Extensive provision of support on contractual basis, especially process technology<br>➢ Relatively low provision of noncontractual support, focused mainly on technology and systems | ➢ Limited presence of expatriate managers<br>➢ Shared strategic control of JV<br>➢ Shared operational control of JV; main foreign influence in the technical area | Good<br>➢ Realistic and compatible goals<br>➢ Shared management based on cultivation of close relations and trust<br>➢ Technical support from International parent<br>Poor<br>➢ Goals in conflict and/or expectations unrealistic<br>➢ Inadequate tech & managerial support from International parent<br>➢ Conflictual relations with high-blame, low trust climate |
| Minority foreign equity share<br>Junior partnership | ➢ International partner is not an integrated MNC<br>➢ Least capital intensive JVs | ➢ Low level of capital invested<br>➢ Extensive provision of support on contractual basis, especially management services & training<br>➢ Relatively low level of non-contractual support, focused on management systems and training | ➢ Limited presence of expatriate managers<br>➢ Technical superiority and managerial experience provides foreign parent with influence focused on strategic matters<br>➢ Operational control in Chinese hands, except for technical parameters and exporting | Good<br>➢ High level of technical & training support, combined with local operational delegation<br>➢ High trust<br>Poor<br>➢ International parent gives low priority to JV<br>➢ Inadequate technical & managerial support from International parent |

JV boards, which are the main channel for Chinese partner representation, assume a less substantial policy-making function in this configuration. Although the normal provisions for unanimity among JV directors on matters such as approval of JV business plans apply, most of the majority equity JVs are in effect being run as subsidiaries.

The formative context of the surrogate subsidiary is distinctive. Most JVs in this category were established by MNCs with considerable international business experience. Western MNCs tend to favor having overall control, if not sole ownership, of affiliates. Their previous experience usually lends them additional confidence to manage new market entry without reliance on local partners. The granting of majority JV ownership became progressively easier in China as restrictions eased along with the dash for growth and foreign investment in the 1990s. MNCs were increasingly favored by the Chinese authorities as providers of foreign direct investment (FDI) because they were seen to have the most capital, advanced technology, and know-how to offer. In these respects, the surrogate subsidiary is representative of the growing numbers of MNCs entering China and other large emerging markets such as Brazil, with relatively large and capital-intensive projects.

A majority equity share is frequently recommended to alliance partners as a means of reducing the risk of control loss, securing unified management, and achieving consolidation among multiple partnerships. It does, however, run another risk: that of marginalizing and demotivating the local partner. It tends to limit the latter's contributions toward running the operation, providing relevant local knowledge, and facilitating network connections. The conventional advocacy of majority equity in effect looks to reduce complexity. It is prepared, if necessary, to sacrifice quality of partner relations for the perceived benefit of having policies carried out without argument or delay and according to the standardized procedures of the international parent organization.

There were two cases among the JVs studied in China that were exceptions to this pattern. They indicate that it is possible to combine having the final say in JV strategy-making that comes from majority equity with inclusion of the local partner in the decision-making process. Dominant equity share does not have to be used to run a surrogate subsidiary; it also permits the option of running the JV as a partnership. Rather than trying to reduce complexity through unilateral decision making and standardization imposed by the international partner, this alternative policy allows the local partner to contribute to a process of absorbing complexity and offering alternative options (Boisot and Child 1999). The quality of the partnership plays a more critical role in this variant of the majority equity configuration, a factor that was stressed by executives in both cases.

*The balanced partnership*. This configuration is based on an equal equity share among the partners, usually 50:50 between just two partners. This arrangement may be mandated by regulations applying to some sectors that prohibit nondomestic firms from acquiring majority JV ownership. It may also suit a situation in which both partners can make complementary contributions of similar value to the alliance. The JVs in which a balanced partnership is found generally have a low value of total capital invested in the JV, thus easing the possibilities for the local partner to match the international partner's contribution. Balanced partnerships are less likely than surrogate subsidiaries to have MNCs as their international parents.

To compensate for reduced income rights from equity and less control, the international partners in this category tended to supply a wider range of noncapital resources on a fee-paying, contractual basis. Those offered without contract were generally confined to management services and training. Strategic and operational control of the JV was shared, though the international partner's influence normally prevailed in technical matters. There was a low incidence of expatriate managers. In this configuration, the quality of partner relations is particularly critical, and tensions between the partners will have more serious consequences than in the dominant share model. The balanced partnerships in which a strong trust-based relationship had developed between the partners and their staff benefited to the full from the partners' complementary strengths and they enjoyed a high level of success. Their success undoubtedly contributed to the further strengthening of the partnership. On the other hand, it was evident that when serious conflict arises within a balanced partnership, it is extremely difficult to resolve.

*The junior partner.* In this third configuration, the international partner holds a minority share of the JV's equity. This does not necessarily mean that the partner lacks any control. In each case studied, the international company retained a degree of influence over strategic matters that was reported to approximate to that of the majority-owning Chinese partner. Provision for unanimity in the JV board over decisions on its business plan and profit distribution undoubtedly worked toward enhancing the minority partner's influence, but other factors were also significant. The fact that in each JV the partner provided the technological basis for both its products and processes was an important source of strategic influence, as well as providing for the dominant say in the technical aspects of operations.

Each of the junior partner JVs had a foreign GM or international partner manager who regularly visited the JV. Another basis for the international partner to retain influence in these circumstances lay in the trust that it had developed with its Chinese partner. This points to the important evolutionary aspect of interpartner relationship building, which can generate a basis for sharing influence through mutual confidence in circumstances where contractual and other legal rights do not provide for formal control. With few expatriate managers allocated to minority-share JVs, however, the time and effort needed to build relations of this quality could impose a very heavy burden on the foreign managers concerned.

Most of the cases with minority equity featured international partners that did not have, or were unwilling to commit, the resources to assume a larger equity share. One of these investors had for many years preferred to benefit from international expansion through licensing its technology rather than through laying out capital. It had extended this philosophy to China. Others also preferred the lower-risk route of securing a significant part of their return from China through technology transfer rather than return on equity. Only in one case did Chinese regulations applying to a strategic industry determine its minority equity position, rather than the international investor's own preference.

Several implications follow from these case studies. One is that they throw light on the different requirements for achieving favorable JV performance in each configuration. Examination of the various configurations of ownership, resource, management, and control that were associated with satisfactory performance suggests that it is the fit between these factors that is particularly significant in this regard. For example, the best performers among the surrogate subsidiary JVs enjoyed considerable managerial and technical support from their international parent companies and very active communications with those parents. At the same time, local managers were encouraged to play an active role in overseeing external activities to which they could contribute with their own particular knowledge, such as marketing and government relations. By contrast, the less well-performing surrogate subsidiaries were characterized by little local management contribution to these external activities. In two cases of relatively low-performing surrogate subsidiaries (one of which has since failed), the internationally branded products brought to China by the UK parent companies were too expensive to appeal to the local market. This was despite strong advice on this point from the local partner. The implication that arises from these contrasts is that, in surrogate subsidiaries, a combination of strong resource support with sensitivity to local conditions (both in terms of products and enlisting active local managerial contributions) will assist the achievement of good performance.

Another important implication to be drawn from the case studies is that it is not possible to identify a single approach to the distribution of control in a JV that will be conducive to good performance, a conclusion also reached by Hébert and Beamish (1997). It depends largely on the particular configuration. In a surrogate subsidiary where one partner has overall control, the trick appears to be to involve the other partner(s) in areas where it has special knowledge or connections. In a balanced partnership, a genuinely shared control and management approach based on a high level of personal communication and trust appears to be a necessary condition for good performance. The shared control may well involve a division of responsibilities between the partners according to their relative strengths. In junior partnerships, where the international partner has minority ownership and control, good performance appears to be associated with continuing involvement by that partner in the alliance's overall management and the provision of necessary technical support. High mutual trust is an important condition for the minority partner to enjoy this level of involvement.

## 11.7 Control and trust

The study of Sino–British JVs just described suggests that the cultivation of an alliance partner's trust can be a complement, even a substitute, for control in a situation where the latter is limited by possessing only a shared or minority equity share. The proposition here is that trust can, in a sense, provide for informal control through the influence it permits when the basis for formal control is lacking.

Faulkner (2000) addresses this proposition when he asks whether trust and control are 'opposing or complementary functions?' He concludes from his in-depth studies of eight international alliances that there is evidence to link trust between the partners to superior alliance performance. It is not possible to discern the directionality of this link, which is in any case likely to be a mutually reinforcing one. The picture for control is less clear, but the evidence suggests that less control is necessary in situations where trust develops well. There is also some evidence to suggest that a partner attempts to exercise greater control over its alliance, and indirectly over the other partner, in situations where trust is low, and perhaps where performance may then be adversely affected due to a combination of low trust and low motivation resulting from low autonomy.

Fryxell et al. (2002) found in a survey of 129 US-based IJVs that 'social controls' and 'affect-based trust' interacted to predict perceptions of superior IJV performance. Social control mechanisms are those designed to permit the evolution and inculcation of norms and values through structured social interaction and training. Examples are team membership, informal social interaction, and face-to-face communication. Social controls are likely to impose restrictions on actual behavior more effectively than do formal controls such as hierarchy, planning, and reporting mechanisms. Affect-based trust is based on personal ties and friendship and involves mutual understanding and a degree of bonding (see Chapter 4). Fryxell et al. suggest that affect-based trust helps social control mechanisms to work. They believe that their findings support Das and Teng's (1998) more general proposition that trust moderates the relationship between control and confidence in partner cooperation. In other words, trust between partners and their respective staffs facilitates the operation and acceptance of control, especially that of an informal nature brought about through close social interaction. This process is likely to enhance alliance performance.

Das and Teng (1998: 500) contextualize their discussion of the relation between control and trust in alliances by reference to the levels of interpartner confidence associated with different types of alliance. Their scheme is reproduced in Table 11.3.

Das and Teng argue that a situation in which there is both high trust and well-developed mechanisms for control in the relation between alliance partners is most likely

**Table 11.3** Confidence levels in different alliance types

| Trust level | Control level: High | Control level: Low |
|---|---|---|
| High | *High* confidence in partner cooperation<br>*Joint ventures* | *Moderate* confidence in partner cooperation<br>*Minority equity alliances* |
| Low | *Moderate* confidence in partner cooperation<br>*Minority equity alliances* | *Low* confidence in partner cooperation<br>*Non equity alliances* |

to exist for JVs because their effective operation requires a high level of mutual confidence and close working. By contrast, nonequity alliances such as licensing agreements and supplier partnerships are more appropriate for a situation in which there is both low trust and limited mechanisms for control. The partners in this situation may have relatively low confidence in each other because their mutual trust is modest and they have limited ability to influence each other's behavior. In between are cases where there are combinations of either high trust and low control, or vice versa. Because these situations only permit moderate confidence in the quality of cooperation, partners are likely to opt either for a majority equity share in order to gain a high degree of control or to limit their risks by choosing a minority equity position. As Chapter 12 discusses, these partner preferences may also depend on circumstances such as the equity share that is permitted by law or the amount of capital that each partner can provide for the JV.

## 11.8 Summary

1. Control is a critical issue for the successful management and performance of cooperative ventures. If partners compete for control and do not arrive at a mutually acceptable solution, this can jeopardize their relationship and inhibit its potential for realizing complementarities and achieving learning. A subtle balance may have to be struck between the need for control and the equal need in an alliance to maintain harmonious and constructive relationships between the partners.
2. Control is a complex multidimensional feature of management, and the complexity is increased when the activity to be managed comes under the purview of two or more separate organizations.
3. This chapter has concentrated on three of these dimensions as they apply to alliances. These are:
   - the extent of control exercised by partners over their alliance
   - the activities and decisions which they control (focus)
   - the mechanisms by which control is exercised.
4. The extent of control available to a partner does not necessarily rest upon its formal rights through ownership and contractual agreements. It may depend quite considerably on informal practices such as a partner company maintaining close personal links with managers and staff working directly in the alliance. The extent of control can also be conditioned by the control mechanisms that are adopted and the activities to which these are applied.
5. Control of a collaboration, which may be based on little or no contractual foundation, will depend very largely upon the relationship between the partners' respective gatekeepers, and the accord they can work out.
6. Control is a subtle phenomenon. In some circumstances it is accepted and regarded as legitimate, in others not. The paradox is that resistance by one partner to the exercise of control by another may diminish the overall control that the former can exercise. Genuine cooperation in a non-zero-sum relationship enables the partners together to exercise

greater control, through the fact that they each have greater influence than is the case if the alliance is beset with conflict and low trust.

7. Although it is a basic tenet of managerial wisdom that adequate and appropriate control is a requirement for satisfactory performance, the evidence on this issue for alliances does not offer clear guidelines on the key issue of whether it is advantageous to share control or to have one leading partner.
8. This chapter has suggested that a partner's control policy should be worked out with a consideration of its goals in forming an alliance and the nature of its dependence on the partner for realizing these.
9. In this respect, it is important for the partners to distinguish between strategic and operational levels of control. Cooperation between firms will usually work best if they each perceive that they have a sufficient voice over the strategic direction it will take. Within an agreed set of long-term goals and priorities, it may then be quite acceptable for one partner to take the lead in controlling certain operational areas in which it clearly enjoys superior expertise, experience, or knowledge.

## 11.9 Questions for discussion

1. Why do alliance partners and managers generally attach so much importance to the question of control?
2. What are the main dimensions of alliance control?
3. Why is it of practical importance for partners to take a view as to what configuration of control is desirable for their alliance?
4. What are the main foundations for control in an alliance?
5. How is the approach to control likely to differ between a JV and a collaboration?
6. Does the distribution of control between alliance partners have any impact on alliance performance?

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# 12 Corporate governance of joint ventures[1]

## 12.1 What this chapter covers

This chapter recognizes that the partners to an alliance are investors in it. Indeed, they are alliance shareholders if it is capitalized through the issuing of equity. Like all investors, they accept certain risks in the expectation of securing favorable returns. They are naturally concerned with how best to govern their alliance in a way that minimizes the risk and maximizes the likelihood of a good return. In this chapter, we address the hitherto neglected subject of how partners, as investors, approach the question of governing their alliance. We concentrate on the important case of IJVs, the governance of which tends to be more challenging than most other forms of alliance. Following a brief introduction, we identify the areas of risk that a company investing in an IJV can face, in regard to financial, resource, and market requirements. These risks are seen to derive from two main sources: the institutional and economic context in which the IJV is located and the special condition of multiple agency that pertains in JVs. We then offer an analytical framework that links the nature and sources of risk to the expected governance preferences of foreign IJV partners. These expectations are expressed in the form of propositions that are offered as a guide to further reflection and investigation. The chapter concludes by placing the subject of alliance corporate governance into the broader context of world economic development, by considering the implications of international partners' governance preferences for the capacity of IJVs to transfer knowledge to emerging economies.

## 12.2 Introduction

One major reason for the attention to alliance control is that it is believed to be of significance for performance. This was discussed in Chapter 11. In this chapter, we turn to another source of concern about alliance control. This stems from the desire of partners to ensure that an alliance is managed in their interests, so as to provide them with an acceptable return at the lowest possible risk. This concern is to do with alliance governance, particularly when the alliance is structured in a corporate form such as the EJV.

[1] This chapter is adapted from John Child and Suzana B. Rodrigues (2004), 'Corporate Governance in International Joint Ventures: Toward a Theory of Partner Preferences', in A. Grandori (ed.), *Corporate Governance and Firm Organization*. Oxford: Oxford University Press, pp. 89–112.

JVs have been relatively neglected in discussions of corporate governance. This chapter suggests key elements in an analysis of JV governance, focusing on partner preferences in the important case of IJVs. The significance of corporate governance for JVs is indicated by the fact that their relatively high failure rate is usually ascribed to a breakdown in relations between their owning partners (Singh and Mitchell 1996). The governance of IJVs formed between partner firms from different countries, is likely to be even more precarious due to cultural differences and to potential dissonance between the governance regulations of the host country location and the governance preferences of one or more partners. A common form of IJV is that established between an international company and a local domestic company in the country where the venture operates. This arrangement is frequently found in emerging economies, and it serves as a potentially important vehicle for the transfer of technology and knowledge that can contribute to the development of such economies (see Chapter 16). Our discussion will concentrate on the IJV governance preferences of the international ('*foreign*') partner. This is partly to provide focus to the analysis, and partly to highlight the implications that such partners' governance preferences have for the ability of IJVs to promote economic development through knowledge transfer to local partners.

The aim of this chapter is to draw attention to key elements of corporate governance in IJVs. Given the nature of IJVs as a subject, it is appropriate to adopt a relatively broad definition of corporate governance as the process of control over and within the firm (i.e. IJV) that aims to reduce risks to its owners and to ensure that its activities bring a stream of acceptable returns to those owners in the long term. This definition draws attention to the behavioral and internal aspects of governance in addition to the purely structural and external aspects that have historically commanded most attention in the governance literature (e.g. Monks and Minow 2001).

The following section identifies the areas of risk that a company investing in an IJV can face, in regard to financial, resource, and market requirements. We then offer an analytical framework that links the nature and sources of risk to the expected governance preferences of foreign IJV partners. These expectations are expressed in the form of propositions that are offered as a guide to further reflection and investigation. The chapter concludes with the implications of foreign partners' governance preferences for the capacity of IJVs to transfer knowledge to emerging economies.

## 12.3 Areas of risk

Three areas of risk for IJV partners concern finance, resource deficiency, and lack of market opportunity. IJV partners can incur a *financial risk* over and above normal commercial uncertainties. The additional financial risk stems largely from the possibility that their investment could be eroded by specific administrative factors in the host country that reduce the level of return on the investment or the ease of repatriating it, and even threatens their ownership rights. These risks are liable to be greater in emerging economies because of their institutional limitations. These include less adequate legal regulations and provisions for the protection of intellectual property, as well as greater political risk (Peng 2000). Moreover, the risks attaching to the asset specificity of investment may be increased by the absence of well-developed secondary markets for the disposal of assets in the event of IJV termination. Additional financial risk can also result from governmental actions such as devaluation and changes in interest rates. For example, the uncertainty created by such actions discouraged foreign investment into Brazil before the stabilization reforms of the 1990s (Barros 1993). Fraudulent or other opportunistic behavior on the part of other IJV partners can pose a further financial risk.

A *resource-deficiency risk* arises if the resources available to an IJV are inadequate for it to operate as a viable business, including the inability to make best use of some resources due to skill or motivational deficiencies. Again, this risk is more likely to arise for an IJV based in an emerging economy than in a developed country (Rodrigues and Child 2001). In an emerging economy, resources may be in short supply and the relevant markets imperfect; it is also more likely that local partners lack important capabilities and resources.

Thirdly, *market-opportunity risk* concerns the possibility that firms may enter new markets with an inaccurate appraisal of the opportunities these offer for achieving an acceptable return on the investment incurred. This is a particular risk for companies lacking international experience, which may underestimate the strength of local competition or the advantages already enjoyed by first-mover entrants (Lieberman and Montgomery 1988). Local partners may fail to deliver the market access they promised, perhaps because their distribution networks are too local or ineffective. This has been a common complaint of foreign-investing firms in China (EIU 1999).

## 12.4 Sources of risk

There are two main sources of financial, resource, and market risk facing a foreign IJV partner. One is the local institutional and economic context in which the IJV is located. The risks arising from this context may therefore be called *contextual risks*. The other source of risk derives from the special condition of multiple agency that characterizes JVs, in which the local partner(s) also acts as an agent for the foreign partner (and vice versa). The risks arising from this source may be called *agency risks*. Following Dunning (1998), the first set of risks involve relationships between the venture and the local environment and are linked to 'locational' features, while agency risks stem from relationships intrinsic to the IJV itself. Moreover, we shall note how contextual conditions can moderate the level of agency risk. Table 12.1 summarizes the forms of financial, resource, and market risk that can derive from contextual and agency sources.

### 12.4.1 Contextual risks

The impact of the *institutional context* on partner risks becomes particularly apparent in the international context where many IJVs are formed between MNCs and local firms.

**Table 12.1** Risks facing (foreign) IJV partners

| | Area of risk | | |
|---|---|---|---|
| Source of risk | Financial | Resource | Market |
| **Context** Institutional | • limits to majority control<br>• minority owner protection<br>• poor contract enforcement<br>• poor accounting standards<br>• inadequate protection of intellectual property | • underdeveloped intermediate institutions (business support services) | • restrictions on business, land use and other licences<br>• informal local protectionism |
| Economic | • inadequate working capital and liquidity | • lack of capital<br>• inadequate managerial and technical expertise | • low rate of growth and GNP per capita<br>• instability of economy |
| **Agency** Partner(s) as agent | • partner engages in fraudulent or other opportunistic behavior<br>• exploitation of minority interests | • deficiencies in partner's capabilities and resources<br>• loyalty of managers and staff from partner is limited | • partner cannot or will not deliver access to domestic market |

Here the effectiveness of the host location's legal system and the attitude of regulatory authorities are crucial.

For instance, the level of protection afforded to corporate investors has been found to vary significantly between countries (La Porta et al. 1998). Protection can be assessed in terms of various measures including legal recourse for the nonfulfilment of contracts, mechanisms to safeguard minority shareholders, risk of expropriation of assets, and accounting standards. Insofar as many IJVs are vehicles for technology transfer, the extent to which intellectual property is effectively protected from the risk of leakage is another major concern to 'foreign' investors.

Local regulations, as well as norms of custom and practice, will define the formal corporate governance options that are available to IJV partners. These institutional features are likely to be 'cultural' in the sense of being historically embedded, and thus to display a high degree of path dependence (North 1990). At the same time, as Porter's (1990) analysis suggests, institutional and legal development is itself a function of the level of economic development and progress towards modernization. National institutions are expected to moderate both the possibilities of choice among corporate governance structures for firms located there, and the corporate governance preferences of local owners and other local stakeholders. Thus the possible choices of governance in strategic alliances are shaped by institutional factors through the mediation of national regulations and formats for corporate governance. An example is the shift towards a policy of economic liberalization in Brazil during the 1990s, which was reflected in changes in rules governing business ownership, including privatization. This in turn encouraged the formation of majority foreign-owned IJVs as well as outright acquisitions.

Some countries continue to impose legal restrictions on the share of IJV equity that can be taken up by foreign partners (at least in certain sectors), and hence limit the ability of those partners to protect their investment and resource provision through normal governance mechanisms such as holding a majority on the JV's board of directors. This remains the case in China, which is now the world's largest recipient of foreign direct investment much of it leading to the formation of IJVs. China also provides an example of how an immature legal system and unpredictable behavior on the part of government agencies have created additional risks for foreign investors in IJVs (Child and Tse 2001). Even though World Trade Organization (WTO) membership now places limits on institutional restrictions in China, they will remain in force for some time to come in strategic sectors of the economy (Nolan 2001).

Some of the institutional restrictions found in situations like China are applied informally, such as when local government agencies refuse business licences to foreign-funded ventures in order to protect local firms from competition, or when product piracy and leakage of technology on the part of local IJV partners are condoned as 'patriotic acts'. Informal institutional behavior of this kind can clearly present risks both to the achievement of market opportunities and in terms of agency costs. It impacts agency risk, in that opportunism on the part of a local partner and/or local managers might be encouraged by a legal regime that fails to support redress or an administrative regime that protects such behavior on the part of local actors. In this way, the institutional regime can lend different degrees of support for trust between local and foreign partners (Child and Möllering 2003).

The extent to which intermediate institutions have developed impacts the risk of deficiency in the resources required to operate an IJV successfully. Such institutions supply necessary business support services. If, for example, banking, legal, market research, technical consulting, and basic utility services are not readily available or are unreliable, these conditions will either hamper the efficiency of the IJV directly or incur additional costs of supplying these resources from outside the country or region.

In these ways, the institutional context in which an IJV operates has a direct bearing on the level of risk incurred by an IJV partner, especially the 'foreign' investor from outside the host country, in respect of finance, resource deficiency, and market opportunity.

The *economic context* in which IJVs are located also impacts the level of risk in each of these three areas. A shortage of working capital and liquid funds within the economy can add to the financial risk that an IJV faces. Similarly, if the instability of the local economy places an IJV's local partner under financial stress, this is likely to encourage opportunistic behavior on its part. For example, the high level of inflation that characterized the Brazilian economy in the 1980s encouraged companies there to engage in opportunistic behavior which exploited profits from price rises rather than from efficient production. Major shifts in government policy in respect of exchange rates, taxation, interest rates or governance regimes both increase the level of risk and encourage defensive behavior of an opportunistic kind. A relatively low level of economic development, combined possibly with a lack of experience in JV partnering, is also likely to limit the capabilities of a local partner to act as an effective agent for the other partner to achieve the objectives it seeks from the IJV.

The major risk impacts of the economic context are, however, likely to fall in the areas of resource deficiency and market opportunity. While many IJVs have been formed to provide MNCs with access to cheap labor, as in Central and Eastern Europe and parts of South-East Asia, a lack of other local resources such as working capital, managerial and technical expertise, and business support services, can pose a threat to an IJV's viability. At the same time, resource deficiency in the local context can provide an opportunity for foreign partners to dominate IJV governance through funding a larger share of equity and providing other assets. Such dominance may also be regarded as essential to overcome inadequacies of experience and even trustworthiness among the local partner's managers. In line with the 'resource dependency' analysis of external organizational control (Pfeffer and Salanzik 1978), the more dependent an IJV is on the resources provided by one of its partners, the greater the power one would expect that partner to have in its governance.

Another significant aspect of the economic context lies in the market opportunities that it offers. Its combination of high growth rates and a huge population is the prime reason why China has attracted so much foreign direct investment despite the other contextual difficulties that have operated there in the past. Market risk in China has arisen mainly as a result of institutional constraints, such as difficulties of securing licences for distribution, rather than from insufficient or volatile market demand. By contrast in other countries such as Argentina, uncertainties regarding the stability of the market per se have presented the greater risk. The instances mentioned of how institutional intervention over licences or access to local sources of capital can impact on economic conditions serve to remind us that in practice, economic and institutional contexts interact.

### 12.4.2 Agency risks: multiple agency

Agency theory is concerned with the ability of 'principals' to ensure that their 'agents' are fulfilling their objectives. Within the Anglo-Saxon tradition of corporate governance, equity owners are regarded as the principals. Their vulnerability stems from their position as residual claimants in the sense their returns depend upon all other contractual claims that have to be satisfied first (Shleifer and Vishny 1997). This means that self-serving or ineffective agents could respectively appropriate or dissipate such returns. Agency theory assumes that agents cannot necessarily be trusted, and that this creates a serious risk for principals when there is an asymmetry of information in favor of their agents. It is therefore concerned with the governance mechanisms that limit agents' self-serving behavior (Berle and Means 1932; Jensen and Meckling 1976; Eisenhardt 1989).

The agency issue can also involve relations between shareholders themselves. Ideally, dominant shareholders will have regard for the interests of the minority, and managers will look after the interests of both. Evidence provided by some authors, such as La Porta et al. (1998) and Claessens et al. (1999) suggests, however, that wherever there is a dominant shareholder there is a tendency for minority shareholders to be sidelined. Lazonick and O'Sullivan (1996, 2000) also suggest that institutional investors will emphasize short term returns, at the expense of those investors who seek to develop the intrinsic worth of their companies through, for example, investing in innovation.

Multiple agency refers to a situation in which there is more than one party in agency relationships, either as principals, agents or both. The formation of EJVs is an important instance of multiple agency. This form of strategic alliance involves a pooling of ownership assets and usually a degree of joint management between partner firms.

The multiplicity of agency relationships in EJVs arises from three of their salient characteristics. First, there are only a few owners, often only two. They have to be regarded as multiple principals because each has its own rationale for entering into the alliance and each is sufficiently salient to require its interests to be respected. Thus if one partner decides to withdraw, the alliance normally breaks down. Second, because the owner-partners usually contribute complementary tangible and intangible assets to the JV (Geringer 1991), they also in effect become agents for each other in ensuring its viability. In other words, a JV cannot survive without the contributions of each partner, which places one partner in the role of acting as an agent for the fulfilment of the objectives that the other(s) invests in the venture. Third, the managers of the JV act as agents for its owners. Their agency role is often complicated by the presence of multiple owners, when each places its own expectations upon venture managers. Further problems can arise if the JV is managed by a mix of personnel who are supplied or appointed by the different partners, especially if they come from different national cultures and traditions of management practice (Shenkar and Zeira 1992).

The property rights over a JV, including rights of ultimate control, legally belong to the partners who contribute key assets to it on a contractual basis, especially in the form of equity (Hansman 1996). In practice, IJVs also depend on the provision of other assets that are provided by the partners outside of equity and often on a noncontractual basis; less tangible assets such as expertise, operating systems, and training. Noncontractual assets of this kind are essentially knowledge assets (Boisot 1998), and it is more difficult to safeguard property rights over them. Foreign IJV partners are in fact often concerned to protect the knowledge assets they provide to an IJV from leakage or misapplication. They can do so by allocating their own personnel to take charge of the assets and control their use, and the presence in an IJV of such staff may in any case be necessary for the assets to be used effectively. For reasons such as these, the provision of noncontractual knowledge assets by a partner has been found to predict its level of control in IJVs, especially over operational decisions (Child and Yan 1999).

In IJVs between international companies and partners from emerging countries, it is normally the former who are in a position to provide advanced knowledge assets. While it is consistent with corporate governance principles for control to go to those who provide assets, of whatever kind, if a foreign partner chooses to exercise tight and restrictive control over the knowledge assets it provides to an IJV, the effectiveness of the venture as a vehicle for knowledge transfer is likely to be compromised.

The strong potential for conflict between JV partners is a complicating factor. Even when the partners have completely compatible objectives, issues of fairness often arise with respect to the relative contributions to and benefits from the JV on the part of each partner. These problems are exacerbated if one partner is able to tip this cost–benefit balance in its favor through, for example, acquiring an advantage over the other partner in technology and other knowledge through superior learning (Hamel 1991). Uncertainty about how an alliance will evolve in terms of satisfying partner interests is likely to be high for the 'foreign' partner in an IJV if it lacks knowledge and experience of the host location, and of the local partner's capabilities and power to exercise leverage within that location. It may also fear the leakage of key knowledge assets through the IJV. Both partners may be uncertain about the long-term intentions of the other towards their partnership.

Agency risk is therefore a broad category referring to a range of possible moral, legal, and managerial failures in an IJV relationship that can give rise to non-delivery, even default, on agreements or expectations. It arises if other partner(s) or IJV managers are either not competent or are not willing to meet a partner's formal and informal expectations. Competency limitations are more likely to arise when the host location of an IJV is an emerging economy. Opportunistic behavior by another partner is always a danger in JVs, including attempts to expropriate key resources from the first partner purposely, to overtake it or to drive it from the market (Doz and Hamel 1998). In emerging economies, institutional authorities sometimes condone opportunistic behavior by local IJV partners and managers (in their role as agents for the 'foreign' investor), which is justified on the grounds of catching up with an economically privileged partner. MNCs can themselves demonstrate opportunistic behavior towards local companies, using various devices to enhance their power such as placing key departments under their own managers even when they only have a minority holding. In order to prevent opportunistic behavior by either party, some countries like Brazil have devised shareholders' agreement instruments that define the special powers of the partners.

IJV owners have to face additional types of agency risks. A partner with a minority holding can be more vulnerable wherever the governance system favors concentration without appropriate protection of minority investors. If the proportion of equity held by an owner is large enough to ensure control of the company, there is incentive for that owner to reduce the return to the minority partners (La Porta et al. 1998; Valadares and Leal 2000). A further common problem of agency in IJVs concerns the loyalty of its managers. IJVs involve partners of different nationality and cultural identity. Even when a foreign owner nominates them, local managers can feel their loyalty divided between demands of this principal, on the one side, and the local partner and community, on the other.

The degree of agency dependence between partners can be asymmetric if one of them possesses superior resources and capabilities. MNCs typically possess superior technological and managerial capabilities that provide them with sufficient influence to exercise considerable control, especially in the early years of IJVs with local firms (Child and Yan 2003). MNCs can also benefit from an accumulation of political capital if they are early entrants or are willing to locate in priority areas designated by host governments (Frynas et al. 2003). Nevertheless, in contexts where government involvement in the conditions for doing business (such as the granting of land, the right to access working capital, and trading licences) remains high, a local JV partner may retain considerable influence if it enjoys substantial political capital in that context (Boddewyn and Brewer 1994; Peng 2000).

## 12.5 Risks and partner control preferences

A range of risks therefore attach to a partner's investment in an IJV. These risks are likely to cause that partner to seek control over those IJV activities and decisions where the risks are concentrated or, if that is not possible, to minimize its exposure. In practice, a number of accommodations are possible. For example, a weaker partner has the possibility over time of progressively securing greater control through learning faster than the other partner(s) (Makhija and Ganesh 1997). In some cases, a partner may be content with the share of return to which it is legally entitled, and to leave the initiative in running the JV to the other partner because of its superior capabilities. Nevertheless, despite these possibilities, it is reasonable to assume that, in the main, partners will be concerned to reduce their risk through appropriate IJV governance arrangements. This section identifies the forms of IJV control that are likely to be favored to deal with contextual and agency sources of risk. The following section then offers an analytical framework for IJV governance preferences and supports this with propositions to guide future research.

The focus of most discussion about corporate governance has been on what the OECD (1999) has characterized as the 'outsider' system of governance. Here, owners have to rely on external levers and mechanisms, such as boards of directors, in order to ensure that their agents will act in accord with their interests. Organization theorists have referred to this as 'strategic control', which is concerned with 'the means and methods on which the whole conduct of an organization depends' (Child 1984: 137). The key assumption in the governance literature, that owners or their supervisory agents have the capacity to make sure that companies are conducted to serve their interests, is however premised on the assumption that such control extends to the use of resources and the conduct of operations. This means ensuring a level of operational effectiveness that will provide a good return to shareholders and a way of conducting operations that will not jeopardize proprietary rights over technologies, brands or other assets. Operational control is therefore also vital to protect owners from risks, and has to be included within the scope of corporate governance. For 'control loss' within organizations means that corporate intentions may not be realized (Williamson 1970). These considerations call for attention to 'insider' controls that complement and support 'outsider' governance.

This broader perspective can be used to indicate the IJV governance and control mechanisms available to a partner for the purpose of limiting the risks it faces. Some elements of financial risk can be reduced by taking a majority share of IJV equity so as to control the use of surplus funds and other strategic decisions through having a majority of IJV board members. The active presence of a partner's own managers within the IJV may also help to reduce those financial risks arising from misadministration of accounts, and this is the prime reason why many foreign partners insist on appointing the chief financial officers of their IJVs (Child 2000). Even in circumstances where an IJV partner can only secure a minority equity share, recommendations have been made on ways in which influence over financial and other strategic decisions might be secured through other means such as the appointment of able people to the IJV board and informed preparation before board meetings (Schaan 1988). Time spent by a partner's senior executives in the IJV's host country may further reduce financial risk, if this leads to closer informal relations with officials in the host country, which in turn reduce the uncertainties attending their application of regulations to the IJV.

The reduction of resource-deficiency risk through the provision of compensatory resources of a physical, informational, and human kind to an IJV also carries control implications. Consistent with the resource dependency perspective, it has been found that an important source of influence over IJVs can arise from the authority and goodwill attaching to the partner who provides such key resources (Child and Yan 1999). While it is unlikely that resource provision will be made primarily with the enhancement of IJV control in mind, this is a useful by-product. Similarly, market opportunity risk can be mitigated by a partner taking control over key IJV appointments concerned with developing market research, distribution, product promotion, and other activities essential for securing market penetration. Market opportunity risk often arises when a local IJV partner lacks relevant market knowledge or marketing skills even in its 'home' market, possibly because its distribution has been effected only through middlemen and/or has been purely local in scope.

Agency risk, as we have noted, takes on a multiple nature in IJVs. It extends both to the possible failure of other partners to deliver on their commitments to an IJV and to the risk that its managers may be self-serving or serving primarily of other partners' interests. The primary 'external' control that a partner can exercise over agency risk is that applying to all companies, namely having sufficient equity for an effective voice in the board of directors. Also through the IJV's board, the partner can endeavor to control the appointment, and removal if necessary, of its key managers. These managers in turn are then in a position to exercise control down through the organization through personal involvement and supervision. Thus the monitoring of middle managers and employees is a further governance-support mechanism open to an IJV partner who has a sufficient equity stake and supplies key members of the IJV's management. This can be complemented by the training of local managers and employees with the aim not only of enhancing their competencies (thus reducing resource-deficiency risk) but also socializing them to the culture and objectives of the IJV partner. Many MNCs use training in this way as a support for their governance of foreign affiliates, including IJVs (Rudman 2003). If the other partner(s) fails to provide the access to markets that was expected of it, the foreign partner can adopt the generally more expensive option of developing its own marketing and distribution systems and appointing sales agents for the IJV. This move places marketing under its own control.

These postulated methods of reducing different categories of IJV risk are depicted in Table 12.2. The overall argument that IJV governance can in these ways be enhanced by measures to strengthen 'internal' control, gains supports from investigations among Sino–foreign IJVs. These indicated that a foreign partner's share of IJV equity was particularly significant for securing strategic control, and hence reducing financial risk, whereas the provision of noncontracted resources, systems, and personnel to the IJV was significant for the enhancement of operational control (Child and Yan 1999).

**Table 12.2** Forms of IJV control aimed at reducing different categories of risk

| | Control via equity share and IJV board majority | Control via key appointments and direct involvement of partner's personnel in the IJV | Control via nonequity resource provision (e.g. systems, training) | Control via managerial monitoring |
|---|---|---|---|---|
| *Contextual risks* | | | | |
| Financial | ✓ | ✓ | ✓ | — |
| Resource | — | — | ✓ | — |
| Market | — | ✓ | ✓ | — |
| *Agency risks* | | | | |
| Financial, resource, market | ✓ | ✓ | ✓ | ✓ |

## 12.6 Risks and partner preferences for IJV governance modes

### 12.6.1 Analytical framework

A review of risks, their sources and partner preferences for IJV governance modes suggests the analytical framework depicted in Figure 12.1. For purposes of simplicity, the framework focuses on IJV governance from the standpoint of a 'foreign' partner, typically an international company, rather than the host country IJV partner(s). It also takes account of the fact that the options available for IJV governance will be constrained by institutional provisions in the host country, including regulations about permissible governance formats.

The left-hand side of Figure 12.1 depicts the sources of risk potentially facing a foreign IJV partner. Contextual risks arise because a country's institutional and economic context establishes certain conditions that generate the level of uncertainty prevailing in an IJV's host environment. Institutional factors impact on the risks faced by foreign IJV partners primarily through the legal system, the attitude of regulatory authorities, and the adequacy of intermediate business support institutions. Macro economic factors bear upon the risks faced by IJV partners in areas such as market opportunity, resource availability and the financial pressures that influence the behavior of local partners. Agency risks arise from the nature of the local IJV partner(s). They comprise the multiple agency risks arising from the dependence of an IJV partner on the other's competence and goodwill. Although the relationship between partners is a micro-level feature, the available choice of local partners in the first place, and their capabilities, reflect the host country macro context, notably the scale and level of development of its economy.

The level of risk in different areas (financial, resource, and market) is expected to impact on partners' policies toward investment in the equity capital and noncapital inputs, and the control deriving from these, as well as policies on structuring control through board membership and key appointments (see section 12.5). The corporate governance provisions established for IJVs, especially equity share, are seen to reflect an assessment of risks and opportunities in the host environment (Pan 1997), though the degree of choice may be limited by host government policy and regulations. Such regulations and approved formats become templates for governance at the firm (IJV) level. This limitation is indicated by the dotted line through 'regulations and formats for corporate governance' to 'IJV partner's corporate governance preferences' in Figure 12.1.

The formal ownership structure of an IJV, in terms of partner equity share and appointment of directors, is seen to impact directly upon the strategic control each IJV partner actually exercises, in line with the legal rights of corporate governance. We have noted, however, that there are other control levers available to owners or managers additional to the equity rights stressed in legal theory and in most discussions of corporate governance. Thus the provision by an IJV partner of noncapital, and even noncontractual, support may well enhance its operational control. The availability of competent managers who can be trusted by one or more IJV partners may also facilitate the delegation of operational control and even of some influence over IJV strategy. The interplay between these levers is likely to give rise to a range of control solutions at the micro level.

The framework presented in Figure 12.1 is not intended to be either static or to imply contextual determinism. Thus, over time IJV partners may be able to take collective action to develop and shape institutional policies in the host country. Also a policy of technology and knowledge transfer can enhance the level of managerial competencies available in the local environment and so reduce one of the economic foundations for resource-deficiency risk.

## 12.6.2 Propositions on IJV partner governance preferences

The strands of the argument we have advanced are brought together in a set of ten propositions intended to provide guidelines for further investigation. The propositions refer to the main sources of risk that have been identified and postulate their implications for the preferences likely to be held by *foreign* partners for IJV governance modes. The sources of risk are categorized into context and agency related. The rationale for each proposition draws upon previous discussion in this chapter, and is therefore summarized only. Propositions are identified by a capital 'P' and the summary rationales by a capital 'R'.

### 12.6.2.1 Contextual sources of risk

INSTITUTIONAL

*P1. The lower the level of legal protection for contract fulfillment, the lower will be the level of capital and other contractual investment in an IJV by a foreign partner, and hence the greater the probability of that partner being in a minority equity position.*

R1. Lack of adequate legal protection raises financial risk, thus discouraging significant commitment of capital, technology or other contracted resources. This reduction of financial risk is traded against weaker governance rights, and this may therefore limit the foreign partner's capacity to deal with agency risk.

*P2. The lower the protection for minority equity holders, the more importance will a foreign IJV partner attach to holding a majority share of IJV equity.*

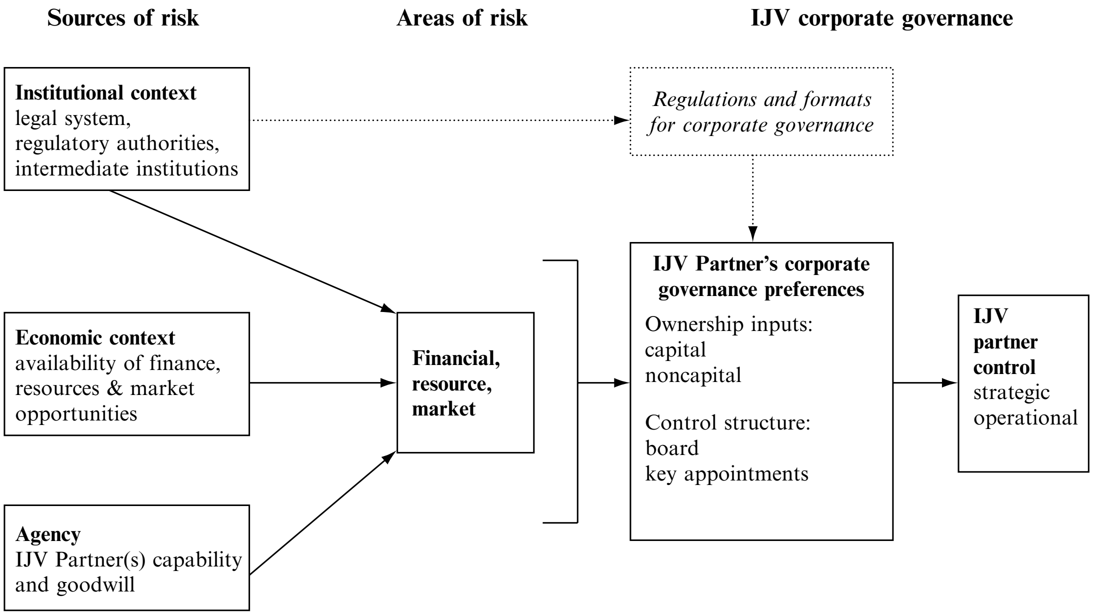


**Figure 12.1** Analytical framework for corporate governance in IJVs.

R2. This proposition may counteract P1. If it is decided to form an IJV in a context that offers low protection for minority shareholdings, a foreign partner is likely to favor offsetting this risk by securing majority control.

*P3. In situations where regulatory restrictions prevent foreign majority equity holding, the lower the level of legal protection for minority IJV shareholders the more importance that the foreign partner will attach to using non-equity forms of control.*

R3. Faced with risks to equity and restrictions on IJV governance through conventional external mechanisms, a foreign IJV partner can only resort to the nonequity based approaches to governance noted in Table 12.2 (making key appointments and direct involvement of its personnel, non-equity resource provision, and managerial monitoring). It will thereby attempt to retain some control over at least the implementation of IJV strategy through building up its operational control by these means.

*P4. The lower the protection for intellectual property, the more importance will a foreign IJV partner attach to securing a majority share of IJV equity and to involving its own personnel in the management of the IJV.*

R4. The significance of intellectual property varies between sectors, and even firms. Assuming, however, that proprietary rights over hard technology (such as products and processes) and/or soft technology (such as brand names and software systems) are an important issue for the foreign IJV partner, then if the host context offers inadequate protection for those rights, the partner will be motivated to secure direct strategic control over the IJV's technology policy via a majority on the IJV board, and to appoint its own managers and experts to monitor the operational use of the technology.

*P5. The less developed are intermediate institutions that provide support for business in the host country, the more will a foreign IJV partner be obliged to supply this support itself, thus enhancing its operational control in the areas of IJV activity concerned.*

R5. Intermediate institutions supply business support services such as market research, education and training, consultancy, and technical advice. If the foreign partner is obliged to supply these directly, or from abroad, rather than securing them from within the host country, it will assume the initiative in the activities concerned through non-equity resource provision. This should enhance its governance over the IJV in terms of operational control.

ECONOMIC

*P6. The more limited the availability of investment capital in the host country, the more likely is the foreign IJV partner to become a majority equity shareholder in order to provide adequate capitalization for the venture.*

R6. This proposition suggests that limited external resource availability can have direct consequences for IJV governance arrangements. When opportunities exist for rapid growth, as in China, the inability of local partners to finance their share of capital expansion has often provided an opportunity for foreign partners to increase their equity shares and thus to take strategic control.

*P7. The more limited the availability of managerial resources in the host country, the more likely is the foreign IJV partner to supply people to key appointments, offer nonequity resources such as management systems, and hence to gain operational control of the venture.*

R7. Similar to R5, this proposition suggests that when the economic context presents a resource-deficiency risk in terms of capable management for the IJV, the foreign partner is likely to compensate in a way that also strengthens its operational control.

*P8. The greater the market opportunities open to the IJV, the greater will be the foreign partner's preferred level of involvement in IJV governance.*

R8. Good market opportunities are a major driver encouraging substantial foreign investment. They increase the attraction of taking up a large share of IJV equity in order to secure the right to a corresponding share of the expected favorable returns on investment. This larger stake will in turn enhance the foreign partner's formal rights to govern the IJV through a majority on its board and thus to assume strategic control.

#### 12.6.2.2 Agency risk

*P9. The lower the local partner's managerial and technical capabilities, the greater will be the foreign partner's preferred level of involvement in IJV governance.*

R9. This proposition is consistent with the reasoning behind P5 and P7. The more that the local IJV partner lacks managerial and technical capabilities necessary for the success of the venture, the less reliable it is to serve as an agent for the foreign partner to attain its objectives through the partnership. The foreign partner will be encouraged to reduce this agency risk through taking on wider responsibilities and assuming greater operational control of the IJV.

*P10. The higher the opportunism displayed by the local partner, and the lower the trust invested in it, the greater will be the foreign partner's preferred level of involvement in IJV governance.*

R10. In circumstances of suspected opportunism by the local partner, and low trust in its goodwill, it is rational for the foreign partner to respond in several ways, all of which enhance its control of IJV governance both strategically and operationally. For example, it may decide to protect its interests through insisting on a larger equity share, on the right to determine key IJV appointments, and on mutually signed contractual safeguards. It may also decide to invest additional person-hours in social contact with the local partner's personnel, in training and development, in the formulation of IJV normative and control systems, and in other activities intended to promote trustworthiness (Child and Möllering 2003). This additional involvement in the internal affairs of the IJV amounts to a centralization of control by the foreign partner with the aim of enhancing its overall influence in the governance process.

## 12.7 A typology of IJV partner governance preferences

The above propositions suggest that different types of IJV governance preference are likely to arise from the partners' perceptions of different levels of contextual and agency risk. Table 12.3 identifies four broad categories of IJV governance preference, again with reference to *foreign* partners: (*a*) concentrated personal governance; (*b*) concentrated specialized governance; (*c*) delegated managerial governance, and (*d*) delegated financial

**Table 12.3** A typology of IJV partner governance preferences associated with level and source of risk

| | | **Contextual risks** | |
|---|---|---|---|
| | | High | Low |
| **Agency risks** | High | Concentrated personal governance | Concentrated specialized governance |
| | Low | Delegated managerial governance | Delegated financial governance |

governance. These four types are located with reference to the interaction between contextual and agency risk.

Preference for a *concentrated personal* form of governance is likely if the institutional and economic contexts present high risk and there is a high level of agency risk from the local partner(s) as well. The expectation in this case is for a foreign IJV partner to favor concentrated personal control based on a majority equity position and accompanied by a strong presence of its own appointed staff within the IJV. This would mean that the foreign partner tends to control both strategic and operational decisions. The concentrated personal type of IJV governance is common in Sino–western JVs, where foreign partners view both contextual and agency risks as high (Vanhonacker 1997; Child and Yan 1999).

A *concentrated specialized* form of IJV governance is likely to be preferred when the institutional and economic contexts provide sufficient protection and opportunity for the foreign investor, but when at the same time the local partner(s) are perceived to generate high agency risk through lack of capability or suspected opportunism. In other words, the local partner cannot be relied upon in respect of its capabilities to manage certain activities and/or its trustworthiness not to behave opportunistically in regard to such activities. For this reason, the foreign partner is likely to retain close control over what it considers to be key IJV activities from the point of view of its interests, allowing discretion to the local partner in other areas. The result is that the IJV partners specialize their areas of control. The control the foreign partner endeavors to reserve to itself is intended, for example, to maintain its ability to prevent technology leakage, to maintain quality standards, and to protect the integrity of its international brands. This effectively confines knowledge transfer in such areas within limits that are specified by contracts and by the partner's managerial discretion. In these cases the local partner may maintain control over areas where the foreign partner has little experience or proprietary interest, such as liaising with government officials and managing the workforce.

Preference for a *delegated managerial* form of governance increases when there is relatively high contextual risk, but where the IJV partners' strategic intentions are complementary, the local partner can offer good managerial competencies, and the quality of relations between them is good. The high level of contextual risk means that the foreign partner may prefer to limit the size of its investment in the IJV and hence its share of equity. This may reduce its influence over the IJV's strategy. Moreover, the foreign partner can have some confidence in leaving the management of many IJV activities to its local partner, including those that concern dealing with contextual risk. The local partner may even supply the general manager of the IJV, though this is less likely when the foreign partner possesses superior managerial expertise and technologies. Examples of this form of IJV governance have been found in China when the foreign partner has only 50 percent of IJV ownership, where governance rights are balanced and both partners agree on the choice of the chief executive officer to ensure unified control (Child 2002*a*). It is distinguished from the concentrated personal type in that the influence of the foreign partner is mostly maintained through the IJV board and the general manager, who may be the only foreigner in the venture. This form of IJV control requires sufficient willingness on the part of local managers to accept the priorities of the foreign partner as a necessary condition for its willingness to delegate discretion to them.

Foreign IJV partners may also be obliged to accept delegated managerial control in situations where national regulations do not allow a foreign majority equity share in certain sectors. It can also be favored in countries such as Brazil where institutional rules allow the local partner to enjoy influence disproportionate to its equity share through granting specific control rights to holders of preferential shares (Leal et al. 2001).

*Delegated financial* governance by the foreign partner focuses on the monitoring of financial returns from its IJV investment. It is likely to be preferred when contextual and agency risks are both low. The institutional environment may present low risk because of effective regulations and ease of repatriating funds; the economy may offer adequate resources (including managerial skills); and the quality and trustworthiness of local partners may not pose significant agency problems. This mode of governance may also be preferred by a foreign partner when the IJV is not highly integrated to its core activities or strategically very significant, when opportunities for growth in the local market are limited, or when it is engaging primarily in the IJV as a financial or speculative investment. In general, this kind of investor is concerned with the maximization of shareholder value, and does not necessarily have a long-term interest in the venture. This can result in unfocused and sporadic governance because the foreign partner can withdraw from the business if it becomes financially advantageous to do so. From the local investor's point of view, the foreign investor fulfills the role of fund raising rather than a supplier of technology or source of learning.

The prime distinction between the concentrated and delegated forms of IJV governance preference lies in the degree of control that the foreign partner seeks to maintain. If the contextual risk is greater than the internal agency risk, the foreign partner is expected to prefer forms of control that are focused on strategic issues and resources. It may not consider significant personal control through the direct involvement of its managers and staff to be necessary. If the contextual risks are less than the internal risks, preference will be for monitoring activities closely and personally, even extending control to routine operations. If risk is high both externally and internally, a concentration of authority will be preferred, involving extensive forms of strategic and operational control, and the personal intervention of foreign managers. When both external and internal risks are low, then it is expected that foreign partner preferences will be for forms of control that are occasional and focused on written reporting rather than close personal contact.

A preliminary comparison of IJV governance in Brazil and China suggests that this typology has sufficient utility to warrant its exploration in further research (Rodrigues and Child 2001). Contextual and agency risks are generally higher in China than in Brazil. It was found that in China, most foreign partners tended to exercise concentrated personal governance with an active involvement in operational decision-making. Brazil, by contrast, appears to be in transition primarily from a concentrated specialized model towards greater delegated financial governance in which local managers are accorded more responsibilities in the venture. The more effective institutional context for corporate governance in Brazil, and the greater sophistication of managerial competencies in that country, would appear to provide some explanation for the contrasts between the two countries in line with the argument we have presented.

The typology also suggests that different modes of IJVs governance can suit different types of foreign investor, subject always to prevailing environmental conditions. For instance, if the foreign investor adopts a long-term horizon and intends to expand to markets where the economic and institutional environment provides low risk, it may prefer to move beyond an initial phase of concentrated specialized governance towards delegated financial governance. In other words, the IJV would develop into a semiautonomous subsidiary managed locally and monitored by its economic results. However, it can be problematic to apply this mode to those emerging economies that are characterized by instability and limited managerial competencies. If, on the other hand, the foreign investor's interest lies in the generation of rapid and high returns, the favored initial approach might be one of delegated financial governance that permits easy withdrawal if either the external or internal environment becomes unfavorable. The delegated financial mode requires an environment that is less prone to contextual risk than is the case in many contemporary developing economies.

Given the impact that environmental contexts are likely to have on the exercise of foreign partner preferences for IJV governance, it is not surprising that international bodies such as the IMF and the WTO are exerting pressures for the creation of favorable regulatory environments for foreign direct investment, or that the OECD is urging the worldwide adoption of the shareholder value principle. Both these policies would create a more propitious, less risky terrain for the free flow of financial capital. If they are implemented, IJVs are likely to become even more important vehicles for the internationalization of financial shareholdings.

## 12.8 IJV governance preferences and economic development

This chapter has indicated that, for an understanding of IJV governance, it is not sufficient merely to take into account the property rights attached to formal equity ownership. The possession by an IJV partner of key nonequity and noncontractual assets, especially knowledge assets, can also provide a significant level of de facto control, especially over operational matters. In the case of IJVs formed between internationally experienced companies and local partners in emerging economies, the former are likely to supply most of the IJVs' necessary knowledge assets. Indeed, in such economies, partnership with MNCs and other companies from developed countries has been regarded as a significant channel for the inward transfer of knowledge and technology to aid economic development. One of the particular benefits attributed to IJVs is the facilitation of tacit knowledge transfer through the interaction of staff appointed or seconded by their partners (Büchel et al. 1998; Inkpen 2000).

A number of factors can, however, militate against this policy objective because they lead foreign IJV partners to retain a level of control that inhibits knowledge transfer. First, investing companies from developed countries generally perceive that they face high contextual and agency risks when forming IJVs in emerging economies. Emerging economies tend to have high scores in country risk tables. Their legal and other institutional systems are typically immature and foreign investing companies are therefore exposed to problems such as corruption, counterfeiting, and a variable application of laws and regulations. Many emerging countries are prone to economic variability as well, which adds to risk in areas such as exchange rates and availability of working capital. Working with local partners who are inexperienced in international practices and who may act opportunistically, for reasons such as economic exigency, cultural antipathy or low trust, often creates a high level of agency risk. According to the analysis we have offered, high contextual and agency risks are likely to lead foreign IJV partners to aim for concentrated personal governance. Second, if the local environment is resource-deficient, and if the local IJV partner is also lacking in capability and resource, the foreign partner will be obliged to provide extensive tangible and intangible assets, and hence adopt a high and extensive level of IJV control. Third, most MNCs, especially those of American origin, have an a priori preference for strong and integrated control over their foreign affiliates, and have institutionalized this into their norms for foreign direct investment (Rudman 2003). Indeed, many of them regard IJVs as merely a stepping-stone towards acquiring complete ownership and control. Fourth, even if local IJV partners are granted access to the knowledge assets that their foreign partners bring to IJVs, they do not necessarily have the understanding or the motivation to transfer such knowledge to their other operations or to disseminate the knowledge effectively. Local partners can resist the introduction of new practices into IJVs by their foreign partners, if they perceive new knowledge and practices as a threat to their social identity (Child and Rodrigues 1996). However, the opportunity to participate in control should eventually reduce such resistance.

Paradoxically, the possession of superior tangible and intangible assets by foreign IJV partners, the transfer of which should be facilitated by IJVs, can actually create barriers to that transfer because the risks perceived by such partners encourage them to adopt restrictive forms of IJV corporate governance. The transfer of technology and expertise to local firms in emerging economies is jeopardized when they have limited power within an IJV and when their participation in sensitive activities is restricted. A degree of shared control and openness between IJV partners and their staff is necessary for knowledge to be transferred between them, especially knowledge of a less codified and more tacit nature.

The issue of IJV partner governance preferences is not therefore just a gap in the corporate governance discourse that needs to be filled. It also has wider implications for the role of international firms in economic development. What Stiglitz (2003) has argued at the macro level applies equally at the level of the firm: the key ingredients in a successful development strategy are local ownership and participation. Policies and practices imposed from outside are unlikely to be implemented, at least as intended. Moreover, failure to permit participation in the governance of their overseas affiliates actually spells danger to the long-term future of international firms (Child 2002*b*). While MNCs are making a major positive contribution to economic development through their investments and employment generation, their lack of accountability to local interests, including local partners, is generating resentment. Some of the most hostile opposition to MNCs is to be found in developing countries and experience suggests that if this resentment leads to conditions that pose greater country risk, foreign direct investment by corporations to the region concerned could dry up. It is therefore a matter of some urgency to find new means of IJV corporate governance that can at the same time reduce perceived risk and permit the participation of local partners in control.

## 12.9 Summary

1. Despite their growing numbers, strategic alliances have been relatively neglected in discussions of corporate governance.
2. In the case of EJVs, corporate governance is defined as the process of control over and within a JV that aims to reduce risks to its owners and to ensure that its activities bring a stream of acceptable returns to those owners in the long term.
3. A company investing in a JV faces risks in three broad areas: finance, resources, and market. These relate respectively to the security of financial investments committed to the venture, the availability of resources that it requires, and the market opportunities that are open to it.
4. When entering into an IJV located in a foreign country, a company also faces additional risks stemming from economic and institutional factors in that foreign context.
5. The above risks are ‘contextual’: they are primarily associated with the context in which the JV is located. Reliance on other partners and on the alliance’s own management introduces another kind of risk: that associated with multiple ‘agency’. Not only may alliance managers fail to honor their commitments; so may partners as well.

6. A range of risks therefore attach to a partner's investment in an IJV. These risks are likely to cause that partner to seek control over those IJV activities and decisions where the risks are concentrated or, if that is not possible, to minimize its exposure. In practice, a number of accommodations are possible in the form of different modes of JV governance. Four such modes are identified: concentrated personal governance; concentrated specialized governance; delegated managerial governance, and delegated financial governance.
7. A partner's preference for one of these accommodations rather than another is likely to arise from how it perceives the balance between the contextual and agency risks that it faces.
8. International firms forming JVs with local companies in developing countries may well perceive that they face high contextual and agency risks. If this leads them to insist on a high level of centralized control over the ventures (concentrated personal governance), it is likely to inhibit them from making available to the local partners the advanced technology and know-how essential for their countries' economic development.

## 12.10 Questions for discussion

1. Why do you think that the corporate governance of alliances, especially EJVs, has not so far been paid much attention?
2. What are the various forms of risk that JV partners face, in their capacity as investing shareholders?
3. In what ways does agency theory require extension to apply to EJVs, and what are the policy implications of that extension?
4. How is the maturity of regulatory institutions in the host country of an IJV relevant to the governance preferences of its foreign partner(s)?
5. What are the implications of the ways in which international alliances are governed for their potential contribution to development in emerging economies?

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# 13 Organizational learning

## 13.1 What this chapter covers

Many alliances are established in order to enhance a company's knowledge or capacity to generate new knowledge through learning. This chapter starts by introducing the concept of organizational learning, its different levels, and its relation to knowledge. It then identifies different forms of learning in and through alliances. Alliance partners' motives toward learning are also extremely significant, and the chapter distinguishes between alliances in which partners seek to learn collaboratively for their mutual benefit from other alliances in which learning becomes competitive and potentially exploitative. Effective organizational learning through alliances requires several conditions to be in place—positive partner intentions, an adequate learning capacity, and the ability to disseminate and apply new knowledge that is learned. The presence or otherwise of these conditions gives rise to a range of learning processes identified by research on IJVs. The closing sections of this chapter turn to the process whereby alliance learning can be facilitated. They identify the potential barriers to learning in alliances, and how the process might be managed constructively.

## 13.2 The nature of organizational learning

It has long been recognized that successful strategies are those which adapt organizations to the opportunities and threats in their environments, and which enhance their internal capacities. Adaptation to external developments and internal enhancement both involve 'organizational learning'. The term has since the 1970s come to be used to emphasize that organizations, just as individuals, can acquire new knowledge and skills with the intention of improving their future performance. It has indeed been argued that the only competitive advantage the company of the future will have, is its managers' ability to learn faster than its rivals (De Geus 1988: 740). Organizations often adopt cooperative strategies with the specific intention of acquiring new knowledge and know-how. Successful cooperation itself requires a learning process by the partners (Inkpen 1995*a*).

In recent years there has been a large amount of discussion and writing on the subject, with Dierkes et al. (2001) and Easterby-Smith and Lyles (2003) being particularly important books of reference. Nevertheless, there is not a generally agreed model or even definition of organizational learning. Most writers agree that organizational learning consists of both cognitive and behavioral elements (e.g. Fiol and Lyles 1985). Villinger (1996: 185) suggests that it is 'the process of developing a potential to improve actions (behaviors) through better knowledge and understanding (cognition)'. While learning is clearly a process, some would go further and include its outcomes within the scope of the term as well. This extension is helpful, because it serves as a reminder that an organization does not necessarily benefit from the acquisition of knowledge and understanding unless these are applied, so that the 'potential to improve actions' is actually realized.

Villinger prefers to use the term 'learning in organizations' because of the uncertainty over whether organizations themselves can actually be said to learn. The idea of 'organizational learning' does not resolve the paradox that 'organizational learning is not merely individual learning, yet organizations learn only through the experience and actions of individuals' (Argyris and Schön 1978: 9). As Nonaka and Takeuchi (1995) recognize, in a strict sense knowledge is created only by individuals and an organization can only support creative individuals or provide suitable contexts for them to create knowledge. Their description of 'organizational knowledge creation' provides an indication of how this individual learning can become available, and retained, within the organization as a whole:

> Organizational knowledge creation . . . should be understood as a process that 'organizationally' amplifies the knowledge created by individuals and crystallizes it as part of the knowledge network of the organization. This process takes place within an expanding 'community of interaction' which crosses intra- and interorganizational boundaries. (Nonaka and Takeuchi 1995: 59)

This touches on the very practical question of how learning by individuals, or groups of individuals, can become transformed into an organizational property. The challenge here is partly one of how to make explicit, codify, disseminate, and store the knowledge possessed by the members of an organization in ways that convert it into a collective resource. It is also partly a problem of how to reduce the barriers that organizational structures, cultures, and interests can place in the way of knowledge-sharing and learning. Paradoxically, although cooperative strategies are usually intended to enhance the learning of partner organizations, the fact that the strategic and cultural fit between them may be less than complete can seriously impede the process.

The nature of the knowledge contributed by the members of an organization, or an alliance of organizations, is of considerable significance for the process of learning. An important requirement for converting knowledge into an organizational property is to make it sufficiently explicit to be able to pass around the 'knowledge network'. Polanyi (1966) distinguished between tacit knowledge and explicit knowledge. The former is usually regarded as personal, intuitive, and context-specific. It is therefore difficult to verbalize, formalize, and communicate to others. Explicit knowledge, by contrast, is specified and codified. It can therefore be transmitted in formal systematic language. To make tacit knowledge available to an organization at large in a form that permits its retention for future use, it has to be converted into a codified or programmable form. It may not be possible to accomplish this, either for technical reasons or because the people with tacit knowledge do not wish to lose their control over it. If this is the case, then the only way to put tacit knowledge to organizational use may be to delegate responsibility for action to the persons concerned and/or to persuade them to share their knowledge with other experts on an informal basis.

The tacit nature of much useful knowledge can pose two problems for a strategic alliance or other form of interorganizational cooperation, depending on the intention of the partners. If the partners are looking to learn competitively from one another, then the retention of knowledge in a tacit form can be a defensive measure, because it means that only their members have access to it. If both or all partners adopt this tactic, then they are likely to face major difficulties in converting the knowledge held tacitly or covertly by each partner into a form usable for cooperative activities. This can, obviously, become counter-productive to the success of the cooperative venture, which almost certainly requires mutual learning in order to achieve other strategic objectives as well. The other problem is more likely to arise when one partner is gaining market access in return for providing superior knowledge to the other—a typical situation for alliances between organizations from developed and developing countries respectively. When the tacit knowledge held by the members of one partner organization is superseded by new knowledge and practices brought in by another partner, the consequent threat to the group identity of the former may generate considerable resistance to internalizing the new knowledge.

Another distinction with important implications for practice is that between the different levels of organizational learning (see Table 13.1). Both theorists (summarized by Pawlowsky 1992) and those writing more pragmatically with reference to developments in JVs (Child et al. 1994) have identified three main levels of organizational learning, in a broadly parallel way. The theoretical approach identifies routine improvements within the boundaries of existing organizational knowledge as the 'lowest' level. The middle level involves changes to the boundaries or structures of existing knowledge bases, which imply a 'reframing' of organizational systems and perspectives. The highest level is learning how to learn through reflexive cognitive processes; it is proactive and generative. These three learning levels correspond to the terms 'single-loop learning', 'double-loop learning', and 'deutero-learning' coined by Argyris and Schön (1978).

**Table 13.1** Levels of organizational learning

| Levels | Theoretical approach | Pragmatic approach |
|---|---|---|
| Higher | *Learning—'deutero learning'*<br>Learning how to learn so as to improve the quality of the organizational learning process itself. | *Strategic learning*<br>Changes in managerial mindsets, especially in understanding the criteria and conditions for organizational success. |
| Middle | *Reframing—'double-loop'*<br>Changes of existing organizational frameworks. Involves questioning existing systems. Oriented towards survival in changing environmental conditions. | *Systemic learning*<br>Changes in organizational systems, with an emphasis on learning how to achieve better integration of organizational activities. |
| Lower | *Routine—'single-loop'*<br>Improvements and adjustments to optimize performance within the limits of existing organizational frameworks and systems. | *Technical learning*<br>The acquisition of new specific techniques such as more advanced production scheduling, or managerial techniques such as more advanced selection tests. |

The more pragmatic approach distinguishes between technical, systemic, and strategic levels of organizational learning. The technical level refers to the acquisition of new, specific techniques, such as for quality measurement or for undertaking systematic market research. This corresponds to routine learning. The systemic level refers to learning to introduce and work with new organizational systems and procedures. The focus here is on an integrative type of learning involving the restructuring of relationships and the creation of new roles. This parallels the notion of organizational reframing. The strategic level involves changes in the mindsets of senior managers, especially their criteria of organizational success and their mental maps of the factors significant for achieving that success. The emphasis on vision here is somewhat different from that on 'learning how to learn', but there is a parallel in the reflexive cognitive processes involved with a view to generating new insights and being proactive. The level of learning to which a collaborative venture aspires will depend on its purpose, and the involvement and needs of its partners. Higher levels of learning are likely to be more difficult to achieve.

Andreu and Ciborra (1996) point to the dynamic processes that link these three levels of learning together by means of three equivalent 'loops'. Their scheme is reproduced in Figure 13.1. At the lower level is the routinization-learning loop. This level of learning is aimed at mastering the use of standard resources and gives rise to efficient work practices. Most of the learning at this level will be technical in nature. Andreu and Ciborra cite as an example 'mastering the usage of a spreadsheet by an individual or a team in a specific department, to solve a concrete problem'.

New work practices can be internalized by the firm in the form of routines, and in this way they become part of its capabilities. This gives rise to a capability-learning loop, in which new work practices are combined with organizational routines. The learning process is systemic in character because it involves generalizing work practices and techniques and placing them into a wider context. This defines not just what the practices do and how they work, but also the circumstances under which it becomes appropriate to use them and who has the authority or competence to apply them.

The third and highest learning loop is the strategic loop. In this learning process, capabilities evolve into core capabilities that differentiate a firm strategically, and provide it with a competitive advantage. Capabilities can be identified as core—having strategic potential—both by reference to the firm's mission and to what will give it a distinctive edge in its competitive environment.

While the Andreu and Ciborra framework depicts a primarily internal process of learning cycles within a single firm, cooperation with partner organizations offers a potential to learn at all three levels. It may provide direct and fast access to improved techniques and specific technologies. It can facilitate the transfer and internalization of new systems, such as lean production and TQM. Cooperation can in these ways enhance a partner's capabilities, and these may assume greater significance if the cooperation also opens a door to new strategic possibilities through, for example, assisting market entry.

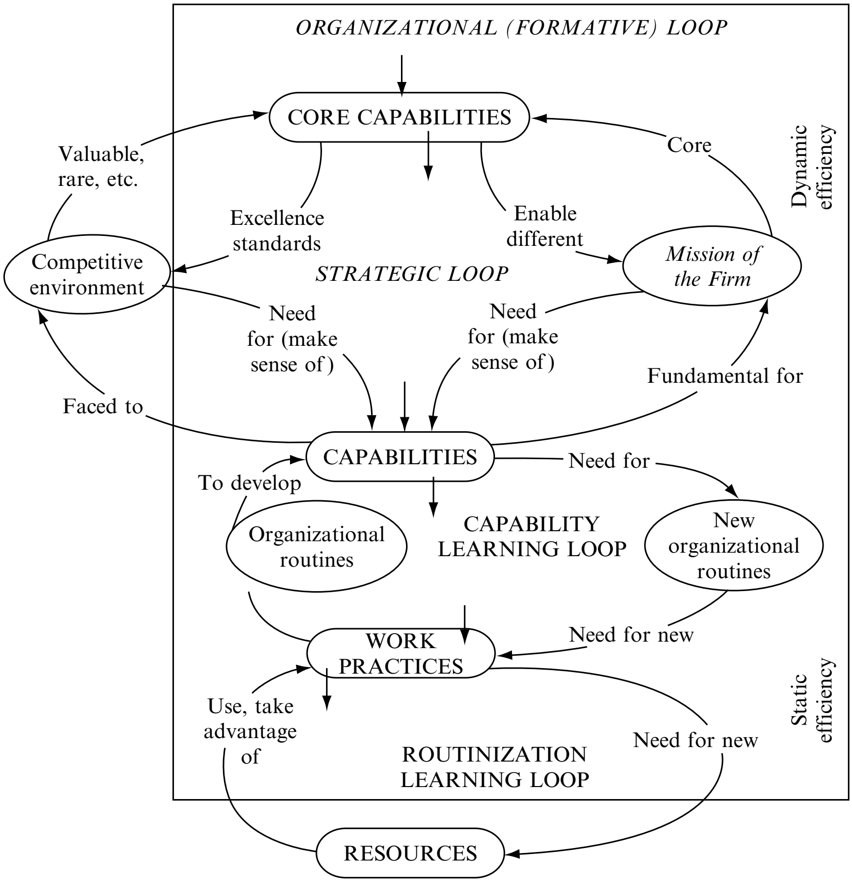


**Figure 13.1** Organizational learning loops at three levels.
*Source*: Andreu and Ciborra (1996: 126, Figure 6.2).

## 13.3 Forms of learning relevant to alliances

The ability to learn is probably the most important intangible asset that a company can possess. Its enhancement is frequently the main motive for entering into collaboration with other companies. Alliances create learning opportunities, especially if the partners possess somewhat different experiences or capabilities. Different experiences would, for example, come from operating in different geographical, cultural, and political environments. Different capabilities would be evident when, say, one partner has a particular strength in research and the other has a highly developed competence in production.

There are four main forms of learning that strategic alliances can facilitate (Inkpen 2002). First there is *learning from experience*. The experience of joining an alliance generates knowledge that can be useful in the design and management of subsequent alliances. The more that parents have already acquired knowledge related to alliances, and the skills to apply it, the more their subsequent alliances are expected to benefit (Lyles 1988; Inkpen 1995*a*; Barkema et al. 1997). This reasoning helps to explain why previous experience of forming IJVs has been found to increase the partners' propensity to form new ventures (Madhok 1997; Gulati 1998). The implication is that parent companies' previous experience both of international business and of IJVs has the *potential* to confer benefits for IJV performance. Previous experience should assist companies to develop realistic expectations and avoid gross mistakes when establishing and managing further international ventures. Lyles (1988), for instance, found unanimous agreement among managers and staff of two US and two European firms, with successful histories of operating JVs in an international context, that there was a valuable transfer of experience from previous ventures. This transfer took place largely through the sharing of experiences, the continuity of top-management oversight, and the development of management systems. The companies were also able to use their experience as a credential, which made it easier for them to form new JVs.

The evidence on the contribution that previous experience makes to the success of alliances is however rather mixed. One reason is that firms do not always capitalize on previous international venturing experience, and indeed it may not be always relevant (Simonin 1997). An investigation carried out by Barkema et al. (1997) suggests that the type of previous experience matters. An IJV partner could have previous experience of JVs with or without experience of international business relations, and vice versa. Moreover, there are various kinds of international business experience, such as trading, technology transfer, JV or a wholly-owned subsidiary. While only the latter two imply experience of managing in a foreign country, international experience across the categories might have a cumulative learning effect. One might therefore expect that both international business experience and international alliance experience will benefit the performance of international alliances. Moreover, since alliances are partnerships, it is relevant to take the experience of both partners into account, though many previous studies have not done so.

Research by Child and Yan (2003) found that several aspects of learning affect the performance of Sino–foreign IJVs. When parents have had the opportunity to learn from previous experience of international business, in particular of JVs, their IJV tends to perform better. The combination of parent experiences is a more powerful performance predictor than that of an individual parent company. Their findings also suggest that previous experience is likely to be of particular significance for JV performance in a developing country context like China, where cultural differences and an underdeveloped institutional framework present major challenges that can otherwise seriously unsettle a partnership. It appears to be helpful for foreign firms entering developing countries to find as an IJV partner an enterprise that can not only provide local knowledge and connections, but that also has some experience of international business and can therefore communicate on the same wavelength. The conclusion that a joint venturing firm should draw upon its relevant experience, and evaluate the extent to which that experience needs to be supplemented by a partner's local knowledge, is consistent with the methodical approach to JV formation advocated by Tallman and Shenkar (1994).

The second form of learning relevant to alliances is that of *learning about an alliance partner*. As Chapter 6 discussed, it is important to learn about a potential partner's motives, capabilities, and culture in order to increase the chances that an alliance with it will jointly create value. The knowledge obtained about a partner in the selection and negotiation phase can be vital to the subsequent success and favorable evolution of the alliance.

The third and fourth forms of learning relevant to alliances can arise once an alliance is established. They are respectively, learning from an alliance partner and learning with an alliance partner.

*Learning from an alliance partner* comes about through the transfer of knowledge between two or more partners. The transfer involves the movement of existing knowledge into a different organizational setting for which such transfer represents a new knowledge input. It can take place through a JV or directly between partners who collaborate by means other than setting up a separate JV. Collaboration provides access to the partner's knowledge and skills. These can include product and process technology, organizational skills, management practices, and knowledge about new environments, including an introduction to key relationships within them. The transfer of knowledge is a frequent and important motive for entering into a collaborative strategy. The process has come to be known as the 'grafting' of new associates who possess knowledge not previously available within the organization. Huber (1991: 97) cites, as an example, General Motors' acquisition of Ross Perot's corporation, EDS, in order to graft on its information-systems expertise. Like any graft, it has to take and faces the risk of possible rejection.

In the case of some alliances that set up a new unit for a specific purpose, such as a JV, the knowledge sought from partners may only be relevant to, and embodied in, the outputs of that unit. Such learning may not have any general value outside the scope of the particular collaboration, though, as we shall see, there is always a danger of underestimating the value for the partner organization as a whole of knowledge acquired in this way. The example of Olivetti (see Box 13.1) demonstrates that cooperation can open up important opportunities for organizational learning that were not envisaged or given much importance when the alliance was first formed.

*Learning with an alliance partner* is a different learning process because it involves the creation of *new* knowledge, or at least a *substantial transformation* of existing knowledge, within the ambit of the alliance. This process implies that mutual learning occurs through a constructive integration of the different inputs offered by the partners and their members. This type of learning is qualitatively different from learning through knowledge transfer, and its realization presents a correspondingly greater challenge. It is, nevertheless, one of the potential prizes of cooperation between organizations that can offer one another valuable complementary knowledge. The motive behind most technology alliances today is not just to pool R&D costs, which can be considerable, but also to capture the innovation synergies that can arise from pooling complementary knowledge and capabilities. The partners are likely to seek to capture new knowledge generated within an alliance through a process that Lindholm (1997) calls 'harvesting'. This involves the retrieval of new knowledge that has been generated in the JV or other collaborative unit and its internalization within the parent firms so that they can use it in other areas of operation.

**Box 13.1 Unexpected learning opportunities from alliances which do not necessarily achieve their stated objectives: The case of Olivetti**

The Olivetti Corporation's main strategic alliance during the 1980s was its partnership with AT&T between 1983 and 1989. Only a few of the alliance's stated goals—such as forming a defence against IBM's dominance or imposing a new operating system (UNIX) in Europe—were achieved. Nevertheless, it had some positive, if unexpected, results as an exercise in learning. One was that the alliance accelerated internal learning and the acquisition and absorption of new knowledge through the broadening of Olivetti's management's horizons. Much the same was true of Olivetti's acquisition of Acorn, a small innovative British computer firm, during this period. While the original objectives of this acquisition, such as gaining a market share in the UK and a strong foothold in the education market, failed, there were unexpected benefits which enhanced Olivetti's knowledge. Acorn's wealth of skilled people and ongoing projects, for example, enabled Olivetti to become a leader in workstation technology.

Ciborra (1991: 66) comments of Olivetti's various collaborations that 'what seems to be particularly significant here is that in each alliance the elements of surprise and tinkering seems to have played a role in learning at least as important as the specific contractual arrangement'.

*Source*: Ciborra (1991).

Learning from and with partners indicates that strategic alliances can provide a means to acquire or generate knowledge that might otherwise not be available. Alliances can also be an important vehicle for the incorporation of new knowledge into practice, particularly through the medium of JVs or cross-partner teams that work on the necessary adaptation and application of knowledge drawn from the partners.

Strategic alliances, especially JVs in which the personnel from different partners work closely together, can facilitate the transfer of tacit knowledge which it would be virtually impossible to obtain from the marketplace and which is not already available in a partner's own organization. The transfer even of *existing* knowledge or practice through an alliance nevertheless presents difficulties. Abstract and codified knowledge reverts to the status of new data for people receiving it for the first time, if they are not in a position to validate it immediately. Members of alliances will be unable to validate such knowledge if it is not structured in a manner familiar to them. Technical knowledge should be easier to absorb if it is already classified and codified according to widely accepted and known standards, but this characteristic is less likely to be true of organizational and strategic knowledge. The creation of *new knowledge* needs to draw upon and synthesize a number of different knowledge systems that the alliance has brought together, none of which may have been applied previously to the specific circumstances faced by the alliance. A number of attempts may be required to arrive at acceptable and effective schemes of classification and codification, and at least one pilot project may be necessary to demonstrate the appropriateness of the emerging approach for the new circumstances.

In addition to the problem of translation from the milieu of one alliance partner to that of another, the passage of information and knowledge between different actors or groups in the learning cycle implies that constructive relationships must exist between them for the process to be effective. Knowledge is socially constituted because it is created or compiled by social groups who have a sense of ownership over it. This sense of ownership means that the groups will attribute value to the knowledge and will assume the right to arbitrate over this value. In other words, social identity is vested in different systems and bodies of knowledge. When knowledge is transferred between organizations, or when the members of different organizations pool their knowledge resources, how the people concerned perceive the validity of what is, for them, novel knowledge will impinge on the extent to which they are prepared to accept and work with this knowledge.

The issue of validity is likely to be more sensitive for organizational and strategic knowledge and practice than it is for knowledge of a primarily technical nature. Although technical knowledge is also socially constituted, several of its characteristics reduce its sensitivity to being transferred or shared between different organizations. One of these characteristics is that technical knowledge is often expressed in a widely accessible, standardized form, some of it in the form of international standards. Also trained specialists, who have a relatively cosmopolitan identity that can bridge discrete organizational identities, are likely to accept incoming technical knowledge as valid. Problems can arise, of course, when knowledge generation requires the collaboration of people from different specialties, for then the presence of widely validated technical standards can increase the problem of integration.

## 13.4 Collaborative and competitive learning

Many cooperative alliances and networks are formed between organizational partners who perceive that they can benefit from their complementarities (Geringer 1991). This gives them a common interest in learning how to extract the potential synergies between their respective competencies. If their goals are also complementary they can collaborate in order to compete better, if they are business firms, or to provide a better service, if they are organizations in the public domain such as universities (Bleeke and Ernst 1993).

Competitors whose goals and interests diverge may also collaborate to benefit from learning opportunities. Opportunities to learn are, in fact, generally greater between competitors, but, of course, they will be wary about sharing their knowledge. The balance between the contributions each partner makes to the alliance and benefits each is able to extract from it will be a sensitive issue. It is subject to negotiation, and to the ability of one partner to outsmart the other. In this kind of situation, the cooperation is often relatively short-lived and the partners may well revert to competing with each other, if and when their alliance breaks up.

So, there are two possible learning situations within an alliance. One is based on an underlying spirit of collaboration between the partners, the other on an underlying attitude of competition between them.

### 13.4.1 Collaborative learning

The collaboration between the Royal Bank of Scotland and the Banco Santander of Spain, announced in October 1988, is described by senior officials from both partners as having promoted organizational learning of mutual benefit. As Box 13.2 indicates, each partner was able to learn about and absorb improvements in banking operations as well as to learn over time how to deepen the process of working together.

As José Saavedra's words remind us, a cooperative alliance develops as a relationship over time. This has led to the notion of strategic alliance evolution in terms of a life cycle, corresponding to the concepts of product and technology life cycles (Lorange and Roos 1992; Murray and Mahon 1993). It is argued that, over time, collaboration moves from initial contacts, through negotiations and start-up, to a phase of managed cooperation (see also Chapter 18). This may, in turn, lead to an extension of the cooperation, a drift towards separation, or a more abrupt decision to divorce. Extension and deepening of the cooperation, based partly on learning how to work together and achieve synergies between complementary competencies, could eventually lead to a free-standing entity with a sense of its own identity and independent management. Faulkner (1995*a*), from a

**Box 13.2 Cooperation between the Royal Bank of Scotland and the Banco Santander of Spain**

Initially, the major areas of cooperation between the two banks included access to branches, shared ownership of German and Belgian banks, offshore banking in Gibraltar, merchant banking, technology development, and acquisitions. As an act of faith and demonstration of commitment, a small percentage shareholding was exchanged at Group level.

The Chief Executive of the Royal Bank of Scotland commented later that:

> We have been surprised by the intangible benefits from the alliance, as each side has got to know and observed the working practices of the other. Simple things like the differing ways in which we prepare and organize meetings; the nature and content of papers presented to internal audiences; and differences in structures and reporting relationships have all provided ample food for thought.

José Saavedra of the Banco Santander also remarked that:

> We have learnt best how to launch an interest-bearing current account after having learnt what RBS's experience has been. We admire how they develop business by phone, even selling loans. At top-management level we are exchanging views on how best to handle credits, and geographical risks. On the Royal side, they look at our branch network with five people or less per branch, and compare it with their average of nine. Probably they will centralize the back office more. Also they are very good at serving customers, and we are very good at developing profitable customers. As time goes on something more consistent will come out of the cocktail shaker. But those are processes that are on going and enriching on both sides.

*Source*: Faulkner (1994).

study of sixty-seven cases, identifies a direct link between organizational learning and the alliance life cycle. He concludes that an underlying 'learning philosophy' is one of several conditions necessary for successful alliance evolution, along with strong bonding and regular new projects. To prevent the collaboration becoming dormant due to operational mismatches or overdependence on one partner, constant adjustments will be needed.

Schacht (1995) studied the role of learning in the evolution of three international strategic alliances entered into by Hoechst. He distinguished between three types of learning that correspond to the categories of technical, systemic, and strategic already mentioned. These are learning new technologies, improvements in the organizational systems that supported learning, and learning about new strategic opportunities. Schacht found that the rates of these three types of learning over time varied as between the three cases. For example, in two of the cases the rate of learning about new strategic opportunities increased over time as the collaboration deepened, but in the third case it appeared to remain rather low. This latter was a collaboration that Hoechst had with Bayer on the development and promotion of an anti-AIDS drug. Although close informal communication developed between the companies' research scientists, which led to a rising rate of technology learning, the static rate of strategic learning appeared to result from the persistence of purely formal communication at higher organizational levels where goals were set for the collaboration and strategic issues discussed.

Schacht concluded from his research that the rate of learning was a key factor driving the evolution of the collaborations, and he identified some of the management policies and provisions that contribute to effective learning. The evolution of collaborative relationships will also depend on the learning objectives that their partners attach to their cooperation. If they are committed to the idea of mutual learning within the partnership for an indefinite period, their relationship is likely to evolve progressively. If, on the other hand, one or more of the partners regards the cooperation as a one-off opportunity to access knowledge it may subsequently turn to competitive advantage against the other—an attitude of competitive learning—then clearly the scope for its evolution is limited.

### 13.4.2 Competitive learning

Competitive learning within an alliance describes the situation where one partner intends to learn as much as possible from the other rather than adopting mutual learning as its priority. As Larsson et al. (1994) note, a dilemma for interorganizational learning is that an attempt by participating organizations to maximize their appropriation of the joint outcomes of collective learning undermines the conditions, such as mutual trust, for the generation of interorganizational learning. This is the case of 'competition for competence' that Hamel (1991) reported from his investigations of international strategic alliances between western and Japanese partners:

> managers often voiced a concern that, when collaborating with a potential competitor, failure to 'outlearn' one's partner could render a firm first dependent and then redundant within the partnership, and competitively vulnerable outside it. The two premises from which this concern issued seemed to be that (1) few alliances were perfectly and perpetually collusive, and (2) the fact

that a firm chose to collaborate with a present or potential competitor could not be taken as evidence that that firm no longer harbored a competitive intent vis-à-vis its partner. (Hamel 1991: 84)

Hamel pointed to the possibility of asymmetric learning between alliance partners which derives from the fact that they have failed, or are unwilling, to transform their partnership into a fully cohesive organization. The lack of 'perfect collusion' is a failure by the partners to achieve total integration of their operations within the JV. The result is that organizational learning becomes a political football in the competitive process. Collaboration of this kind involves a race between the partners to learn from the other, to their own advantage rather than for the benefit of the alliance as an organization in its own right. Performance in this race is associated with interpartner bargaining power. The partner with the greater bargaining power can, during the formation of the alliance, establish conditions favorable for it to achieve asymmetric learning by, for instance, insisting that the other partner's technology be made fully available. Successful asymmetric learning during the life of the alliance will in turn enhance that partner's bargaining power vis-à-vis the other to the point where the former dominates the alliance or where it breaks up under the strains that asymmetry generates (Makhija and Ganesh 1997).

Pucik (1991: 127) comments, with reference to technology transfer in strategic alliances, that the partners should approach the matter in a planned rather than a haphazard manner: Organizational learning is not a random process, but a carefully planned and executed set of policies and practices designed to enlarge the knowledge base of the organization. Preventing an asymmetry (or creating an asymmetry in one's favor) in organizational learning is a strategic requirement for firms engaged in competitive collaboration, when technology is transferred between competitors. Win/win outcomes so fashionable in academic literature are not likely to occur with one of the partners placed at a bargaining disadvantage. Not providing a coherent strategy for the control of invisible assets in a partnership is a sure formula for failure.

The prisoner's dilemma applies to learning within the framework of an interorganizational alliance. That is, when individual partners behave in an individually rational manner, attempting to maximize what they can extract from the cooperation at the expense of the other partners, the potential for all partners to gain is lost (Axelrod 1984). Organizations are therefore likely to learn the most together when they all choose collaborative learning strategies, involving high levels of openness ('transparency') and receptivity to new knowledge—the model of being a 'good partner' in strategic alliances (Larsson et al. 1994: 16). If, in the course of time, trust grows between the partners as their alliance evolves and demonstrates benefits to all partners, this should help to safeguard the collaboration against the temptation towards short-term maximization by any one of them.

## 13.5 Requirements for organizational learning

There are certain requirements for a company to learn through membership of a strategic alliance. The first is that the partner includes learning among its *intentions* when forming an alliance and that it attaches value to the learning opportunities that arise. We have just seen that these intentions may be informed by collaborative or competitive motives. Secondly, the partner must have the necessary *capacity to learn*. Thirdly, that partner needs to be able to take the knowledge that has been acquired or created and *convert it into an organizational property*. This requires that the new knowledge be disseminated to the appropriate persons or units within its organization, understood by them, and retained for future use. If this conversion process is successfully achieved, there will be a positive feedback loop strengthening the partner's intention to learn further through its present alliance or future ones. While these requirements all appear rather obvious, they are not so easy to achieve in practice. Figure 13.2 depicts them graphically and they are now discussed in turn.

## 13.5.1 Partner intentions

Hamel (1991) found from a detailed study of nine international alliances that the partners varied considerably in how far they viewed the collaboration as a learning opportunity, and that this was an important determinant of the learning they actually achieved. For instance, several of the Western firms had not intended to absorb knowledge and skills from their Japanese partners when they first entered alliances with them. They appeared, initially, to be satisfied with substituting their partner's competitive superiority in a particular area for their own lack. In every case where this 'substitution' intent was maintained, the partners failed to learn in any systematic way from their collaboration.

Other companies, including many of the Japanese partners, entered into the alliances regarding them as transitional devices in which their primary objective was to capture their partner's skills. In several cases, partners undertook cooperative strategies for the purpose of learning the business (especially to meet international requirements), mastering a technology and establishing a presence in new markets.

These are illustrations of a company's intention to use the learning opportunities provided by collaboration to enhance its competitive position and internalize its partners' skills, as opposed to collaborating over the long term and being content merely to

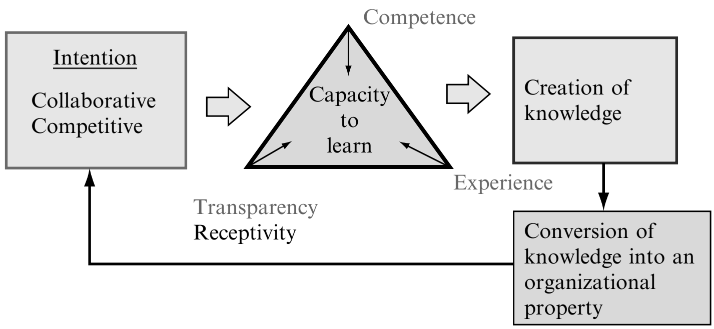


**Figure 13.2** Determinants of learning in and from alliances.

access rather than to acquire partner skills. The threat posed by this strategy to an unwitting partner is obvious and it does not provide the basis for an enduring long-term cooperative relationship. In fact, when learning from a partner is the goal, the termination of a cooperation agreement cannot necessarily be seen as a failure, nor can its stability and longevity be seen as evidence of success. Hamel noted that a partner's ability to outstrip the learning of the other(s) contributes to an enhancement of that partner's bargaining power within the cooperative relationship, reducing its dependence on the other partner(s) and hence providing a gateway to the next stage of internalizing those partners' knowledge and skills. For these reasons, Hamel concludes that, in order to realize the learning opportunities offered by an alliance, a partner must both give priority to learning and consciously consider how to go about it.

Simonin (2004) also found in a survey of 147 US companies having international strategic alliances that those companies' learning intent was a strong and consistent predictor of knowledge transfer from their partners to them. In other words, the more determined the companies were to learn through forming an alliance, the more they succeeded in doing so. To anticipate an issue discussed later in this chapter, Simonin's results also indicated that the chief barrier to knowledge transfer through alliances lay in the ambiguity of the knowledge regarding cause–effect relationships and the like.

Garrette and Dussauge (1996) found a significant difference in the apparent learning intentions of 'scale' and 'link' strategic alliances in the global automotive industry. Their conclusions were based on a study over time of 150 such alliances between thirty-six different car and truck manufacturers from Europe, North America, Japan, and Korea. Scale alliances are those in which the partners contribute similar resources pertaining to the same stage or stages in the value chain. These alliances may permit the achievement of scale economies or the reduction of excess capacity. They include joint R&D collaboration, the joint production of particular components or subassemblies, or even the coproduction of an entire product. The PRV alliance established in 1971 by Peugeot, Renault, and Volvo to develop and manufacture a common V6 engine provides an example. Another is the Global Engine Alliance of Hyundai, Mitsubishi Motors, and DaimlerChrysler launched in 2002 to build aluminum head four-cylinder motors. Link alliances are those in which the partners contribute different and complementary capabilities relevant to different stages in the value chain. A common case is when one partner provides market access to products developed initially by the other firm, and an example is the alliance linking General Motors to Isuzu (Hennart 1988; Garrette and Dussauge 1996).

The scale alliances were formed between competitors with fairly similar production volumes, and it appeared that the partners were primarily seeking to benefit from economies of scale. Learning, in the sense of capturing the other partner's skills, did not appear to be a priority objective. On the other hand, link alliances were formed much more frequently by partners from different parts of the world, which creates more favorable conditions for transfers of knowledge to take place. The worldwide market shares of link-alliance partners, relative to one another, varied more than in the case of scale alliances. This asymmetry between link-alliance partners, together with the complementary knowledge they possess, sets up conditions for learning and knowledge transfers to take place between them. Garrette and Dussauge take the fact that the link alliances

**Box 13.3 An example of a clear learning intention**

A US automotive supplier (Beta Corporation), like many others in its sector, was losing market share to Japanese companies in the early 1980s. Its management saw the formation of a joint venture with a Japanese company closely linked with one of the largest Japanese car manufacturers as an excellent opportunity to learn about Japanese management:

Beta concluded that purchasing Japanese technology was not the answer. The Japanese were using more expensive raw materials and were using the same equipment. In Beta's view, the differences had to be managerial. Beta had some idea of things like JIT and other techniques but senior management could not agree on what the real important differences were. They decided that a JV would help them learn from the Japanese. As a Beta manager commented, 'Our feeling was that we might not get rich from the JV but at least we could learn a lot about Japanese management.'

*Source*: Inkpen (1995*a*: 92–3).

tended to be reorganized more frequently than scale alliances as an indicator that the partners were in fact sharing knowledge and skills. Inkpen (1995*a*) provides an example of a US company that entered into a JV with a clear intention to learn (see Box 13.3).

## 13.5.2 Learning capacity

A partner's capacity to learn will be determined by a combination of factors:

- the transferability of the knowledge;
- how receptive its members are to new knowledge;
- whether they have the necessary competencies to understand and absorb the knowledge;
- the extent to which the partner has incorporated the lessons of experience into the way it approaches the process of learning.

### 13.5.2.1 Transferability

Unlike the other three factors listed, this one refers to a quality of the knowledge itself rather than to a feature of the would-be learning partner. Transferability shows the ease with which the type of knowledge can be transferred from one party to another. Explict knowledge, such as technical product specifications, is relatively easy to transfer and to be absorbed. Tacit knowledge is far more difficult.

### 13.5.2.2 Receptivity

The more receptive people are to new knowledge, the more likely they are to learn. When the members of a collaborating partner organization adopt the attitude of students towards their counterparts from the other partner, they are being more receptive to insights from that partner than if they assume that they already possess superior techniques, organizing abilities, and strategic judgement. For example, some Chinese partners in JVs with foreign companies make the mistake of assuming that they cannot learn useful motivational practices from their foreign collaborators because they already have a superior knowledge of Chinese workers. Equally, some foreign partners unwisely disdain advice from their Chinese collaborators on the best ways to relate to external governmental authorities which wield an unusual degree of influence over the conditions for doing business.

Hamel (1991) found several influences on a partner organization's receptivity. Firms which had entered an alliance as 'laggards', in order to provide an easy way out of a deteriorating competitive situation, tended to possess little enthusiasm for learning from the other partner or belief that they could achieve it. They tended to be trapped by deeply embedded cultures and behaviors that made the task of opening up to new knowledge all the more difficult. In clinging to the past, they were not capable of 'unlearning' as a necessary prerequisite to learning (Hedberg 1981). Receptivity also depended on the availability of some time and resource to engage in the processes of gathering knowledge and embedding it within its own routines through staff training and investment in new facilities. The paradox of deteriorating competitiveness as a pressure to learn and yet a constraint on being able to achieve it becomes critical for poorly performing partners. In some alliances, it may be resolved by the additional cash and other resources injected by the other partner. If a collaborator has, however, slipped far behind its partner(s) in the skills and competencies necessary for it to absorb new knowledge, it may find closing the gap extremely difficult.

#### 13.5.2.3 Competence

Cohen and Levinthal (1990) argue that a firm's 'absorptive capacity' is a crucial competence for its learning and innovative capabilities. Absorptive capacity is a firm's ability to recognize the value of new, external information, assimilate it, and apply it to commercial ends. This competence is largely a function of the firm's level of prior related knowledge. Hence existing competence favors the acquisition of new competence, which implies that a partner entering an alliance with learning objectives should ensure that it does so with not only a positive attitude towards learning but also a minimal level of skills. If those skills are not available, the training of staff to acquire them should be an immediate priority.

Competence is required at all three levels—strategic, system, and technical—if a partner is to take advantage of the opportunities for learning offered by cooperation with other organizations. At the strategic level, a collaboration which is perceived as peripheral to a partner's overall strategy will probably yield fewer opportunities for the transfer of learning from the collaboration back into the partner's main organization. The lack of perceived strategic importance is likely to reduce the level of interaction between partner and the cooperative venture. Another problem can arise from a partner's failure to appreciate that it can derive broad strategic lessons from the cooperation rather than ones restricted to narrower issues. General Motors, for example, approached its NUMMI JV with Toyota with the expectation that what it could learn from Toyota would be confined to production skills in the manufacturing of small cars. As a consequence, although the lessons to be learnt were actually of general relevance, they were not applied to General Motors as a whole (Inkpen 1995*a*: 63).

Competence at the system level is required in order to make the most innovative use of new knowledge or technology which is acquired. For example, the introduction of mill-wide computerization in the paper and pulp industry opened up radical new possibilities for the constructive redesign of mill organization and the combined empowerment and enrichment of mill workers' jobs. This new technological development came about through close cooperation between paper manufacturers and system suppliers. The ability of UK paper manufacturers to take full advantage of the potential offered by the new systems depended on their organizational vision and competence, in terms of being able to envisage and accept radically changed roles and relationships (Child and David 1987).

The need for a partner to possess adequate skills for it to absorb and use new technical knowledge is a self-evident requirement. With the complex nature of many modern technologies, and the importance of deploying them in conjunction with the 'human' skills and motivations of employees, a multidisciplinary technical competence is required. A particular technical skill the lack of which can cause problems in international alliances is competence in the partner's language. Hamel (1991) noted how the fact that employees in Western firms almost all lacked Japanese language skills and cultural experience in Japan limited their access to their Japanese partners' know-how. Their Japanese partners did not suffer from a lack of language competence to the same degree and benefited from the access this gave them to their partners' knowledge. Similarly, Villinger (1996) found that in east central European firms acquired by Western companies, both Eastern and Western managers perceived language and communication deficiencies to be the main barriers to learning between the two parties, even though for the most part rather little priority was being given to improving language competencies.

#### 13.5.2.4 Previous experience

Experience is always a two-edged sword. Prior knowledge gained from an alliance which has been converted into an organization's routines can become a barrier to further learning, especially that of a discontinuous rather than merely incremental nature. Being good at single-loop learning may therefore become a handicap for double-loop learning (Argyris and Schön 1978). Having said this, it is expected that previous experience of cooperation will normally enhance the partners' capacity to learn because it gives them greater knowledge of how to manage, monitor, and extract value from their alliances. If partners enter alliances with the intent of learning to augment their competitive ability, then the benefits of previous experience will derive mainly from the extent to which it has developed their ability to extract value from the cooperation (Simonin 1997).

If there is an intention to collaborate for mutual benefit, and on a long-term basis, the experience of working together can in itself create relationship assets for the partners. They will have basic understandings about each other's capabilities and the qualities of confidence and trust in their relationship should have already been established. The fact that they have already overcome the hazards of the initial period of working together will have generated a degree of commitment to one another (Fichman and Levinthal 1991). These benefits of previous joint experience will tend to extend the openness shown by the partners towards each other, and hence add to the effectiveness of the learning process. Nevertheless, the value of previous experience as a capability that promotes learning in alliances between organizations will depend on the relevance of that experience. This is suggested by Inkpen's finding (1995*a*: 65–6) that previous JV experience on the part of the partners of ventures with Japanese companies did not lead to improvements in their learning process. Hamel's (1991) research on competitive learning, mentioned earlier, indicated that the rules of the learning game with Japanese partners could be quite different to those with western partners.

Nonetheless, some western companies have learned successfully through alliances with Japanese partners. Rover's alliance with Honda illustrates the interplay between the conditions we have identified, relating to the nature and level of the knowledge, and the partner's learning intention and experience (see Box 13.4).

**Box 13.4 The Rover–Honda alliance: Learning by Rover**

In the alliance between Rover and Honda, Rover had a high intent to acquire technology and this technical learning was relatively easy to achieve. Also in the later stages of the alliance, Rover was receptive and keen to undergo technical learning. The nature of the technology transfer was clear and Honda was willing to provide the information in joint learning working teams.

Process-learning, involving knowledge about Honda's organizing systems, was more difficult, since by its nature it involves a lot of tacit knowledge as well as features related to Japanese cultural paradigms. This kind of knowledge was less transparent and less easily transferred, but as Rover's learning intention and receptivity grew, it became one of the success stories of the alliance from the Rover viewpoint. Processes such as 'Just-in-time' were adopted and adapted to Rover's situation, and organizational innovations such as multifunctional teams and a flattening of the management hierarchy were introduced.

Once the cooperation had deepened by the mid-1980s to embrace the joint development of new automobile models, Rover's intent and receptivity to learning from Honda increased dramatically. The whole nature of Rover's attitude to itself, its personnel, and its way of working became transformed, so that a learning philosophy came to underlie it. By this stage, Rover's senior management had fully accepted the strategic value of the alliance, though this was not so true for its parent company, British Aerospace, which ultimately sold the company to BMW and led to termination of the cooperation.

*Source*: Faulkner (1995*b*).

### 13.5.3 Converting knowledge into an organizational property

Nonaka and Takeuchi (1995: 70), drawing largely upon cases of successful Japanese innovation, stress that the conversion of knowledge into a form that organizations can use is a 'continuous and dynamic interaction between tacit and explicit knowledge'. For this process to succeed, in their view, there must be possibilities for four different modes of knowledge conversion:

1. *Socialization* (tacit knowledge → tacit knowledge): 'a process of sharing experiences and thereby creating tacit knowledge such as shared mental models and technical skills'.
2. *Externalization* (tacit knowledge → explicit knowledge): 'a process of articulating tacit knowledge into explicit concepts'. This form of knowledge conversion is typically seen in the creation of concepts that offers wider access to the knowledge and also links it to applications.
3. *Combination* (explicit knowledge → explicit knowledge): 'a process of systematizing concepts into a knowledge system. This mode of knowledge conversion involves combining different bodies of explicit knowledge . . . through media such as documents, meetings, telephone conversations, or computerized communication networks'.
4. *Internalization* (explicit knowledge → tacit knowledge): This process is closely related to 'learning by doing'. It involves the embodiment of explicit knowledge into individuals' tacit knowledge bases in the form of shared mental models of personal technical know-how. (Nonaka and Takeuchi 1995: 62, 64, 67, 69)

Nonaka and Takeuchi emphasize that organizational learning depends upon the tacit knowledge of individuals, and upon the ability first to combine tacit knowledge sources constructively and then to convert these into more explicit forms that are subsequently combined. Tacit knowledge itself is enhanced by explicit knowledge, taking the form for example, of training inputs. Theirs is an illuminating framework for understanding the processes that must be in place for new knowledge to become an organizational property and hence constitute organizational learning.

Even within single organizations, there are often obstacles in the way of the smooth operations of these processes that derive from lines of internal differentiation. These lines of differentiation are both vertical (creating hierarchical barriers) and horizontal (creating barriers between specialist and physically separated groups or units). Differentiation forms the basis for distinct social identities and perceptions of competing interests. When two or more organizations come together to collaborate, such barriers are typically augmented by their different corporate cultures and, in the case of international alliances, their different national cultures.

These barriers reduce 'transparency'—the openness of one partner to the other(s), and its willingness to transfer knowledge. Hamel (1991) found that some degree of openness was accepted as a necessary condition for carrying out joint tasks in an alliance, but that managers were often concerned about unintended and unanticipated transfers of knowledge—transparency by default rather than by design (1991: 93).

## 13.6 A typology of organizational learning situations

It is now possible to draw together some of the preceding analysis by identifying different situations that can arise regarding learning within cooperative relationships between

**Table 13.2** Forms of organizational learning in cooperative relationships

| | Change in | | |
|---|---|---|---|
| Form of learning | Cognition | Behavior | Motivation to learn |
| Forced learning | × | + | low |
| Imitation or experimental learning | × | + | moderate |
| Blocked learning | + | × | high |
| Received learning | + | + | high but asymmetric |
| Integrative learning | + | + | high and mutual |
| Segmented learning | part | part | low |
| Nonlearning | × | × | low |

*Note*: × = change absent; + = change present.
*Source*: Adapted from Child and Markóczy (1993).

organizations. We do so by referring to the basic distinction between cognitive and behavioral learning (Fiol and Lyles 1985), and the motivational factors associated with intent and transparency.

The typology set out in Table 13.2 incorporates these distinctions. It is adapted from the one first used by Child and Markóczy (1993) to identify different kinds of learning processes experienced by host-country managers in IJV between Western and Chinese or Western and Hungarian firms, and also incorporates further categories identified by Inkpen (1995*a*: 74).

The first situation shown in Table 13.2 is the case of *forced learning*. Here there is no change of cognition and hence understanding, but new behavior is acquired under some pressure. It could be argued that this is a case of adaptation rather than learning, because of the lack of cognitive internalization. A common example of forced learning in collaborative ventures arises when one partner insists on the unilateral introduction of new organizational routines or systems without the other either accepting the rationale for them, or indeed being offered adequate training to understand it. Although the term 'forced' refers here to how the acquisition of new behavioral practices is brought about, and not necessarily how the process is perceived by those on the receiving end, it is likely to meet with some reluctance on their part. Forced learning can readily arise in a situation where there is an asymmetry of power between the partners and a low motivation to learn by members of the less powerful partner. Forced learning is clearly unlikely to be very effective or long-lasting.

A second possibility also results in the adoption of new practices (behavioral change) but without any appreciable learning of the rationale behind them (cognitive change). This is *learning by imitation*. It is likely to arise in the earlier stages of collaboration and may represent a phase of experimentation before practice can engender understanding, or before knowledge deepens into 'know-how'. There is probably at least a moderate level of motivation to learn in this situation, but the fact that the learning takes the form of imitation might indicate some limitation in the quality of training offered to support the learning process.

There were several cases of imitation arising in joint ventures in both China and Hungary. For example, in some Chinese JV hotels local staff displayed positive attitudes towards learning new routines for customer service, in large part because they were well rewarded for this. It was doubtful whether they really acquired an understanding of the thinking behind the new approach since its execution was often wooden and repetitive. John Child is reminded of the occasion when he had to go in and out of one hotel several times in succession with various packages, being greeted on each entry by the same commissionaire with 'welcome to our hotel' and on each exit with 'have a nice day, sir'! In several Hungarian JVs with Western partners the previous dependence of managers on higher government authorities was transferred to a new dependence on the foreign 'expert' partner in which its instructions were followed but without much apparent new understanding (Markóczy and Child 1995).

The two situations mentioned so far are ones in which, at most, behavior and practices have changed but without any significant increase in know-how or understanding. However, the opposite can also occur, when the members of an organization undergo changes in cognition that are not reflected in their behavior. This can be due to inadequacies of resourcing which prevents implementation, an over general or theoretical formulation of the new knowledge, or the over-riding of the situation by other strongly held beliefs. These factors cause the translation of new understanding into revised behavior to be blocked. In the context of an alliance between organizations, *blocked learning* can arise when staff from one partner receive training from those of another partner but are not accorded the appropriate positions and/or budgetary resources to put what they have acquired at the cognitive level into practice. Their motivation to learn may well be high and the intentions of the other partner towards their learning may be positive, but the organization of the training may, for example, not be matched to that of the responsibilities and resources allocated under the collaboration. This is, in fact, often the complaint of executives who attend off-site courses and are then frustrated in the application of their new learning when they return by superiors and colleagues who do not understand the change in competence that has taken place.

Another possibility is that the participants in an alliance learn both cognitively and behaviorally. This could be a unilateral process of *received learning* when one partner willingly receives new insights from another. If both parties endeavor to express and share their knowledge and practices, *integrative learning* may be achieved. This latter exhibits the potential that a cooperative strategy offers for organizational learning in its most advanced form, in which innovative synergy is attained between the different contributions and approaches that the partners bring to their alliance. Integrative learning involves a joint search for technical, system-building, and strategic solutions to the needs of the alliance. It means that partners are receptive to the concepts and practices brought in by their counterparts, and are willing to modify their own ways of thinking and behavior in the light of these.

Two further possibilities are included in Table 13.2 for purposes of comparison. In both cases the motivation to learn from cooperation is low and little learning actually takes place. The first is one of *segmented learning* in which, at best, very limited learning takes place because the partners to a collaboration choose to allocate separate responsibilities between them for different areas of cooperative activity. Segmented learning often arises when the mutual trust between partners is low or when restrictions are imposed by governments on the exchange of technology, as occurred under the COCOM rules. Hertzfeld (1991), an experienced consultant, has for instance suggested that a segmented mode of learning is necessary for foreign JVs within the former Soviet Union in order to avoid disputes over their leadership.

The other possibility is that of *nonlearning*, in which no learning takes place at all. This is likely to arise when the motivation to learn is low because the partner concerned accords a low (or even negative) priority to learning from the cooperation and/or because there is low transparency of knowledge between the partners. The case of a Sino–European JV, reported by Child and Markóczy (1993: 626), illustrates a negative learning priority. The Chinese partner attempted to resist the reconfiguration of production and support functions along more effective lines because it saw this as reinforcing the power of the European management over the running of the venture's facilities and over the labor force.

## 13.7 Barriers to organizational learning

The examples just mentioned point to various barriers that can arise to effective learning within IJVs. Pucik (1991) argued that barriers to organizational learning within strategic alliances can arise from (1) misplaced strategic priorities, such as short-term objectives and giving low priority to learning activities; (2) unfocused organizational control systems, as when little or no reward is given for contributions to the accumulation of learning as an invisible asset, and the responsibilities for learning are not clear; and (3) inconsistent HRM policies, such as surrendering responsibility for staffing to the alliance partner.

As well as these failures to plan and provide for learning in an alliance, other obstacles to the necessary transference of knowledge identified by Nonaka and Takeuchi (1995) are liable to arise because of the divergent ways of sense-making and associated with the social identities of the different parties which make up the collaboration.

When the members of different organizations come together to collaborate, they bring their own social identities with them. These social identities are sets of substantive meanings that arise from a person's interaction with different reference groups during his or her life and career. They derive therefore from belonging to particular families, communities, and work groups within the context of given nationalities and organizations (Tajfel 1982; Giddens 1991).

The receptivity of the members of a strategic alliance to knowledge transfer from their partners, and their ability to learn collaboratively from the knowledge resources they bring to the alliance, are bound up with their social identities. Social identities are likely to create the greatest difficulties for collaborative learning in alliances that are socially constituted by partners who are distinct organizationally, nationally, and in terms of the economic development level of the society from which they come. Learning in these circumstances is not a socially neutral process. Just as with knowledge that is offered in the learning process by one organizational speciality to others, so knowledge and practice transferred from a partner to the alliance impinge on the other members' mental constructs and norms of conduct. Their social identity derives from a sense both of sharing such ways of thinking and behaving, and of how these contrast with those of other groups. The process of transferring practical knowledge between different managerial groups will be interdependent with the degree of social distance that is perceived between the parties involved. So, if initially this distance is high, the transfer is likely to be impeded. If the transfer is conducted in a hostile manner or in threatening circumstances, then the receiving group is likely to distance itself from those initiating the transfer. There is a clear possibility of virtuous and vicious circles emerging in this interaction.

International cooperation presents a particular challenge for organizational learning that is intended to draw upon knowledge transferred between the partners, or the partners and the cooperative venture, and to build upon the potential synergies between their complementary competencies (Child and Rodrigues 1996). While alliances and other types of international organizational networking are extremely important means for international knowledge transfer and synergistic learning, they introduce special sensitivities into the process. They may be uneasy with respect to accommodating the interests of their constituent groups and to managing the cultural contrasts between them. These differences contribute to a sense of separate social identity between staff who are attached or beholden to the respective partners.

Some types of internationally transferred knowledge impinge on group social identity more than others. This is particularly true of knowledge relating to new systems and strategic understanding. Resistance to the transfer of such knowledge is likely to heighten the separate identities of the partner groups, including those doing the knowledge transfer for whom persuading their recalcitrant colleagues may take on the nature of a crusade. The relation between social identity and international knowledge transfer is a dynamic one, in which contextual factors such as the performance of the JV also play a part through inducing changes in factors which condition the process, such as partner dominance and compatibility. The transfer of strategic and systemic knowledge between alliance partners is likely to become even more difficult when there is a significant cultural difference between them. The reason is that such knowledge is difficult to interpret because of its complex, context-dependent and tacit nature (Bhagat et al. 2002; Simonin 2004). Cultural differences can therefore create barriers to knowledge transfer because they create problems of interpretation in addition to sensitivities in regard to social identity. By contrast, technical knowledge is generally less ambiguous and tacit. In addition, the sharing and transfer of technical knowledge are normally less socially sensitive, and indeed are likely to benefit from the common engineering or other occupational identity shared by the staff directly involved.

The cooperation of Western transnational companies with firms in eastern Europe provides an instructive contemporary example of the problem. Western companies are expected to make a significant contribution to the transformation of the former Communist countries of eastern Europe, not only as financial investors but also as agents for new organizational learning (EBRD 1995). This collaboration often takes the form of JVs that dramatically illustrate how social identities, stemming from the mixed social constitution of such ventures, impact upon the learning process. For example, Simon and Davies (1996) interpret and discuss barriers to learning by local managers working in IJV companies located in Hungary. They draw upon the self-reported experience of the managers, and on their own experience as process consultants in the Hungarian operation of a major multinational. They argue that managerial learning is concerned basically with role learning. Roles and the willingness or confidence to assume them are frequently linked to the social identities people hold within a particular cultural setting. The authors conclude that a major barrier to learning among Hungarian managers stemmed from the vulnerability of their social identities. In the threatening conditions of radical organizational change, and with expatriate managers often being perceived as arrogant and controlling, the learning that occurred mostly amounted to compliance, which was a strategy for survival. Their study illustrates how the social psychological conditions affecting learning are informed by a broader context of the meanings which Hungarian managers ascribe to the evolving conditions of transformation in which they find themselves.

The members of an organization will be reluctant to give up the beliefs and myths that constitute important supports for their social identity. Jönsson and Lundin (1977) write of the 'prevailing myth' as one that guides the behavior of individuals in organizations, at the same time as it justifies their behavior to themselves and hence sustains their identity. Beliefs and myths form an important part of the 'cultural web' (Johnson 1990) that sustains an existing paradigm and set of practices against the possibilities of their replacement through organizational learning. The social identities of those involved in JVs are likely to be tied up in this way with their distinctive and separate beliefs, rigid adherence to which may be sustained by their very proximity to their partners who comprise an 'other' or out-group. This proximity reinforces the sense of difference on which social identity thrives.

It is therefore perhaps not surprising to find Inkpen and Crossan (1995) concluding from their study of organizational learning in forty North American–Japanese JVs that it was a rigid set of managerial beliefs associated with an unwillingness to cast off or unlearn past practices which tended severely to constrain the learning process within the ventures. For example, American managers often failed to appreciate their Japanese partner's areas of competency. In line with the American belief in the appropriateness of formalization, these managers commonly expected that the knowledge associated with differences in skills between the Japanese and American partners would be visible and easily transferable (1995: 608). Nonaka and Takeuchi (1995: 95) illustrate from Japanese cases how, if the senior architects of an alliance recognize this problem, they may be able to undermine this rigid and blinkered thinking by deliberately injecting a sense of crisis and engendering 'creative chaos'.

## 13.8 Management of organizational learning

This closing section outlines a number of provisions that can be made towards facilitating the process of learning within cooperative ventures. It assumes that the partners share a genuine wish for integrated learning, and that their prospects for cooperation are not vitiated by the strong competitive intent of one or more partners to exploit their collaboration for short-term ends. We have seen, of course, that these assumptions do not always apply. We look first at overcoming the cognitive and emotional barriers to learning, then at reducing organizational barriers, and finally at fostering the intensive communication and circulation of information required for effective learning. These issues overlap to a considerable extent, and the provisions for tackling them should therefore be mutually supportive.

### 13.8.1 Overcoming cognitive and emotional barriers

A lack of intent to learn can be an important cognitive barrier in the way of realizing the learning potential of collaboration with other organizations. This can arise because a partner enters into an alliance for reasons other than learning, such as to spread the risks of R&D or to achieve production economies of scale, and does not appreciate that it has something valuable to learn until it becomes more familiar with that partner's capabilities. Inkpen (1995*b*: 13) found several examples of North American firms that did not have a learning intent when entering a collaboration with a Japanese partner, and developed this only when they became aware of their inferior levels of skill. Ways of reducing lack of intent to learn due to inadequate prior knowledge include programmes of visits, and (better) secondment, to prospective cooperation partners, and close examination of their products and services. The highly successful Korean Chaebol have, for example, learnt a great deal through reverse engineering of other companies' products, and investigations along such lines can enhance an intent to learn through collaboration by signaling technical and other skill deficiencies.

Drummond (1997) studied projects or programmes involving Japanese and local participants within Toshiba's consumer-products subsidiary in the UK and the Semp–Toshiba JV in Brazil. Each project succeeded in creating new organizational knowledge. A high level of managerial commitment to the projects, signifying an intention to generate knowledge through them, was one of the consistently important factors facilitating the learning process.

The emotional barriers to learning within a collaboration often boil down to a problem of mistrust. As we have seen in Chapter 4, there is no short cut to establishing trust. It is, nevertheless, possible to identify conditions which promote trust and therefore to derive practical guidelines to that end. Commitment to the relationship, and a degree of direct personal involvement by the partners' senior managers, are again important here. If the principals take the time and trouble to establish a close personal relationship, this gives confidence and a signal for other staff from each partner to regard one another in a positive light. The conditions for reducing emotional barriers to learning within a collaboration require a long-term view of the cooperation and sufficient managerial commitment, especially from the top (Faulkner 1995*a*).

### 13.8.2 Reducing organizational barriers

Serious organizational barriers are created if the senior managers of alliance partners do not know how to benefit from the opportunity to learn from their collaboration. Inkpen found that a major problem arose because of the inability of the North American parents of joint ventures with Japanese partners to go beyond recognition of potential learning opportunities to exploitation of these opportunities. They did not establish organizational mechanisms to assist this exploitation. In some cases they even resisted the idea that there was something to learn from the collaboration, so contributing to a situation of blocked learning where JV managers could not get their improved understanding carried over into practical actions (Inkpen 1995*b*; Inkpen and Crossan 1995).

The role of senior managers in an alliance is again critical, as a lever for reducing organizational barriers to learning. Managers and staff will take their cue from the senior levels. Senior managements are in a position to establish organizational procedures and provisions that foster the learning process within their cooperative ventures. Inkpen and Crossan (1995) identify ways in which provisions can be designed, or practices encouraged, by senior managers that facilitate links across organizational boundaries to promote the learning process. In the case of JVs, these include '(1) the rotation of managers from the JV back to the parent; regular meetings between JV and parent management; (2) JV plant visits and tours by parent managers; (3) senior management involvement in JV activities; and (4) the sharing of information between the JV and the parent' (1995: 609).

Control is a further organizational feature that facilitated learning in the Toshiba experience. There are two main aspects to this: (1) establishing limits to the actions of participants in the learning process and (2) assessing outcomes. Control is not usually regarded as a facilitator of learning. Indeed, learning is normally associated with autonomy and creativity, which are considered as opposites to control. However, as Drummond points out, this is to adopt a naïve view of organizational politics—a belief that those participating in learning projects will not try to direct their process towards their own objectives rather than those which benefit the alliance as a whole. Control, then, seems to be a very important condition for a learning intention to be given clear direction. The systematic assessment of outcomes should ensure that these are recorded and so entered into the organization's memory. It also provides feedback on the effectiveness of the learning process that should enable the alliance and its partners to improve their capacity to promote learning. This capacity was identified in Table 13.1 as deutero learning.

When the collaboration takes the form of a separately established JV, the leadership provided by its CEO in terms of building trust and a shared identity between staff from the two partners is critical. This means that the CEO should forcefully articulate a long-term view of the collaboration and its development. Among more specific provisions, the venture's CEO must establish adequate communications between staff who need to work together to pool their knowledge and skills, and must ensure that meetings are held to discuss views, including differences, openly. He or she must also see that there is an adequate circulation of information, sufficient personal contact between managers and staff seconded by the partners, and adequate resources of time and funding invested in activities oriented towards learning. Not least, the CEO has to generate a sense of common learning objectives through a shared identity with the collaboration, based among other things on an understanding that its members enjoy real possibilities for career progression within it.

This focus on the facilitation of learning by the people who are placed in charge of alliances or JVs derives from their critical position in the middle of the vertical system between the partners, on the one hand, and the staff working within the alliance, on the other hand. It echoes the conclusion reached by Nonaka and Takeuchi (1995) that what they term the 'middle-up-down' style of management can make a crucial contribution to fostering knowledge creation. Managers in the middle can reduce the gap that often otherwise exists between the broad vision coming down from top management and the hard reality experienced by employees. In the case of alliances, the manager in the middle is the venture CEO, who has the additional tasks of articulating the objectives for learning within the collaboration and providing the practical means to facilitate it.

The aim of the organizational provisions just mentioned is to promote the conditions for integrated learning within alliances. Another requirement, which the techniques of organizational behavior can facilitate, is to break down the hostile stereotypes which partner groups may hold of one another, and which if allowed to persist will militate against the development of trust and bonding. Many of the techniques first developed by practitioners of 'organization development' can be used to advantage in this situation, though one must remain sensitive to the cultural mix when deciding on specific methods. The 'confrontation-meeting' approach, which often works well with North American personnel, could for instance cause grave offence if tried with staff from East Asia. Once stereotypes are recognized and diffused, various techniques for team building are available to promote a collaborative approach to learning between members of the alliance.

## 13.8.2 Open circulation of information

A climate of openness can also facilitate organizational learning. It involves the accessibility of information, the sharing of errors and problems, and the acceptance of conflicting views. Drummond found that Japanese managers particularly stressed the need to share problems and make information accessible in their UK subsidiary. They insisted on the importance of documenting problems when they occurred so as to avoid them in the future. The availability of information also stimulates an awareness of new needs and concepts. It requires mechanisms to encourage the circulation of such information to the persons or groups who need it. These mechanisms are obviously more effective if the barriers to learning just described are not a serious impediment.

The idea of 'redundancy' expresses an approach to information availability which is positive for organizational learning. Redundancy is 'the existence of information that goes beyond the immediate operational requirements of organizational members. In business organizations, redundancy refers to intentional overlapping of information about business activities, management responsibilities, and the company as a whole' (Nonaka and Takeuchi 1995: 80).

For learning to take place, information or a concept available to one person or group needs to be shared by others who may not need the concept immediately. It may, for example, be information on how a particular problem was tackled creatively in another one of a partner's alliances. If that information is circulated, it is accessible to others should a comparable problem arise. Redundancy also helps to build unusual communication channels, and it is indeed fostered by the melding of horizontal with the more usual vertical channels for reporting information. In this way it is associated with the interchange between hierarchy and nonhierarchy or 'heterarchy' (Hedlund 1986) which helps to promote learning on the basis of procedures that are different from those officially specified by the organization and hence based on the solutions to old problems (Nonaka and Takeuchi 1995).

Modern IT makes a very significant contribution to the promotion of information redundancy, through its capacity for information storage and more importantly through its ability to transmit that information to virtually all points within an organization. Email in particular, offers access to information and the facility to communicate in ways that are not constrained by boundaries of time, geography, or formality. So long as the partners to an alliance link up their email systems, these provide an excellent vehicle to circulate nonconfidential information and to encourage creative commentary around it.

The case of PepsiCo, summarized in Box 13.5, illustrates how information redundancy and modern IT are used to promote learning within the company. Open and fast communication is coupled with an encouragement of local managers to act upon the information circulated to them, including initiatives to contact others within the company worldwide from whom they might usefully learn.

**Box 13.5 PepsiCo's approach to creating information redundancy**

PepsiCo is one of the world's largest global food and beverage corporations. It operates through many local alliances, and stresses the value of open communication both within its corporate systems and with its partners. An illustration of open communication with its partners is the fact that, in PepsiCo's China joint ventures, all the general managers speak Mandarin Chinese, and its Asia-Pacific budget meetings are conducted entirely in Mandarin.

Despite its size and scope, PepsiCo does not operate with organization charts or many formal procedures, but instead prefers to encourage informal communication flows and to promote the empowerment of its constituent units. As one corporate officer said, 'at the end of the day the most relevant information for me, and the job I have to do, is going to come from the people who are closest to the project ... so the lines of communication are open at all levels'. Senior officers of the corporation stress the benefits of this approach for encouraging learning.

PepsiCo circulates information within its corporate network to the point of redundancy. Its internal email system is an important vehicle for this circulation. It overcomes international time differences, permits simultaneous communication with several people, is very fast, and encourages an open, informal expression of views. Consolidated reports for different countries and regions are also widely circulated. If, as a result, managers wish to learn more about developments elsewhere in PepsiCo's worldwide operations, they have access to all the company's telephone numbers and are encouraged to make direct contacts and to decide whether to travel to the location, subject only to their travel and entertainment budgets. Many examples are told of how this rich circulation of information, and the ability to act upon it, have promoted learning and the transfer of beneficial practices throughout the corporation. For instance, it facilitated the transfer from their Hungarian operation to their China joint ventures of knowledge about ways of curbing theft on distribution runs.

*Source*: John Child, personal interviews.

## 13.9 Summary

This chapter has made the following key points:

1. There are three levels of organizational learning: technical, systemic, and strategic. Cooperation with partner organizations offers a potential to learn at all three levels. It can provide access to techniques, facilitate the transfer of new systems, and enhance a firm's ability to undertake new strategic initiatives.
2. Different forms of learning are possible in and through the formation of strategic alliances. These are learning from previous alliance experience, learning about a prospective alliance partner, learning from that partner once an alliance is formed, and learning with the partner through mutual collaboration.
3. The underlying attitude behind an alliance can be collaborative or competitive. The former allows for joint learning by both partners and is likely to be more productive over the long run. The latter creates a situation in which one partner intends to learn as much as possible from the other, while at the same time offering as little knowledge as possible. Organizational learning becomes a political football in the competitive process between the firms and this is not a sustainable situation in the long run.
4. There are several requirements for learning to take place within an alliance. The partner must have an intention to learn. It must have the necessary capacity to learn. It must also be able to convert any knowledge it gains into a usable organizational resource.
5. There are various forms of learning within cooperative relationships: forced learning, imitation, blocked learning, received learning, and integrative learning. Each of these is associated with different degrees of change in understanding and in behavior.
6. The successful promotion of organizational learning within cooperative ventures requires the surmounting of cognitive and emotional barriers; the reduction of organizational barriers, and openness of communication and an effective circulation of information.

## 13.10 Questions for discussion

1. In which ways can alliances be expected to achieve learning and generate new knowledge for their partners?
2. What are the different forms of learning that can take place within and through strategic alliances? Are some harder to achieve than others?
3. Under what conditions is learning in alliances likely to become a competitive rather than a collaborative issue between the partners?
4. What conditions are required for a strategic alliance to become a learning organization?
5. What specific policies and practices can managers introduce in order to promote organizational learning within their alliances?

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# 14 Human resource management

## 14.1 What this chapter covers

Human resource management (HRM) often finds itself some way down the priority list of strategic alliance managers, yet it can make a significant contribution to alliance success. As with all organizations, the people who work in and for them constitute their most important resource. Following the Introduction, this chapter outlines key HRM activities. It then examines the contribution of such activities to major issues confronting alliances, namely selection of personnel, the development of a common culture including building trust, control, and learning. The last section considers the broader policy issues concerning the approach to HRM in alliances, including the question of whether a leading partner should standardize its practices across different alliances and affiliates.

## 14.2 Introduction

Until recently, the human resource issues arising in strategic alliances have received rather little attention. This is despite evidence that many performance problems in alliances stem from poorly designed and executed HRM policies (Frayne and Geringer 1990). When alliances are established, the feasibility studies which are undertaken and negotiations between partners typically focus on matters of technology, markets, ownership and management structures. They often neglect HRM issues, in the belief either that these are less consequential or can be sorted out once the alliance is up and running (Drouin 2001). One study, for example, estimated that only about 4 percent of the time spent in creating collaborative ventures is devoted to resolving human resource-related issues (Coopers and Lybrand/Yankelovich, Skelly and White 1986). Yet poor adjustment by alliance managers and staff to working with their partner's personnel can lead to failures of cooperation between firms. The problem is usually more acute when the alliance involves joint working between personnel from different nationalities. American firms have, for example, been noted for a neglect of rigorous selection and training for international assignments, and this has been associated with a high failure rate among their expatriates (Adler and Ghadar 1990).

Many HRM issues have to be resolved for strategic alliances to realize their full potential. These tend to be more complex than in a unitary, domestic company, because alliances typically contain two or more cultural systems which can create conditions for conflict and which may promote personnel processes unique to that type of enterprise. As Shenkar and Zeira (1987) point out, the human resources of an IJV can comprise as many as eight different employee groups, each with their own distinct characteristics—parent company expatriates, host parent transferees, host country nationals, third country expatriates of foreign parents, third country expatriates of host country parents, third country nationals recruited directly by the venture, foreign headquarters executives, and host parent headquarters executives.

The partners to an alliance bring to their cooperation their own corporate cultures and associated HRM practices. In the case of an international alliance, the situation is further complicated by the presence of different national cultures and practices conditioned by different home country institutions, such as legal regulations and professional standards. HRM policies have to be tailored to social environments like China and many other emerging economies, which are relatively unfamiliar to western multinational enterprises.

A carefully considered set of HRM policies and practices can make a significant contribution to the success of alliances. They can assist the adjustment of corporate cultures and practices to the partnership, offer appropriate selection procedures, assist the key processes of control, conflict resolution and learning, and foster the development of staff who are capable of working effectively in a milieu of interorganizational collaboration. In these and other ways, HRM can help to enhance the productivity of alliances, as well as the ability of partners to benefit from them. The HRM activities through which these contributions can be made are recruitment and staffing, training and development, performance appraisal, reward policies, and advice on organizational design and development (Schuler 2001).

## 14.3 Key HRM activities

The key activities normally associated with HRM are:

### 14.3.1 Recruitment and staffing

This activity begins with an analysis of the jobs to be done in the alliance. This identifies the number of managers and employees required to work in the alliance, and the attributes they will need. In rational terms, the numbers and types of staff required is contingent on the scale and scope of the alliance's operations. In practice, the alliance's employment establishment can become a matter of negotiation between the partners, especially when one partner is looking to the formation of the alliance to absorb its surplus employees. Enterprises often carry an employment surplus in countries such as China, where this burden is regarded as a contribution to the well-being and stability of society. The diffusion of information about vacant positions, through advertising, employment agencies or other channels, is critical to maximizing the chances of obtaining a good pool of applicants.

Appointees then have to be selected from among the pool of applicants. The selection of the alliance's CEO or general manager is particularly critical to its success. A variety of techniques are available to assist the selection of the best candidates from those available, though the use of such techniques is not necessarily given the same weight in different cultures. For example, in some countries a job applicant who has personal recommendations and connections can be favored without much weight being given to more objective techniques.

The partners to an alliance may therefore have different customary methods for spreading information about vacancies and they may use different selection criteria and practices as well. Such differences have to be resolved, unless there is a clear division of responsibility between the partners for recruitment and selection to specific areas and/or levels of appointment within the alliance.

### 14.3.2 Training and development

Training normally refers to the improvement of specific skills, whereas the development generally refers to learning that enhances their capabilities and understanding over time. The idea of development implies that training should be a continuous rather than a one-off process. It should be associated with planning for employees to progress through the company, in a way that reconciles the needs of the alliance with individual career development. The criteria and systems for training and development have to be made with the consent of alliance partners and, again, there is not always agreement on them. The question of which partner's nominees should be developed for eventual appointment to senior management is, for instance, likely to be linked to the areas of control that each partner is to exercise in the alliance.

### 14.3.3 Performance appraisal

Performance appraisal is an HRM process that aims to assess the performance of employees against agreed targets. The establishment of such targets is more likely to be agreed in an alliance for routine activities rather than for managerial ones. As we shall see later with the case of Black & Decker–Eastern Hemisphere, methods of performance appraisal can be culturally sensitive and not readily agreed within either an alliance or a foreign affiliate company.

### 14.3.4 Rewards

Rewards can be monetary or take a nonmonetary form such as being accorded public recognition within an organization for job-related achievement. They can become extremely sensitive issues within an alliance, especially an international one that has staff who come from different cultures and labor markets. For example, in an IJV between an MNC and a local company from a developing country, the tendency to pay expatriate managers seconded from the MNC at much higher rates than local managers usually gives rise to strong feelings of inequity. Similarly, difficulties can arise because it is customary in the culture of one JV partner to have public recognition of staff performance, whereas in the other partner's culture this is kept very discreet.

### 14.3.5 Organizational design and development

Organizational design and development are sometimes seen to fall outside the remit of HRM, especially questions of organizational structure and strategy. Potentially, however, staff who are well versed in HRM issues have a lot to contribute on matters of organizational design especially their likely personal and interpersonal impact. For instance, the structure of an alliance's hierarchy will impact on the quality of communications and it may be regarded in a different light by the partners' employees if they come from cultures that have contrasting expectations about the psychological distance between themselves and top management that is appropriate. Informed advice on matters such as these can make a considerable contribution towards the smooth running of an alliance.

Organizational development focuses on the process of facilitating change that is intended to adapt an organization to meet new circumstances and to improve its general performance. As we point out in Chapter 13, many alliances are formed to promote technological innovation and other forms of learning. An HRM input can help the development of supportive organizational forms and practices, such as offering training in effective teamwork and establishing selection procedures so that suitably qualified staff are recruited to learning teams.

The above human resource management activities are, in principle, mutually supporting and the links between them can be shown in the form of an 'HRM Cycle' (Figure 14.1.). Organizational design and development are not shown in the Figure because they bear upon all the more specific activities that are shown.

The logic of the HRM cycle is as follows. Recruitment and selection that is effective in matching people's capabilities and personalities to the roles that need to be performed will raise their chances of achieving satisfactory performance and in this way contribute to the performance of the whole alliance. The performance of alliance members needs to be appraised against appropriate criteria in order to determine their remuneration and other rewards, or at least the element in the reward package that is variable and formally

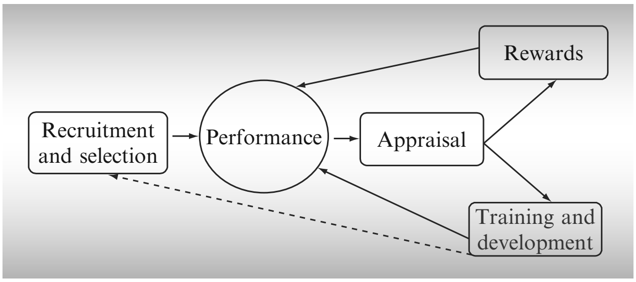


**Figure 14.1** The HRM cycle.

related to performance. A reward system that is regarded by managers and employees as both fair and meaningful (in the sense that the rewards are valued and seen to be attainable) can be expected to reinforce their commitment to achieving high performance. By contrast, a reward system that is not seen to be either fair or reasonable is likely to have a negative impact on performance. If there is no link between rewards and performance, the reward system will lack motivational impact. Hence, the HRM cycle depicts a feedback loop from rewards to performance. An effective appraisal process can at the same time serve to identify opportunities to develop the capabilities and skills of alliance members. Effective training and development policies are expected to have a positive impact on their performance. If the appraisal process consistently exposes substantial development needs, or there are deficiencies in capabilities and skills that training and development programs cannot put right, this implies that the selection process used for the alliance is deficient. In the light of such feedback, shown in Figure 14.1 by a dotted line, the alliance will need to modify the criteria and techniques that it is using for selection.

## 14.4 HRM and alliance formation

Drouin (2001) concluded from examining the contribution of HRM to alliance performance that it was critical for human resource issues to be considered early in the formation process. HR issues have to be negotiated and worked on at the preoperational stage of a new alliance. Practice is often very different. With the exception of items entering into due diligence, such as the pension fund liabilities that might arise when taking on some of a partner's workforce, HR issues are rarely given much attention during alliance formation. This means that there is a widespread failure to treat HRM as a strategic issue when alliances are formed.

One area that requires careful consideration at the outset is recruitment and selection. How will suitable staff be chosen for the alliance? How will the partner companies fill key positions and can they agree on the criteria for making such appointments? There are a large number of options that have to be considered for each position within the alliance. One is to transfer or second staff from a partner company on a short-term basis of, say, three years to the alliance to fill managerial, technical, and operational positions. Alternatively, staff can be recruited from outside the partner companies because of their special attributes. For instance, some alliances between Mainland Chinese and international firms have recruited overseas Chinese expatriates to serve as general managers in the belief that they can offer a combination of business experience, cultural sensitivity, and neutrality as between the different parents. Many of the more routine positions in the alliance are likely to be filled by staff recruited from the local labor market (Zeira and Shenkar 1990).

New business development managers are normally the people responsible for making a new alliance happen. Business development managers provide the main linkage between the parent companies during the negotiation process. They may well have the primary responsibility for finding and selecting a potential partner, and they usually play the major role in negotiating the alliance agreement. Negotiation is not just a question of hammering out the terms of a deal and then closing it. It is also a process of building a new relationship and creating trust between the partners, both of which are vital for the subsequent success of the venture. Two key consequences follow from this:

1. The selection of the business development manager, or other person, to lead a partner's negotiating team is critical for the entire alliance process. The more knowledge and experience this person has, the more likely is the alliance to be a success. If it is an IJV that is being formed, the experience should ideally be of previous IJVs. As his or her experience builds up, the business development manager will become increasing essential, so that it becomes very important to develop the incentives to ensure that the individual remains with the company (Lei et al. 1997).
2. Ways need to be found to carry forward the trust and good relationships formed through a successful negotiation into the operations of the new alliance. This is particularly important if one or more of the partners comes from a culture, such as those of East Asia, in which personal trust is highly valued as a basis for doing business and working together. This requirement can present a real difficulty because business development specialists will normally move onto a fresh assignment once an alliance is formed. While this represents a good use of their specialist competencies, it also means that the relationships they have formed with their opposite numbers and others involved in the negotiation can fall by the wayside. It is therefore appropriate, as soon as agreement is reached on who will serve as the alliance's CEO, to bring that person into the negotiation process so as to establish his or her good relations with leading staff from each partner and to maximize his or her ability to participate in laying down policy guidelines for the alliance's operation. If this is not done, there can be a serious and damaging hiatus between the negotiation and operation of the alliance.

## 14.5 HRM and qualities required of alliance managers

As in any organization, it is vital to select people to fill the leading positions of an alliance with great care in order to ensure they have the required qualities. Chapter 10 on alliance general management emphasized the fact that cooperative strategies cannot be implemented without managers who have the appropriate abilities and competencies to make them work. It is important to assess what these qualities are so that programs of personal development can be oriented towards them. A further need is to ensure that the corporate career system recognizes the importance and responsibility of roles directly concerned with making alliances work. A common problem is that alliance partners may not be willing to provide their best managers, or specialists, to the alliance. This can arise because the partners do not value the alliance sufficiently, or because they fail to communicate adequate opportunities to move to the alliance. The alliance's HRM function should be concerned to make sure that all these requirements are in place.

A symposium organized by the American Society for Training and Development listed the 'traits' of the future executive (Galagan 1990). Since the future for many corporations has already become one of operating in the global market, making increasing use of cooperative strategies, this list provides quite a good basis for identifying the kind of skills required by alliance managers. The skilled future executive is one who:

- has a global vision and understanding
- facilitates the vision of others
- intuits the future rather than predicting it from the past
- recognizes need for continuous learning
- facilitates the initiative of others in addition to using authority
- specifies processes
- operates as part of an executive team
- accepts the paradox of order amid chaos
- is multicultural
- inspires the trust of a wide range of stakeholders, including alliance partners

The personal characteristics from which these traits can most readily be developed are open-mindedness, flexibility, self-confidence, sensitivity to others, and a multicultural experience, together with the basic requirements of ability, drive to achieve, and necessary technical knowledge. In selecting managers and employees to work with alliance partners, HRM departments should assess the extent to which candidates possess these characteristics.

Lane and DiStefano (1994) identify seven abilities that constitute 'a profile of effective global executives'. These are equally necessary for managers involved in purely domestic alliances, except that the first would require amendment to 'strategic skills in the domestic market'. The abilities are:

- to develop and use global strategic skills
- to manage change and transition
- to manage cultural diversity
- to design and function in flexible organization structures
- to work with others and in teams
- to communicate
- to learn and transfer knowledge in an organization

This list provides a useful point of reference against which the adequacy of a company's HRM activities to develop alliance managerial skills can be assessed. It encompasses a wide range of abilities which, taken together, demand a great deal from any single manager. They certainly require time and experience to develop. Quite often a team of people from one partner share in the management of an alliance with staff from the other partner, and this should allow some spread of the necessary qualities between them. Nonetheless, as is emphasized in other sections of this book, the abilities to communicate, work with others, and manage cultural diversity are particularly fundamental ones for managers to be effective in a cooperative context.

Several of the abilities in the list are considered in more detail in other chapters. Adapting leadership and control to the flexible condition of alliances was addressed in Chapters 10 and 11. Managing cultural diversity is discussed in Chapter 15. The ability to learn and transfer knowledge is central to Chapter 13. The management of change and transition runs through several Chapters, particularly 13, and 18. The question of strategic awareness also enters into policy on learning within alliances. The motives behind cooperative strategy were the subject of Chapter 5. The two remaining abilities are, however, absolutely central to the management of cooperative relationships themselves, and HRM can do a great deal to develop them. They are the ability to work in teams and the ability to communicate.

### 14.5.1 The ability to work in teams

The ability to work in teams is becoming ever more essential along with the increasing number of specific competencies companies have to bring together, whether through alliances or on their own. The range of necessary competencies widens as product portfolios become more comprehensive, as more geographical markets are entered, and as a growing number of external groups become relevant including governments, environmental and community bodies. In some cases, alliance partners are expected to offer some of these competencies, this in turn adds to the work that has to be accomplished jointly with partner staff in meetings and in teams. The competitive advantage that can result from working closely together with suppliers and customers also places a requirement on effective teamwork that crosses the boundaries of organizational, if not national, cultures.

The development of managers to work effectively in teams can build on both the task and maintenance functions that have been identified as necessary for successful group dynamics (Cartwright and Zander 1960). The task side requires an understanding of the necessity for objectives, targets, timetables, and procedures to be agreed by members of the team. The way this is accomplished may require some working through cultural differences about, for example, the value of explicit as opposed to implicit group norms. The maintenance side is concerned with sustaining the emotional tone of the team so that its members remain willing to work constructively with each other and committed to the achievement of the team's purpose. Recognition of the need for this function can be generated through reflection on the experience of group processes. Exposure to these processes can be provided through role-playing and incorporated into a training program intended to enhance whatever learning has previously taken place through a person's team working experience. Teams can generate a high level of internal emotion, particularly those bringing together diverse views while under pressure to achieve results. It is therefore particularly important to develop people's sensitivities to the interpersonal and group processes which are involved, so that they can better cope with them constructively.

### 14.5.2 The ability to communicate

The ability to communicate is an even more basic requirement. The particular communication abilities that alliances require, especially international ones, are multilingual skills and high levels of cross-cultural awareness and sensitivity. Sensitive communication is an aid to the building of trust and the promotion of an awareness of the common goals that an alliance has been established to pursue. The manner of communication must not be ethnocentric if it is to be acceptable to the recipients. The technologies for communication that are available today, such as electronic mail, video-conferencing, and video-phoning, can do much to promote its reach within an alliance or even network of alliances. These technologies can also be adapted to the forms of presenting and disclosing communication which are mutually acceptable to partner organizations.

## 14.6 Career opportunities

As a company enters into cooperative alliances, especially those with partners in other countries, it needs to adjust its policies on career development in order to ensure that appropriate staff will be willing to take up positions of alliance management. The managers and other employees it appoints to, or hires for, its alliances should not suffer career disadvantages compared with those who advance through purely 'in-house' positions. Otherwise, it will be difficult to attract people with the required abilities to undertake roles in the alliance and the significance of the company's cooperative arrangements will be devalued. This can be a particularly serious problem for a firm that has begun the process of internationalization through alliances, but has not reached the point where its global business is significant in relation to its domestic business. In these circumstances, managers who are assigned to overseas alliances tend to find re-entry into the company's mainstream activity and career lines very difficult. They may well have grown used to a level of decision-making autonomy and breadth of responsibilities that it is difficult to match within the domestic structure, even with promotion. Perhaps more significantly, they may well become marginalized in terms of the informal corporate power system. Such managers rarely make it to the top of the corporate hierarchy, and there is a danger of losing them to competitors (Adler and Ghadar 1990).

An increasing number of companies have, however, already developed global lines of business and are proceeding to build complex networks of JVs, subsidiaries, and project alliances which are intended to align the advantages of local responsiveness, global integration, and learning (Malnight 1996). This places a premium on those companies recognizing the importance of the managers who are implementing these networks of cooperative arrangements and adjusting their career opportunities and compensation packages accordingly. The development of corporate networks coordinated by regional units will eventually blur the distinction between 'in-house' and alliance management roles sufficiently for the problem to recede. The intensification of communication between all a company's units, using electronic media, should also promote the same effect.

As these developments proceed, corporate cultures and career structures are likely to become increasingly transnational.

In many of the emerging markets, other HRM problems arise because of specific local conditions. These may, for example, be widely regarded as hardship posts with many staff, and their families, reluctant to take up positions of alliance management there. Good experienced local managers may be in very short supply, with the result that market forces jeopardize orderly compensation policies. China, which is the most significant emerging market in the world today, exemplifies many of these special HRM problems and is discussed later in this chapter.

## 14.7 The development of a common culture and trust

For an alliance to realize its full potential, there has to be not only a match between the partners' strategic objectives and the resources they contribute, but also a fit between their respective cultures and practices. IJVs are the form of alliance in which achievement of this cultural fit is likely to present the greatest difficulties. Communication blockages and conflicts of loyalty are among the personnel problems most often highlighted by research into IJVs (Shenkar and Zeira 1987). Barriers to communication between IJVs and parent companies, and between the parents themselves, can easily arise not only due to geographical dispersion but also because differences of culture and organizational identity are obstacles (Child and Rodrigues 1996). Similarly, loyalty problems arise if there is not a reconciliation of the values and goals expressed by the different groups involved in the set of relationships in and around IJVs.

Appropriate HRM policies can play an important role in fostering a shared corporate culture that articulates goals and standards for the alliance, and a willingness to adopt common practices in the pursuit of those objectives. These are further reasons why careful thought needs to be given to the selection criteria applied to managers and staff who are recruited to work in and with the alliance, both from within the parent companies and externally. These criteria should refer not just to required technical competencies, but also to the openness and flexibility of candidates' attitudes towards working in ways that are compatible with those of the partner companies. The attitudes and behaviors helpful to the success of an alliance can be further developed through training and reinforced by the systems adopted for performance appraisal, reward, and promotion. Depending on the nationalities involved in the alliance, training in partners' national cultures and languages can be a most important step towards breaking down internal cultural barriers and blocks to mutual understanding. This rather obvious point appears to be widely accepted in principle but less often carried out in practice, judging by evidence from alliances in Eastern Europe (Villinger 1996).

It is particularly important that the partners' staff who have to work together do receive language instruction (where relevant) and training designed to promote their understanding of the partner's culture, national institutions, mind-sets, and codes of behavior. This preparation will not compensate for errors in selection that result in people who are intolerant, inflexible, or otherwise ill-suited to working with other organizational or national cultures. It will, however, enable those who are well chosen to avoid some of the pitfalls that can otherwise jeopardize the effectiveness of cross-partner teams and meetings. The facility and willingness to converse, at least to some degree, in the partner's language expresses goodwill and in so doing opens the psychological door to further communication.

An appreciation of the likely cultural or political sensitivities of a partner's staff can avoid unnecessary conflict and mistrust. For example, in collective meetings with East Asian staff, it is vital not to place individuals into a position where they are shamed before their colleagues—this is culturally an extremely sensitive matter. This does not mean, however, that opinions and evidence should not be challenged in the management meetings held by, say, a Sino–western JV. What it requires is that care and time has to be taken over the course of several meetings to move towards a shared understanding that everyone present, especially the senior foreign manager, can be questioned in a courteous way without any face being lost, and that this amounts to a 'testing of reality' which is of benefit to everyone in carrying out their work. The aim, in this case, is to blend the personal courtesy of the East with the open enquiry of the West. It is much more difficult to achieve this if the partners' HRM routines do not include suitable briefings and role-plays to prepare staff for these situations.

The approach to communications and information flow pursued within the alliance can also support the objective of achieving a positive cultural adjustment. Communication policies can be adopted to create awareness among employees of the reasons for changes that are underway within the alliance and how these relate to its *raison d'être*. A company newsletter can be an important source of information about the vision and philosophy of the alliance, and efforts can also be made for information on policy and other developments to be displayed regularly in areas where employees have access. Regular meetings between partners' managers and staff may also be another means of enhancing communication. An emphasis on communication, of course, requires that there is a good strategic fit between the partners and that the joint message they give out is therefore positive and sincere; otherwise the exercise is likely to be counterproductive.

Chapter 4 offered guidelines for the development of trust within alliances. The most fundamental basis for developing trust is for the partners to reach a realistic, clear, and acceptable set of mutual commitments toward achieving the success of their partnership. Some of these commitments relate to the management structure for the alliance and the questions of who will occupy key alliance positions. We noted in Chapter 11 that a number of different solutions are possible here. The key is that the partners perceive the allocation of managerial positions to be fair and acceptable. Fundamental arrangements of this kind may be agreed with the distribution of power and control over the alliance in mind rather than simply who is most competent to take responsibility for the different functions within the alliance. As such they will fall outside the normal scope of HRM intervention. However, an informed HRM view will certainly be helpful in advising on questions of appropriate competence and how best to select for this.

HR specialists can contribute importantly to facilitating the conditions that assist mutual trust to develop within an alliance once it is formed. These include:

1. Systems to ensure that there is adequate communication and sharing of information within the alliance and between its partners.
2. The selection of people to manage and work in the alliance who are sensitive to the concerns and cultures of others.
3. A procedure for resolving conflicts, and a process whereby HR consultants can be made available to work through cultural misunderstandings and interpersonal conflicts with the personnel concerned.
4. Policies to encourage the development of mutual bonding between alliance personnel, such as ensuring that periods of appointment and secondment to the alliance are of sufficient length and arranging a program of regular social activities in which staff are encouraged to participate.

Cyr and Schneider (1994) cite the case of a JV between a Swedish multinational and a Hungarian company in the field of telecommunications, where a conscious attempt was made to create a new organizational culture based on mutual trust. This culture emphasizes people as well as excellence in products and services, and the results for the venture were claimed to be impressive. There was a sound base for the development of a shared culture because the JV was considered beneficial to both partners. The Swedish company wished to establish a presence in East European markets and was also attracted by the lower costs of operating in Hungary. The Hungarian partner welcomed the opportunity to learn new technologies and the creation of more employment. The development of the new JV culture was promoted by a number of HRM policies, summarized in Box 14.1, which appeared to have achieved this aim. A survey of employees indicated that they generally perceived foreign and local managers to have the same goals, that cultural differences were respected, and that the JV had a good long-term future. There was less satisfaction with other matters, such as the persistence of a language barrier and the lack of a bonus system, but the efforts devoted to HRM had resulted in a high level of cultural compatibility.

## 14.8 HRM practices as control mechanisms

Frayne and Geringer (1990) consider the role of HRM practices as control mechanisms. They refer particularly to IJVs in which the control exercised by partners may be an issue of acute concern because many such alliances are between competitors. We saw, however, in Chapter 11 that control is a general requirement in alliances, in part to make sure that the contributions made by partners are implemented satisfactorily. Controls to support the quality standards associated with a partner's respected brand names provide a familiar example of this need.

The recruitment and staffing of a JV, especially those in senior positions, can be a crucial control mechanism. It not only adds to the formal control rights provided by equity share; it may provide an important basis for the exercise of control even for a

**Box 14.1 HRM policies promoting the development of a new culture for a Swedish–Hungarian JV**

1. A sharing of responsibility through the appointment of Hungarians to key positions within the JV, including general manager, financial controller, and HRM manager.
2. Promoting awareness of the other partner's culture, including the organization of visits by Hungarians to the Swedish company.
3. The use of various mechanisms for information exchange, including electronic mail (with linkages to all other companies in the Swedish group), a newsletter published in Hungarian and English, regular senior management meetings (usually weekly), departmental meetings, and occasional 'brainstorming' sessions for managers.
4. A high priority given to training. For example, US$1.36 million was spent on the training of Hungarian engineers in the first year of the JV. Some of the training content covered the behavioral norms of the Swedish partner company.
5. Payment levels which are somewhat higher than those for similar jobs in the area, with salary increases partly determined by performance appraisal.

*Source*: Cyr and Schneider (1994).

parent company that has a minority ownership (Schaan 1988). Even when the alliance does not involve the establishment of a new joint organization, the assignment of capable members of its staff to joint teams, meetings and other activities is likely to be a necessary condition for a partner to exercise influence as well as to learn from the other partners. Research by Child and his colleagues in Sino–foreign JVs has also indicated that the holding of senior management positions, especially the posts of general manager and financial manager, is a basis for partner influence. The staffing of senior positions added to the control leverage offered by equity share and the provision of key noncapital resources (Child and Yan 1999).

The staffing of an alliance is an issue, that needs to be considered at a very early stage in its formation, for decisions taken then have major consequences. A key decision concerns who is to participate in the formation process. Selection of people who have the required technical competence, authority within their companies and interpersonal skills can assist the successful formation and management of an alliance. They are likely to promote confidence and trust among the partner(s), and be able to champion the alliance within their own company. These qualities improve their chances of securing their company's negotiating priorities. If they retain a connection with alliances once they are formed—serving, for instance, as the first general manager—they should both be able to capitalize on the trust they have established for the benefit of the alliance and, at the same time, enjoy the authority to exercise considerable control over it. Future expansion of the cooperation will usually require both additional investment from the partners and support from authorities and influence groups in its particular location. Key appointees of the kind we have mentioned are in a good position to develop the necessary internal networks within their own parent company and the external ones to the partners and the local environment.

Frayne and Geringer argue that the training and development of alliance employees can also be a control mechanism. They see this aspect of HRM offering three specific control benefits (1990: 59–60):

1. By removing performance deficiencies, training and development can improve the employee's ability to perform better and so allow the organization to become more effective.
2. Training can be used to encourage people to think and behave in ways consistent with the parent companies' cultures, objectives, and interests.
3. Training can also be used as a mechanism to establish and maintain a unique culture for the alliance that is appropriate to its specific circumstances.

The Swedish–Hungarian JV previously mentioned provides an example of how training was used in these ways.

Performance appraisals are a further HRM practice which partners can employ in their efforts to exercise control in their alliances. They help to identify training and development needs, provide a point of reference for the provision of incentives, and permit partner companies to monitor progress towards the attainment of critical objectives for their cooperation. It is also important that the performance evaluation criteria and methods used are suited to the specific circumstances of the alliance. Many alliances are formed in order to develop a field of technology, or a geographical market, which is novel to one or all the partners. Their established systems of performance evaluation may well not be entirely relevant to the new circumstances. There is evidence that, even when this point is appreciated, parent companies tend to employ the same performance evaluation methods for their alliances as they use for other of their operations which are located in more conventional, stable, and low-risk settings (Anderson 1990).

The need to pay attention to local circumstances also applies to the use of compensation and reward practices as a control mechanism. At the local level, compensation systems are intended to control the quality and contribution of employees by attracting good recruits, motivating them to perform, and retaining them within the alliance. The retention of good managers and employees can be facilitated by tying bonuses and possibly career paths to the attainment of the alliance's long-term strategic objectives. This may, however, encourage the staff in question to identify exclusively with the alliance rather than with the partner company. We point out in Chapter 18 that a strengthening identity with the alliance rather than the parent companies may be an attribute of the alliance's successful evolution over time, and that it is a matter on which the parent companies have to take a considered view. Problems may also arise if the rewards a company offers diverge substantially across the various partnerships in which it is involved, and between such partnerships and its own core units. Multinational enterprises are for this reason now tending to reduce the additional payments and allowances they often used to offer to expatriate staff.

The use of HRM practices as control mechanisms within a cooperative strategy evokes the cooperation–competition dilemma identified by game theory (see Chapter 3). On the one hand, in order to promote effective collaboration between partners, they should seek agreement on the matter of how their alliance's human resources are to be managed.

On the other hand, the strategic management of human resources can be a valuable mechanism for securing influence over an alliance to protect a firm's interests when these do not wholly coincide with those of its partner. If authority over human resources and HRM policy is shared with a partner in these circumstances, the abdication of control and of opportunities to make appointments that are critical for learning from other partners may place the firm at a severe disadvantage. The contribution of HRM policies to learning in and through alliances is examined in the next section.

## 14.9 HRM policies and organizational learning

Pucik (1988*a*,*b*) draws attention to the key role of HRM policies in the context of strategic alliances that involve competitive collaboration. Such alliances are between competitors, for whom 'the change from competitive to collaborative strategies is often merely a tactical adjustment aimed at specific market conditions . . . The objective is similar: attaining the position of global market leadership through internalization of key value-added competencies' (1988*a*: 78). Unlike the physical resources which may be contributed to alliances, competencies are fundamentally information-based invisible assets, that cannot be purchased, whose market value cannot easily be established, and which are difficult to control. They include management and organizational skills, knowledge of the market, and technological know-how.

Invisible assets are embodied in the people within organizations. Pucik argues that, in situations of competitive collaboration, a company can only preserve its competitive advantage through being better at accumulating competencies than its partners. This means basically that it has to achieve a superior organizational learning capacity. Since the object of this learning is knowledge embodied in people, 'the object of . . . HRM activities is to complement line management in providing a supporting climate and appropriate systems to guide the process of learning' (1988*a*: 81).

The significance of this point has been illustrated by the experience of many Western JVs with Japanese partners (Pucik 1988*b*; Hamel 1991). Pucik studied twenty-three existing or dissolved JVs that US and European manufacturing firms had established in Japan. The results, for the Western partners, were mostly disappointing and to the advantage of the Japanese partners. He concluded that many of the reasons for this poor performance had to do with poorly designed and executed human resource strategies (see Box 14.2).

Pucik (1988*a*) identifies failures to support competitive learning in five main areas of HRM. First, a partner company may lack adequate human resource planning for its alliances, so that its strategic intention in the alliance is not communicated to its staff, learning is given a low priority, and there is a lack of involvement by the human resources function in matters such as staffing the venture. Staffing is the second area that may be neglected. For instance, low quality staff may be assigned to the venture, or staffing may be left to the other partner. Third, the training of both the partner's staff and that of the alliance may be neglected, particularly in matters such as language and crosscultural competencies which can be vital in opening doors to the other partner's know-how.

**Box 14.2 Human resources practice and competitive learning: The case of Western JVs in Japan**

Evidence collected by Vladimir Pucik from interviews with Western and Japanese managers of twenty-three US and European manufacturing firms having JVs in Japan showed clearly that the execution of a successful competitive strategy in the Japanese market was often severely handicapped by deficiencies in the human resource system. So many times, the Western firms underestimated the critical role of HRM strategies for the long-term viability of the cooperative venture. This was in contrast to the behavior of the Japanese partner where human resource concerns were often close to the top of the managerial agenda.

'The strategic intent of most Japanese partners in the joint ventures studied was often to learn as much as possible about technology contributed to the joint venture by the Western firms. A carefully implemented human resource strategy secured a rapid diffusion and assimilation of the newly available know-how to the Japanese parent, while, at the same time, very little of the local knowledge filtered back to the Western parent. Without such a reservoir of local knowledge, the Western firm's freedom of action in the Japanese market was greatly reduced.

From the typical Japanese perspective, control over human resource strategies should over time push the joint venture firmly into the orbit of the Japanese parent firm. This was happening irrespectively of the actual distribution of the equity in the joint venture or the initial input or know-how. As confided by the Japanese president of a fifteen-year-old joint venture where the Western partner was the majority owner: ''We have constant problems dealing with our guests from overseas. They believe that because they own 65 percent of us, they are entitled to exercise control. But obviously, that can't be the case.''

In this particular venture, the main office was in a building next to the headquarters of the Japanese partner. More than half the top managers were seconded from the Japanese parent; all others, except for a single expatriate without language skills, also came from the Japanese parent firm when the venture was originally formed. New employees were recruited through the personnel office of the parent. Recruiting materials did not even mention that fact that the majority owner of the company is a foreign firm. Training programs at all levels were contracted out to the Japanese partner. The level of bonuses paid to all employees paralleled closely bonuses paid at the parent firm. Under these conditions, the president's statement is rather natural.'

*Source*: Pucik (1988*b*: 496).

Fourth, the company's performance appraisal and reward systems may not encourage learning and the transfer of know-how. Fifth, the company's organizational design and control systems may not allocate clear responsibilities for learning, or provide the means for bringing together the people who have access to the other partner's know-how. Control over the HRM function within the alliance may also be given away.

In recognition of these problems, Pucik advocates the adoption of a ten-point plan for the HRM function in firms engaged in alliances (particularly international ones) that seek to incorporate a continuous organizational learning capacity into their strategy. The ten points are (1988*a*: 89–91):

1. Get the human resource function involved early, at the stage of forming an alliance.
2. Build learning into the partnership agreement; for instance, by agreement on the exchange of personnel.
3. Communicate the company's strategic intent vis-à-vis the cooperation.
4. Maintain HRM input into the alliance.
5. Staff up the alliance with the purpose of learning.
6. Set up learning-driven career plans, including repeat assignments to the alliance.
7. Use training to stimulate the learning process; for instance, in team-building and crosscultural communication.
8. Responsibility for learning should be specified; for instance, include learning objectives in the business plans for managers transferred to the alliance.
9. Learning activities should be rewarded, so that, for instance, expatriate transfers into critical locations are made sufficiently attractive.
10. Monitor the HRM practices of the other partner, and the pattern of staff assignments to and from the alliance made by the partner.

## 14.10 Fundamental policy issues for HRM in international alliances

### 14.10.1 A strategic approach?

Strategic HRM, as it has come to be known (Fombrun et al. 1984), advocates that HRM policies and practices should be consistent with the strategic objectives of the organization concerned. It is an approach that regards the primary contribution of HRM as enhancing the contribution of 'human assets' to a firm's performance rather than reflecting a commitment to employees and their welfare. Many would maintain that these two orientations are not necessarily in conflict (e.g. Cascio 2002), though pressures to reduce costs can, for example, make it difficult to reconcile the two.

The extent to which HRM is accorded a strategic role is a key issue for strategic alliances as well. Drouin (2001) concluded from her research on seven IJVs involving two Canadian telecommunications firms that there are performance advantages for companies that do adopt a strategic approach to HRM, especially during the formation of alliances. Subsequent performance benefits accrue when alliance partners:

1. are sensitive to the requirements of HR concerns in complex multicultural contexts. For example, the partners take care in selecting members of the core alliance team who are culturally sensitive and who take a positive approach toward building relationships.
2. give attention and time to fostering good quality communications between the partners and between their staff working within the alliance.
3. attach importance to organizational learning and orient HR policies and practices toward fostering learning.

Although in practice, HRM is often not regarded as a strategic activity within alliances, the evidence we have from Drouin's work and other recent research (e.g. Pfeffer 1998; CIPD 2001) suggests that a strategic approach does pay performance dividends.

### 14.10.2 Standardization?

One of the issues that multinational corporations have to resolve when forming alliances with local companies is whether to try to apply their standard HRM practices or whether to adapt these to local conditions. MNCs face two significant but usually contradictory pressures. One pressure is to integrate their practices across all their operations globally—global standardization. The other is to adopt practices that are suited to local conditions—local responsiveness.

The advantages of global integration lie in the possibility of applying to an alliance what is believed to be international 'best HRM practice', the greater ease of monitoring and maintaining standards of practice and, for the MNC partner, the integration with its global activities and operations that standardization permits. On the other hand, localization takes account of factors in the alliance's immediate context that impact on what is possible or functional for HRM practice. For example, if local labor market rates of pay are substantially below those in a partner's domestic economy, it will not necessarily wish to apply an internationally standard structure of payment. Similarly, if the skill and competence levels of local employees and managers are substantially below those prevailing in its other operating locations, an MNC partner may have to accept an approach to the design of jobs and allocation of responsibilities that differs from the one it applies elsewhere.

Lu and Björkman (1997) examined how these two pressures had been resolved for HRM activities in a sample of sixty-five JVs between Western MNCs and Chinese firms. They found a fairly high degree of accord with the MNC partner's standard international practices in some activities, notably:

1. Performance appraisal.
2. Criteria for financial reward.
3. Promotion criteria.

One reason for the greater standardization of practices in these areas is that they were highly controlled by the MNCs. Another is that many of the foreign parent companies did not regard local practices as appropriate for developing competitive human resources. This was evident in the case of appraisal schemes, which the foreign IJV parents wanted to use detailed measures linked to specific task objectives. In contrast, local practices tended to emphasize the quality of a manager's personal relations and attitudes toward colleagues. The case of Black & Decker–Eastern Hemisphere, summarized in Box 14.3, illustrates that appraisal is likely to be a particularly sensitive cultural issue in international alliances, where a difficult decision may have to be made between introducing a globally standard practice or one adapted to the local context.

In other areas of HRM practice within the China–Western IJVs that Lu and Björkman studied, there was greater responsiveness to local conditions:

**Box 14.3 Black & Decker–Eastern Hemisphere and the attempt to introduce the appraisal development plan (ADP)**

Black & Decker–Eastern Hemisphere (B&D–EH) is a regional group within Black & Decker, the world's largest producer of power tools, electric lawn and garden tools, and related accessories. It is headquartered in Singapore and is responsible for the Middle East, Africa, the Indian subcontinent, all of Asia-Pacific, and Australasia.

In 1996, the then recently appointed president of B&D–EH had to decide whether to introduce the company's US-designed performance appraisal and management development plan—the ADP—or a hybrid alternative presented to him by the regional HRM manager. A key feature of the ADP was a 360-degree performance procedure that provided each employee with feedback from subordinates and peers as well as from their manager. The alternative advocated by the local HRM manager was an 180 degree procedure that involved feedback from a manager but not from peers or subordinates. She argued that Asian people would not be willing to provide open feedback on their peers or their boss; that they would not believe in the confidentiality of the ADP system; and that a change in one step from the existing MBO system to ADP would be too radical to gain support.

The CEO has seen the positive effects of adopting ADP in the USA. It had encouraged people to work together and therefore had the potential to build a highly effective team. On arriving at B&D–EH, he had found a major disparity in the management styles being adopted, including some downright bad management. Black & Decker was also seriously underperforming in Asia compared with other regions. There was pressure to apply ADP as a proven corporate system despite the doubts being raised as to its suitability for the culture of the region.

*Source*: Black & Decker–Eastern Hemisphere and the ADP Initiative. Case study 9A98G005, Richard Ivey School of Business, University of Western Ontario, Canada (1998).

1. Recruitment methods
2. The amount of training provided.

One of the local factors affecting the approach to recruitment was whether the IJV was established at an already operational site owned by the local partner. If this were the case, recruitment from external sources was reported to be difficult since the local partner preferred the IJV to accept all or most of its existing employees. The content and amount of training provided was also influenced by local skill levels as well as the more general need to introduce Chinese managers to the nature of operating in a market system.

China is at the time of writing the world's largest recipient of foreign direct investment and therefore the home to a very large number of IJV and other alliances between local and international companies. It is still engaged in a long process of economic reform that is taking it away from its communist and closed economy past and towards an open market-based economy. China's accession to the WTO in December 2001 is accelerating this process. Because HRM practice is particularly sensitive to the local social and political context, and bearing in mind China's significance within the international business world, it is worthwhile before closing this chapter to examine some of the distinctive HRM issues that can arise in the management of foreign JVs there.

## 14.11 HRM issues in the management of Sino–foreign joint ventures

There are somewhat over 200,000 foreign-invested enterprises registered in China, mainly comprising EJVs and wholly-owned subsidiaries. These enterprises now play a very substantial role in the Chinese economy. They account for approximately 30 percent of the country's gross industrial output by value, and almost 50 percent of its total foreign trade. Larger foreign companies, especially the multinationals, are endeavoring to introduce international 'best practices' in the field of HRM. In so doing, however, they can encounter a number of challenges from local Chinese conditions in each of the key areas of HRM—recruitment, training and development, performance assessment, and compensation (Farley et al. 2004; Warner 2004).

There are several aspects to the HRM issue in China. At the level of overall policy, Chinese and foreign conceptions of the human aspects of management differ so substantially that it is a major innovation to introduce many western or Japanese HRM procedures into alliances which are overwhelmingly Chinese in their staffing (Easterby-Smith et al. 1995; Warner 2003). In China, the linking of rewards to performance, the use of appraisal as a support for personal development, and employer discretion in hiring and firing, have not been elements of normal practice (Von Glinow and Teagarden 1988). It may therefore be difficult to implement an HRM policy which is agreed between the Chinese and foreign partners not just because of incomplete congruence between their goals, which can arise in any alliance, but also because of the different cultural understandings which underlie approaches to personnel management (Shore et al. 1993; Boos et al. 2003). This creates a dilemma over the most appropriate appointment to head the HRM area—should this be a nomination of the Chinese or the foreign partner? In the short-run, a Chinese nominee will have the advantage of understanding local conditions and norms. In the longer term, however, a foreign nominee may be instrumental in introducing greater innovation based on a wider knowledge of good international practice. In practice, many HR managers of foreign affiliates in China are either expatriates or, if Chinese, are recruited from the major MBA programmes in China that teach modern HRM principles (Warner 2004). The issue of who should head the HRM function in a foreign affiliate is not unique to China. It will arise in any alliance between companies from developed and developing countries, or between a partner with international experience and one with purely local background.

At an operational level, the most vexing problem is the recruitment and retention of good local Chinese managers (Boos et al. 2003). Björkman and Lu (1997) mentioned that as many as 59 percent of the participants at a roundtable discussion with the Chinese government concluded that recruiting and retaining managers was the number one problem facing firms with foreign investment. This was twice the percentage who considered the Chinese bureaucracy to be the major issue. There are particularly acute shortages of qualified and experienced Chinese people in the areas of financial management and HRM.

Despite the increase in Chinese men and women who have an MBA, it can still be difficult to find suitable recruits for JV managerial positions from among the Chinese partner's staff. Applicants often lack the competencies expected by the foreign partner, and they may well have deeply-embedded work practices of the kind that the foreign partner is seeking to avoid. Recourse therefore has to be made to the very tight managerial labor market. The activities of headhunting companies reflect the keen competition between foreign-funded companies for the best managerial recruits, and encourage a high level of managerial mobility between firms. As a result, there has been a steady rise in the costs of compensating local managers. Many foreign companies also provide their Chinese managers with expensive fringe benefits in order to retain them; benefits such as housing, pensions, insurance, company cars, and overseas training (including generous allowances while abroad).

The process of recruitment can also be problematic. The Chinese tend to favor using personal contacts to find new members of staff, in a society where this may engender an additional degree of loyalty to the organization among those selected. This method is used much more often than newspaper advertisements. However, nepotism can be a serious problem and it assists Chinese staff to resist external pressures to recruit non-optimum candidates when a foreign manager takes formal responsibility for the selection process.

The obverse to employing local Chinese managers is to rely on the use of more expatriates. While, as Chapter 11 notes, this has certain advantages for maintaining control over JVs, it is extremely expensive. There is, then, a heavy economic incentive to replace expatriates with local managers. Law et al. (2004) found, that to be successful, foreign firms have to set localization objectives and then support these with appropriate HRM practices including training.

Many companies send their managers and staff with managerial potential to local universities and business schools on short courses, especially to develop functional specialists in areas such as finance and HRM where knowledge of local conditions is essential. They may then use international management training companies to provide focused higher level training subsequently. Key staff are often sent abroad for formal training. Although this is expensive, it offers several advantages. Training abroad can improve the quality of cooperation by demonstrating the effectiveness of the foreign partner's practices in other parts of the world, including other Asian countries that can provide role models for Chinese employees. It can reduce resistance to changes that the foreign partner seeks to introduce. It is also an important reward for such employees. There is a considerable risk of people who have undergone foreign training being poached, and one measure that can help to counteract this is to break up the training period into a number of shorter visits spread out over several years (Björkman and Lu 1997).

Foreign managers in China often complain that their Chinese colleagues are reluctant to accept responsibility. One antidote to this is the introduction into JVs of assessment systems. These could also help to identify opportunities to develop local middle managers for promotion to senior positions in the future. Regular assessment and a systematic approach to promotion have not, however, always been installed or fully used. One of the reasons for this points up a dilemma in the partner relationship. The foreign partner can be reluctant to promote middle managers who have been recruited from the Chinese partner, because they have doubts about their attitude, competence, and loyalty. The Chinese partner can be unwilling to accept the promotion of externally recruited local people into senior positions and they may be in a position to deny approval for such promotions in the JV's board (Björkman 1995). The assessment and promotion process can therefore easily become transformed into a battle for loyalty between the partners and their respective criteria. In order to avoid problems of this kind, JV contracts now increasingly specify that the General Manager has complete authority to make managerial appointments.

Other developments in China present challenges for HRM policy and practice. With encouragement from the central authorities, trade union organization is spreading within foreign firms there. Bargaining and contracts may become increasingly collective, and it was claimed by the Chinese authorities that by 2000 over 300,000 collective labor contracts had been signed—mainly it appears in Northern state-owned enterprises rather than foreign JVs (Warner 2003). As the larger multinational companies multiply their JVs within China, in some cases establishing holding companies for them, so it becomes necessary to have an integrated HRM policy and the appointment of an all-China HRM manager may be appropriate.

## 14.11 Summary

This chapter has made the following main points:

1. A carefully considered set of HRM policies and practices can make a significant contribution to the success of alliances.
2. They can assist the adjustment of corporate cultures and practices to the needs of the partnership, offer mechanisms of control, help to handle conflict and build trust, promote organizational learning, and foster the selection and development of staff who are capable of working effectively in a milieu of interorganizational collaboration. In these and other ways, HRM can help to enhance the productivity of alliances, as well as the ability of partners to benefit from them.
3. HRM should have a central role in an organization's cooperative strategy. It needs to be brought into the planning and negotiation of alliances, when many of the relevant parameters, such as staffing and the allocation of managerial rights, are being decided.
4. The quality of cooperation will be enhanced by selection, training, and staffing policies which focus on communication competencies (including relevant language skills) and which promote cultural understanding.
5. Consideration also needs to be given to organizational procedures which facilitate adjustment and bonding between partners, such as the wide reporting of progress made through the cooperation.
6. Central HRM procedures for selection, training, appraisal, and compensation need to be aligned with a partner's policies on control and learning within its alliances. The chapter has identified how HRM

procedures can contribute to the realization of these policies as they are applied to the particular circumstances of the partnership.

7. The potential benefits that can be realized from closely aligning HRM activities to a company's cooperative strategy point to the desirability of having this function represented at the highest level in the meetings and other discussions which formulate the strategy. If HRM is confined to the periphery of cooperative strategy formulation, as is quite often the case in practice, then its ability to facilitate the successful implementation of the strategy will be correspondingly limited.
8. HRM practices are highly sensitive to cultural and institutional norms. This makes for difficult judgments as to where and how best to introduce a company's standard international HRM practices to an alliance located in a country such as China which has its own strongly embedded norms.

## 14.12 Questions for discussion

1. Why are HRM issues so often given little attention in the formation of strategic alliances?
2. In which ways would appropriate HRM practices be expected to enhance the performance of an alliance?
3. Can HRM offer a partner the ability to control a JV unobtrusively?
4. Which aspects of HRM in an international strategic alliance are likely to prove the most sensitive to local custom and practice?
5. What do you understand by the term 'international best HRM practice'? Under what circumstances should a multinational alliance partner endeavor to apply it to its alliances in different parts of the world?

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# 15 Culture

## 15.1 What this chapter covers

This chapter examines the ways in which culture can impact upon the implementation of cooperative strategies. It shows how culture can create barriers to collaboration between organizations, and yet how, at the same time, the knowledge embodied in cultures can provide a valuable resource for an alliance. We ask what culture is, why it is relevant for cooperative strategy, what specific consequences culture can have, what policy options there are for managing cultural diversity within alliances, and how cultural fit can be achieved.

## 15.2 The nature of culture

Culture is a heavily used but elusive concept. Although it refers to a supposedly universal phenomenon, political and social scientists continue to debate how much culture really matters in the broad sweep of history. The problem is that, while culture may be pervasive and widely manifest in social behavior, artifacts, and the humanly created environment, it is in itself intangible. Indeed, some writers regard culture more as a metaphor than as a 'real' phenomenon.

This elusiveness has encouraged a great deal of 'conceptual chaos' so far as the definition of culture is concerned (Martin 1992: iii). Kroeber and Kluckhohn back in 1952 isolated no less than 164 different definitions of culture, drawn primarily from the study of anthropology. Taken together, these definitions identify the features that express a culture: knowledge, values, preferences, habits and customs, established practices and behavior, and artifacts. They range between an emphasis on culture as a set of ideas and culture as a series of tangible expressions in art, architecture, and even technology (Keesing 1974).

How does culture differ from other fundamental influences that shape the ways in which people think and behave? Figure 15.1 contrasts culture with two other important influences, namely 'personality' and 'human nature'. Culture is neither specific to an individual as is personality, nor is it a trait of human nature present universally among all people. Rather it consists of patterns of thinking and behavior that are characteristic of a social group or collectivity of people. This is why we commonly refer to national, regional, organizational and occupational cultures. Most people belong to more than one social group and are therefore likely to have internalized more than one culture. Another distinction concerns how people acquire their cultures. It is widely accepted that culture is something we learn. It is not inherited as is human nature or, at least partially,

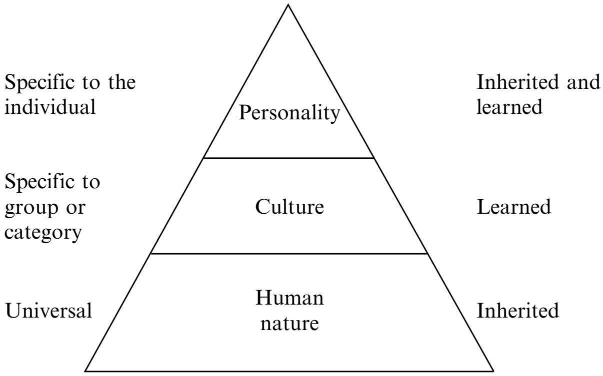


**Figure 15.1** Culture contrasted with other sources of human thinking and behavior.

personality. This has a very important practical implication for cooperation between the members of organizations coming from different cultural environments. For it means that despite the way we absorb a certain primary culture as we grow up, it may always be possible to learn further cultural attributes through experience or training. In other words, our culture is not necessarily fixed by our upbringing. We have the potential to learn not only to adapt to new cultural environments, but also to internalize new cultural values and practices if we find them sufficiently attractive.

Practising managers, consultants, and management researchers have shown a growing interest in the implications of culture. Hofstede's work (1980, 1991; Hofstede and Bond 1988), originating with a large-scale investigation across different national branches of IBM, has been one of the most influential contributions. Hofstede defines culture as 'the collective programming of the mind which distinguishes the members of one group or category of people from another' (1991: 5). He therefore focuses on the aspect of culture that is in the mind rather than its physical manifestations, and stresses that culture is learned and shared within social collectivities. The two collectivities of present interest as the sources of mental programming are the organizations in which people work and the societies in which they live. These have given rise to the concepts of 'organizational culture' and 'national culture'.

Brown (1995: 6–7) cites fifteen different definitions of *organizational* culture. Those writers who treat culture not as a metaphor but as an actual phenomenon generally agree that culture comprises shared values, beliefs, and ways of behaving and thinking that are unique to a particular organization. From his review of research and case studies, Brown concludes that 'an organization's culture has a direct and significant impact on performance. . . . Organizational strategies and structures and their implementation are shaped by the assumptions, beliefs and values which we have defined as a culture' (1995: 198).

One of the more influential theories of organizational culture is that developed by Schein (1985). He distinguishes between assumptions, values, and artifacts. Assumptions lie at the core of an organization's culture. They are what the members of an organization take for granted and what they believe to be reality. They therefore influence what they think and how they behave. At a somewhat more conscious level, organization members hold values, which are the standards and goals to which they attribute intrinsic worth. Artefacts are the tangible and surface manifestations of a culture, such as an organization's physical decor and dress code, its ceremonies, its stories and myths, its traditions, rewards, and punishments.

Martin (1992, 2002) identifies and illustrates three main perspectives on organizational culture. These respectively draw attention to (1) the culture which may be shared by all the members of an organization and which therefore acts as a unifying force; (2) the subcultures of different groups within an organization—such as specialist groups or managers compared with workers, or the staff drawn from different strategic alliance partners—which tend to act as a differentiating and divisive force; and (3) cultures as a fragmented mix of cross-cutting personal identities, full of paradoxes and ambiguities which are promoted, *inter alia*, by the constant flux of change in modern organizations and societies. In the light of these possibilities, culture may respectively be (1) a means to integrate people around a common task or operation, like a strategic alliance; (2) a divisive factor which threatens to fragment the alliance; or (3) a source of confusion for employees which may be alienating and distressing for some of them.

Organizational cultures are associated with places of work that may be relatively short-term employment locations for many people. Also such cultures may change substantially and suddenly with new circumstances—the experience of downsizing has been a case in point. The economic threat and psychological shock accompanying compulsory redundancy can rapidly destroy any sense of sharing a common culture with management. The practices which people have learned within the framework of a particular organizational culture may be more deeply embedded and therefore persist beyond a cultural change.

National cultures, by contrast, are acquired with upbringing and are deeply embedded as a result. The mental programming that takes place during childhood, and is reinforced during a lifetime of living in a particular society, is therefore likely to be resistant to change. For this reason, culture becomes a particularly significant phenomenon in alliances that are international rather than purely domestic. As well as having their roots in the traditions of a country, national cultures are also tied up with the specific institutions of that country and its prevailing political ideologies. These institutions and ideologies can within a generation or two have a significant impact upon national cultures, as comparisons between Mainland China and Taiwan or Hong Kong, or between the East and West Germanies, have made abundantly clear.

The fact that national economic and political ideologies can generate their own mental programming serves to remind us that national culture, though historically embedded, does not necessarily rule out the capacity for some mental adaptation on the part of the individual. As Ralston et al. (1999) have found in the case of China, the younger generation which has grown up and entered employment during the age of reform displays more individualistic and materialistic (and therefore in some respects more Western) attitudes than does the older generation. Earlier research by industrial sociologists into 'central life interests' suggests that people can draw a distinction between work-related values and behavior and those they adopt within their families and communities (Dubin 1956; Dubin et al. 1975). In other words, under conditions that motivate them to do so, many people may be able and willing to adapt their national cultural dispositions in clearly delineated situations such as working in an international cooperative venture.

**Box 15.1 Trompenaars's seven dimensions of national culture**

1. *Universalism versus particularism*—always applying the best way or a standard rule vs. deciding on the basis of the specific case, especially when friendship is involved;
2. *Individualism versus collectivism*—people regarding themselves primarily as individuals vs. as part of a group or community;
3. *Neutral versus emotional*—attaching importance to being objective and detached as opposed to permitting emotions to become involved;
4. *Specific versus diffuse*—confining business to the contractual versus involving personal contacts as well;
5. *Achievement versus ascription*—evaluating people on achievement versus evaluating them according to background and connections;
6. *Attitudes towards time*—future versus past orientation and how past, present, and future are seen to be related;
7. *Attitudes towards the environment*—the view that individuals can shape the environment and other people ('inner-direction') versus one that we have to live in harmony with the environment and with other people and hence take our cues from them ('outer-direction').

Another complication is that there is only partial agreement as to the key dimensions of national culture for people's behavior in organizations. Trompenaars (1993) proposes a model of seven fundamental dimensions of national culture relevant, he claims, to understanding diversity in business (see also Hampden-Turner and Trompenaars 1993). These are summarized in Box 15.1.

It is evident that there is a substantial overlap between these dimensions, especially in regard to individualism (dimensions 2, 5, 6, and 7), relationships (dimensions 4, 5, and 7), and universalism (dimensions 1, 3, and 4). Hofstede, the source of the other widely applied approach to measuring national cultural differences, criticizes Trompenaars on this score. He concludes from a reanalysis of Trompenaars's data that only two dimensions can be confirmed statistically—individualism/achievement and universalism/diffuse—and that both are correlated with Hofstede's individualism dimension (Hofstede 1996). Hofstede's own dimensions of national culture relevant to organizational behavior are fivefold, as shown in Box 15.2.

## 15.3 Culture's relevance to cooperation

Cooperative strategies bring together people from different organizations into a working relationship. The organizations from which they come will each have developed their own distinctive 'cultures'. These cultures embody shared attitudes and norms of behavior. They encourage people to regard their organization as different from, and often as superior to, other organizations, and therefore to hold onto their ways of doing things,

**Box 15.2 Hofstede's five dimensions of national culture**

1. *Individualism versus collectivism*—the extent to which the ties between individuals are loose, with everyone expected to look after himself or herself and his or her immediate family rather than belonging to strong, cohesive wider ingroups.
2. *Power distance*—the extent to which the less powerful members of institutions and organizations within a country expect and accept that power is distributed unequally.
3. *Uncertainty avoidance*—the extent to which the members of a culture feel threatened by uncertain or unknown situations.
4. *Masculinity versus femininity*—the distinction between a set of values and attitudes usually associated with men (e.g., assertiveness, competitiveness) in contrast to those usually associated with women (e.g., concern for people, attaching value to cooperative relationships).
5. *Time-orientation*—long-term versus short-term gratification of needs, where the former is more oriented towards the future emphasizing the value of perseverance and thrift, combined with valuing ordered relationships and having a sense of shame or honour. [This fifth dimension emerged from research among Chinese populations and has sometimes been called 'Confucian Dynamism'.]

*Source*: Hofstede (1980, 1991); Hofstede and Bond (1988).

particularly when confronted with those of a new and unfamiliar partner. If the collaborating organizations originate from different countries, their members will have a sense of belonging to distinct 'national' cultures as well, and the sense of difference between partners' managers and staff will be exaggerated as a result. When different cultures are brought together through a strategic alliance, they can generate barriers to cooperation while at the same time offering the potential for each partner to learn from the positive aspects of the other's ways of thinking and acting. However, the mutual learning cannot take place until the barriers are removed.

### 15.3.1 Culture as a barrier

One barrier to effective cooperation can arise when culture becomes an expression of social identity (Tajfel 1982), symbolizing the group with which people identify and which distances itself from other groups. If the bringing-together of two or more groups through a cooperative strategy is interpreted as threatening the interests of any one of them, this sense of distance between them will be heightened. People in groups and organizations often resist changes to structures and practices of the kind which can result from an alliance because they regard the changes as threatening their real interests. The culture they share will serve to express and also rationalize their concerns (Sathe 1985). Finding ways of bridging and reconciling the strong and distinctive organizational and national cultures which partners may bring to an alliance is, therefore, a major challenge which they cannot avoid if their cooperation is to succeed.

National cultural differences can present barriers to cooperation both at the level of simple misunderstanding and at the more fundamental level of conflicts in values. Misunderstanding can arise from culturally associated differences in language and the interpretation of behavior. For example, the same words or phrases can convey inconsistent meanings to people from different cultures. The brand name 'Nova' denotes a star in English, but is likely to be understood as 'No va' (i.e. doesn't go, doesn't work) in Spanish. The English idiom 'out of sight, out of mind' will be understood as referring to someone who is blind and incompetent when translated into Arabic. What is understood as humorous or ironic in one language may well be taken literally in another. There are also cultural differences in the approved mode of discourse between people which, if not appreciated, can readily lead to misunderstanding and antagonism. In Anglo-Saxon culture it is polite to wait until another person has finished speaking before speaking oneself. In East Asian societies, it is a mark of respect to pause before replying, thus indicating that what the other person has said is deserving of careful thought. In Latin cultures, by contrast, to interrupt another before he or she has finished speaking is to show acceptable enthusiasm for what they are saying. The same interpersonal behavior is likely to be interpreted in quite contrasting ways by people from different national cultures. Shouting can convey importance or a lack of credibility. Eye contact can signify respect in one culture but a lack of it in another. Touching may denote warmth or an invasion of personal privacy.

These types of linguistic and behavioral cultural differences can have serious consequences for cooperation if they are not addressed with sensitivity. They are, however, relatively superficial and it should not be too difficult for the members of cooperating organizations to cope with them so long as they are well briefed and willing to accept the differences in others' behavior with humor and respect. It is the deeper level of culture, where the socially embedded values held by partners and their employees may clash, that more serious problems concerning the priorities for the alliance and how it is to be run have to be resolved. The impact of deeper cultural values can be illustrated with reference to the two dimensions of universalism versus particularism and individualism versus collectivism.

In a country where universalistic values predominate, what is good and right can be defined and always applies. In a country where particularistic values predominate it is valid to take specific circumstances into account and to make exceptions, particularly if personal relationships and obligations come into play. To point up this difference Trompenaars (1993: 34) cites a story created by two American social scientists Stouffer and Toby (1951):

> You are riding in a car driven by a close friend. He hits a pedestrian. You know that he was going at least 35 miles per hour in an area of the city where the maximum allowed speed is 20 miles per hour. There are no witnesses. His lawyer says that if you testify under oath that he was only driving at 20 miles an hour, it may save him from serious consequences. What right has your friend to expect you to protect him?

In a universalistic culture, people will tend to adopt the view that the friend has no right to expect protection because he broke the law and because further disregard for the law through false testimony would only compound the harm. The more serious the offence against the law, the less right the friend has to expect protection. In a particularistic culture, people will tend to adopt the view that the friend deserves support, the more so when he is in serious trouble. Trompenaars has applied this question, and others bearing on the same cultural dimension, to around 15,000 employees in many different countries, 75 percent of whom are managers, the rest working in administration. His results suggest the 'Anglo-Saxon' and 'northern' countries to be high on universalism: Australia, Canada, Denmark, Finland, West Germany, Ireland, Japan, Norway, Sweden, Switzerland, the UK, the USA. At the other end of the scale, the most particularistic countries tend to be China, South Korea, Indonesia, Russia, Venezuela, and the former Yugoslavia.

The implication of this analysis is that where there is a partnership between organizations from countries that contrast greatly along the universalism/particularism dimension, it will be more difficult to establish the mutual trust on which a good relationship has to be based. The two parties are likely to be suspicious of each other, with the universalists thinking of their partners that 'they cannot be trusted because they will always help their friends' and the particularists thinking of the other group that 'you cannot trust them; they would not even help a friend'.

The differences in selection criteria applied by Chinese and foreign JV partners, noted in Chapter 14, reflect a clash between universalistic and particularistic norms. Most international companies adhere to the principle of selecting the best available recruits according to the requirements of the job, regardless of any personal connections they may have with existing managers or staff. Indeed, personal connections may be frowned upon as opening the door to subsequent favoritism which would distort the procedures for assessment and advancement, and in so doing probably demoralize other employees. By contrast, Chinese companies tend to favor the recruitment of family members. It is a Chinese social norm that members of an extended family should help each other, and managers also believe that recruitment on the basis of personal connections will encourage the employees concerned to be loyal members of the organization. The clash here between two cultural norms poses a problem the resolution of which demands special care and attention on the part of JV management.

In a country where individualistic values predominate, people tend to have a prime orientation towards the self rather than towards common goals and objectives. Judging by the Hofstede and Trompenaars research, countries in which individualism is relatively pronounced include most highly industrial ones, including the Anglo-Saxon nations, the Netherlands, and some East European countries. Austria and Germany are an exception, with less individualistic attitudes than most other West European countries. Countries in which collectivism is relatively pronounced include most of the poorer nations and those sharing a Chinese cultural heritage. Japan emerges somewhat in the middle overall, but is the most collectivist, or communitarian, among the highly industrialized countries (Hampden-Turner and Trompenaars 1993).

Considerable difficulties can arise in cooperation between companies which respectively manage and organize according to individualistic and collectivistic principles. In the former, for example, high value will tend to be placed in quick decisions, individual responsibility, expression of individual views and goals, competition between people for recognition and advancement, and individual incentives. In the latter, high value will tend to be placed on taking time to consult and secure consent before decisions are made, on group or team responsibility, sharing common superordinate goals, a high level of interpersonal and interdepartmental cooperation, and systems of rewards that do not single out individuals. It is far from easy to reconcile these contrasting principles when managing a strategic alliance, though the attempt could pay off handsomely through realizing the benefits of their complementary strengths.

The countries in which individualism prevails tend to be creative but rather poor at managing the collective effort required to convert invention into products that can be produced efficiently through organized effort and so made attractive to the market. By contrast, the countries in which a collectivist culture prevails tend to be less a source of invention but extremely good at developing ideas and putting them into practice. A revealing example is the way that Japan took up and developed management techniques such as TQM, originally invented in the USA, so effectively that they became part of what we now call the 'Japanese system of management'. There is an evident potential synergy between partners bearing these respective strengths of individualistic and collectivistic cultures, if only ways can be found for them to cooperate together to draw out and meld the complementary strengths of their two approaches. It was, indeed, the expectation of many US–Japanese JVs that they would achieve synergy between the technical inventiveness that is fostered by American individualism and the ability to carry this through to efficient production that is fostered by Japanese collectivism in the form of good teamwork. In the event, as we saw in Chapter 13, some of these JVs came under strain because the Japanese learnt more from them than did their American partners. Although some commentators are inclined to the view that, in being smarter JV partners, the Japanese are also rather underhand, Casson (1995) offers a rather different interpretation. He argues that the disparity in benefit from these JVs is due, at least in part, to cultural differences. The Americans' individualism and competitiveness breed a sense of mistrust which prevents them from learning from the cooperation, while the high-trust Japanese are more open and engage with their alliance partners to learn as much as possible.

### 15.3.2 National differences in management

Contrasts in the value priorities that the members of different societies tend to hold are expected to give rise to consistent differences in their behavior, as the previous section has illustrated. This has led writers on management to explore whether certain management practices have become characteristic of different countries as a result of their cultural differences and, in addition, of their particular political and economic systems (Hickson and Pugh 2001). From what has been said already in this chapter, one might expect there to be a large difference in the management practices adopted by American and Japanese companies. If there is a gap of this kind, it may well present difficulties for cooperation if and when companies from those two countries form an alliance. This is an important aspect of the 'cultural fit' between partners that was discussed in Chapter 6.

The authors have highlighted the management practices which previous research suggests is characteristic of the main industrialized nations (Child et al. 2000). These are listed below and the contrasts between them are evident. Their research into the impact of foreign companies on management practice in acquired UK subsidiaries largely confirmed the characterizations that have been made of US and Japanese practice. By contrast, there was not much support for the characterizations of French and German management practice that are, in any case, based on relatively sparse evidence. The East–West contrast between Japanese and US practice, which has caused problems for some alliances between firms from those countries, is today being extended (though not in exactly the same form) as firms from other East Asian companies enter into alliances with partners from the USA (Whitley 1999).

1. *Japanese management practice*

   The policies and practices particularly associated with Japanese companies are:

   - Long-term orientation:
     - strategic rather than financial,
     - emphasis on growth,
     - long-term employment commitment;
   - Rewards based primarily on seniority and superior's evaluation;
   - Internal training and seniority system; heavy investment in training;
   - Collective orientation:
     - decision-making and knowledge creation via collective participation and responsibility;
   - flexible tasks:
     - low specialization,
     - synthetical orientation,
   - Emphasis on lean production and continuous improvement.

2. *Management practice in the USA*

   The management policies and practices particularly associated with US companies are:

   - short-term financial orientation;
   - rewards related to specific performance indicators;
   - high rate of job change and intercompany mobility;
   - rationalistic approach: emphasis on analysis and planning;
   - reliance on formalization and systems;
   - delegation down extended hierarchies.

3. *German management practice*

   There is some disagreement between investigators over the key characteristics of (West) German management—these may reflect differences in sampling (for example, large versus Mittelstand firms) and methodology (Ebster-Grosz and Pugh 1996). However, while the picture which emerges of German management policies and practices is not so clear cut as that portrayed for US and Japanese management, its main contours are the following:

- long-term business orientation;
- emphasis on production improvement rather than short-term profit distribution;
- orientation towards employment is not necessarily long term;
- strong technical and production emphasis, including a substantial investment in training;
- managers and staff tend to remain within one functional area during their career;
- emphasis on planning, procedures, and rules;
- preference for participation and collective action.

4. *French management practice*

   France is also a particularly difficult country to categorize, and the same applies to its management practice. Hampden-Turner and Trompenaars (1993: 333) comment that 'France defies easy categorization. It requires a sense of irony, for which the French are famous, to make sense of seemingly contradictory results.' Bearing this caution in mind, the management policies and practices which have been described of French companies are:

   - strategic rather than financial orientation;
   - tall organizational hierarchies, with a large proportion of managerial personnel;
   - high degree of specialization;
   - widespread use of written media;
   - individual rather than collective working and decision-making, though the latter tends to be centralized.

5. *British management practice*

   The management policies and practices particularly associated with British companies have some similarity with those associated with US companies, but with considerably less emphasis on formal systems and records:

   - short-term financial orientation;
   - large general management superstructures;
   - low level of functional specialization;
   - high mobility of managers between functions;
   - use of formal meetings, especially committees;
   - interactive informality—limited formal and paper-based reporting;
   - limited importance attached to systems and standard operating procedures.

The previous section has already indicated that culture is important for cooperative strategy. There are, however, a number of more specific ways in which organizational and national cultures can be consequential for the formation and operation of an alliance. These illustrate the two faces of culture for cooperative strategy: as a challenge and as a resource. The impact of cultural differences within an alliance on its performance is likely to depend on the balance between these two faces of culture and how they are managed.

### 15.3.3 Culture as a challenge

Cultural differences can pose a challenge for cooperative strategy in three main respects. First, the degree of difference between the cultures of prospective partner organizations may affect the cooperative form in which they are willing to engage. Second, a large cultural distance between prospective alliance partners is likely to protract the process of forming an agreement to cooperate. Third, cultural differences can give rise to operational problems.

It has been widely assumed that the degree of distance between the culture to which a firm is accustomed and that of the environment in which it is planning to invest will influence the kind of organizational arrangement it is willing to accept for that investment. However, there are conflicting arguments and inconclusive evidence concerning the effect that cultural distance will have (Shenkar 2001). A high cultural distance is likely to generate additional risk and uncertainty in the perceptions of the investing company's decision makers, especially if the other culture is unfamiliar to them. Part of the risk lies in the need, in a culturally different environment, to depend on agents and partners whom it does not know well. It is therefore argued that a firm will seek to compensate for this risk by exercising greater control in its dealings with foreign agents and partners. If the presence of greater cultural distance between prospective alliance partners is associated with low levels of trust between them, they might be encouraged to seek managerial as well as legal safeguards for their crucial interests (Shane 1994). This implies that the main investor, and/or provider of key resources such as advanced technology, is in cases of high cultural distance likely to prefer direct foreign investment rather than licensing and in forming an EJV to hold a majority equity share that provides the right to managerial control.

The counter argument is that when there is high cultural distance, a firm may prefer to rely on a local partner to contribute local knowledge and it will therefore be willing to opt for limited control over their cooperative venture. This may be a particularly important consideration in the early stages of entering an unfamiliar environment, such as that of many emerging economies, in which many parameters of doing business are subject to local negotiation (Beamish 1988). Also insofar as limited control is a concomitant of committing limited investment, this alternative will reduce the company's financial exposure in an unfamiliar environment. The inconclusive nature of the evidence on this issue probably reflects complexities that require further investigation. For example, high control may be more efficient when the firm entering a new market through a cooperative alliance enjoys a specific advantage that its partner cannot easily imitate or apply, such as superior operational methods that do not fit a local culture (Anderson and Gatignon 1986). A firm that is already experienced in working within another culture may feel more confident about assuming a dominant control over the management of an alliance.

A large cultural distance between prospective partners is likely to protract the process of forming an agreement to cooperate. While it can be assumed that each partner recognizes that there is an advantage to be gained from cooperation with the other, cultural distance between them will add to the difficulties of finding a mutually acceptable basis for that cooperation. Because cultural differences increase the chances of mutual misunderstanding and even personal offence, they have to be transcended before a basis for trust can be established. And without mutual acceptance and trust, the risk of cheating and noncompliance with contacts is greater (Williamson 1979). Particularly if the representatives and negotiators on behalf of the prospective partners are not familiar with each other's organizational and national cultures, the transcending of their cultural differences can come about only through a time-consuming process of recognizing the other cultures, demonstrating mutual tolerance, and then finding ways of reconciling the differences as they impinge upon practical aspects of the proposed cooperation. Additionally, the partner who is not familiar with the country context in which the alliance is to operate has to invest further time and effort in finding out how the cultural norms and institutional practices of the host country are likely to effect its calculations and plans for making the alliance into a profitable operation. Can it, for example, market and promote its products through the alliance in its normal tried-and-tested ways?

Thirdly, cultural differences can lead to a good many operational problems. At worst, they can lead to a breakdown in the working relations between partners' managers and staff. If the partner's cultures convey conflicting priorities and norms of behavior, they will heighten the sense of separateness between staff seconded or recruited by the partners to work together. This sense of being different is bound to be present anyway in the early stages of cooperation. Sharp cultural differences will reinforce and perpetuate this unless considerable effort is made to overcome them. This is illustrated by one such case where cultural insensitivity and inflexibility almost led to the breakdown of a JV (see Box 15.3).

**Box 15.3 The need for cultural sensitivity and flexibility**

A joint venture between a European and a Chinese partner almost collapsed because its first general manager, a European with only limited international business experience, insisted on the introduction of practices and procedures from his parent company in an aggressive and culturally insensitive manner. Not only did he fail to consult his Chinese colleagues, but he engaged in brow-beating and shaming behavior in meetings with them, conduct that is particularly offensive to Chinese cultural norms. In this case, the Chinese partners held 60 per cent of the joint-venture equity and were, through their majority on the board, able to insist that a replacement be made before relations broke down completely. The replacement, a Canadian with wide international business experience, was able to mend the relationship through adopting a much softer style more acceptable culturally to the Chinese. Important aspects of this softer style were regular consultation with the Chinese deputy general manager, especially before all senior management meetings, care not to cause public loss of face in those meetings, and a greater involvement of Chinese managers in the downward communication of information.

*Source*: John Child, personal research.

Alliances are communication intensive and relationship dependent, and they therefore cannot function well if they are internally divided by substantial cultural barriers. If cultural distance is not reduced, or at least channeled into a form that avoids conflict, it is likely to give rise to serious breakdowns in communication of information and integration within the alliance. Chapter 13 indicated, for example, how such breakdown would seriously inhibit the learning capability of the alliance. The achievement of accommodation between partner cultures is also a condition for a strategic alliance or other form of cooperation to develop its own culture.

Cultural accommodation in alliances may also require the acceptance of what appear to be some inefficiencies according to the norms of one partner. Take the case of a Western company in partnership with one from East Asia—say China or Japan. The Western company probably operates according to rather individualistic, universalistic, specific, and short-term performance norms. The East Asian company probably operates according to relatively collectivistic, particularistic, diffuse, and longer-term performance norms. From the Western perspective, the other partner's decision-making processes will appear to be protracted because of the time taken to achieve prior consensus according to collective norms. The way of organizing work preferred by that partner will seem to submerge individual accountability within the group or department as a whole. The Western company will probably regard its partner's approach to personal-performance assessment as insufficiently focused on achievement in the job as measured by standard criteria, and unduly particularistic. This is because the East Asian partner is likely to take into account considerations such as the employee's commitment and loyalty to the company, as evaluated by the person's supervisor or manager, rather than apparently more objective information. East Asian partners will probably pay considerable attention to particular personal circumstances that have affected performance, as well. The Western preference would be to evaluate at regular intervals in terms of task-specific criteria, and to link reward directly to such evaluation. We saw an example of this East–West contrast and the problems it caused in the Black & Decker–Eastern Hemisphere case summarized in Chapter 14, Box 14.3. The Western approach emphasizes criteria which relate to a limited, defined set of responsibilities over an equally limited time period, whereas the East Asian approach emphasizes criteria which are more holistic and more relevant to the longer-term contribution of people to the whole organization. Managerial effort clearly has to be devoted within the alliance to reconciling, or building upon, these different approaches, which for the other partner will be seen to suffer from significant limitations.

Differences over operational issues can arise even within the ambit of so-called Western culture. Trompenaars (1993: 32–3) provides an example of this from the experience of an American computer manufacturer with operations in various European countries. Differences arose between a strong Anglo-Saxon belief, held by managers from USA and UK that a substantial part of remuneration should depend on an individual's achieved performance and the greater allowance that managers from Mediterranean countries wished to make for personal circumstances which affected people's levels of performance in a particular year.

Because of the operational and relationship problems to which they can give rise, national cultural differences have usually been considered to be a potentially major contributor to alliance failure or unsatisfactory performance. As Pothukuchi et al. (2002: 245) have put it, 'cross-national joint ventures have been reported to suffer from communication, cooperation, commitment, and conflict resolution problems caused by partners' value and behavior differences, which in turn cause interaction problems that adversely influence joint venture performance'. However, they point out that differences in partners' organizational cultures also have the potential to affect alliance performance negatively because these present conflicting expectations and incompatible practices. In a survey of 127 JVs between Indian partners and those from twenty-one other countries, Pothukuchi and his colleagues found that indicators of national and organizational culture distance influenced organizational outcomes differently, and that negative effects originated more from differences in organizational culture than from differences in national culture. They caution that some of the inconsistency in the findings of previous studies on the relationship between cultural distance and alliance performance may be due to the failure to take account of differences in partners' organizational cultures, especially those concerning openness of communication and willingness to share information. This resonates with the point to be made in Chapter 18 that successful alliance evolution depends on conditions such as openness that promote mutual accommodation and learning between the partners.

### 15.3.4 Culture as a resource

The marked differences between, say, US and Japanese management practice can, from one perspective, create difficulties for mutual understanding and cooperation. From another perspective, they denote potential complementarities between US and Japanese cultural strengths. Each partner has something distinctive and valuable to offer. In other words, under the right conditions, a mix of cultures does not just create problems; it can also bring positive benefits to cooperating organizations. Cultural diversity creates an opportunity to use the competencies and knowledge contained in each partner's culture for the benefit of the alliance.

Take the example of a Western company that forms a JV to enter an emerging economy market. Its culture will probably emphasize universalism, specificity, achievement, future time orientation, and inner-directedness, all values that help to create a well-organized yet dynamic approach to organizational management. At the strategic level, this culture will encourage a focus on key objectives, long-term planning, and a determination to succeed. In operational terms, it should provide a good basis for efficient production, high-quality standards, and attractive products. In many emerging economies, however, the local partner's culture is likely to attach relatively greater value to particularism, collectivism, and diffuseness. These values can contribute to the alliance's success in a number of ways. Particularism can inform the alliance management's ways of relating to significant government authorities and members of key business networks, some of which may open up significant market opportunities. Recognition of the value attached to collectivism in the host society can contribute to a modification of HRM policies in ways that encourage the commitment and loyalty of local employees, such as orienting assessment to group rather than individual performance. An appreciation of how the norm of diffuseness applies to business relations can improve the chances of achieving useful transactions in the host society. For example, in a cultural milieu such as China's, it is of great value for the executives of international companies to recognize that the way into local business and governmental networks lies in understanding and respecting the highly diffuse mode of transacting that prevails in that country (Boisot and Child 1996).

At the same time, the alliance should benefit if it develops its own corporate culture. So long as it is not undermined by unfulfilled expectations or internal conflict, which in an alliance would most obviously concern the relation between the partners, a corporate culture can be an important resource available to the leaders of organizations (cf. Deal and Kennedy 1982; Hampden-Turner 1990; Brown 1995). It can promote social cohesion and act as a ‘cement’ that bonds an organization together. Because a shared culture encourages people to accept a common goal and to identify with each other, it can also facilitate the processes of coordination and control within an organization. By giving the members of an organization common reference points and ways of interpreting reality, a shared culture can reduce uncertainty and promote consistency of effort. In providing meaning to their work and to their membership of an organization, an appropriate and cohesive culture can also be an important source of motivation for employees. For these reasons, an alliance between partner companies should benefit if they permit, and indeed encourage, it to develop its own culture.

In seeking to develop a common culture for their alliance, the partners should attempt to analyze the relative strengths of their own organizational and national cultures, and build these into the norms and behaviors adopted by their cooperative venture. Two considerations inform this recommendation: first, the opportunity for the alliance to benefit from its parents’ accumulated cultural capitals, and, secondly, the need for the partners to retain sufficient control over their alliance and to maintain an identity by alliance managers with their goals. Unless a partner is content to regard the alliance as merely an investment opportunity and to adopt the role of a sleeping partner, it needs to maintain an active link with the venture, which the maintenance of a shared identity, as well as regular reporting procedures, can both symbolize and underwrite. These links are a necessary complement to the development of the alliance’s own culture. They enable the strengths of partner cultures to feed into the alliance culture while, at the same time, reducing the risk of the alliance forming an identity and pursuing objectives that become at odds with those of its parents. The collaboration between the Royal Bank of Scotland in Britain and the Banco Santander in Spain illustrates how two partners came to realize the cultural strengths and limitation of the other, and learned from the comparison (see Box 15.4).

The ideal for cultural management in alliances, then, is to harvest from the diversity of partners’ cultures while at the same time building effective bridges between them. It is beneficial to have a diversity of cultures among organizational members because this offers a stimulus to learning, and sensitivity to local environments, but at the same time there is a need to manage the cultures so that they become forces for integration rather than division. There is a parallel here with the path to effective organizational learning within alliances, discussed in Chapter 13. The parallel lies in the necessity of combining a variety of contrasting and even conflicting perspectives (differentiation) with ways of drawing together the advocates of these perspectives into a shared commitment to implementation (integration). The management of culture and of learning within alliances each requires a reconciliation of the paradox of organizational differentiation and integration. The two are, of course, closely related because cultures embody knowledge that may be highly relevant to the success of the alliance in its specific context.

**Box 15.4 The alliance between the Royal Bank of Scotland and the Banco Santander of Spain**

In 1988 the Royal Bank of Scotland and the Banco Santander, two banks small in European terms but large in Scotland and Spain respectively, formed an alliance in order to develop the critical mass to compete successfully on the European banking stage. Although they were too similar in functional terms to have high complementarity of assets and resultant synergy, the alliance has been successful because of the partners' cultural affinity, and the consequent development of commitment and trust. The respective cultures, however, provided some surprises for the partners in the early days of the alliance. Santander operated more by word of mouth, whereas RBS committed everything to paper. Santander took much longer to answer letters than RBS. The Spaniards were much more comfortable with personal physical contact than the Scots. However, perhaps surprisingly, they were more concerned with protocol at meetings and dinners, and were apt to take offence if what they deemed an inappropriate seating plan was drawn up by RBS. However, the two banks grew to realize that they could benefit from exposure to other ways of doing things, and what could have been cultural clashes became opportunities for mutual learning in many cases. Both sides learnt not to be so ethnocentric in their attitudes, a necessary precursor to success in the new polyglot European market.

*Source*: Faulkner (1995).

## 15.4 Managing cultural diversity

When organizations decide to cooperate, they often bring diverse cultures to their alliance. Cultural diversity is becoming more common with the rapid increase in alliances between organizations from different countries, which is one of the key features of contemporary globalization. A diversity of organizational cultures is also becoming more frequent with the growing cooperation between large and small companies in newer industries such as biotechnology and electronics in which research-based companies link with those having broad market access, and specialist component-makers link with assemblers. Nationality is the main source of distinction between social cultures, while differences in company size and types of primary competence are sources of corporate cultural variation.

The more that the cultures of cooperative partners diverge, the more of a challenge it becomes to achieve a 'fit' between them. Fit refers to the extent to which different cultures are brought into a workable relationship that permits the alliance to operate without undue misunderstanding and tension between the partners or between the staff they attach to the alliance. Cultures that do not match, in the sense that they are different, may or may not be fitted together depending on the intentions, goodwill, and skills of the members of the different cultures.

As Chapter 6 noted, the active management of cultural diversity aims to achieve a 'cultural fit' between partners that is essential if their cooperation is to achieve its full potential. Cultural fit refers to a condition in which the partners' cultures (and that of a third host country, if that applies) are either combined or accommodated in a mutually acceptable manner. 'Fit' does not necessarily mean integration of the cultures and their associated practices; there may be other ways in which they can be acceptably accommodated. For an alliance to work well there has to be trust between the partners and their staffs. Trust and cultural fit are interdependent. A poor cultural fit is likely to breed suspicion and act as a barrier to the building of mutual trust. If actions or events damage trust between the partners, this will rekindle their sense of cultural difference and of having a separate rather than a common identity. There are a number of broad policy options on the management of cultural diversity, some of which, however, provide a better cultural fit than others.

Two fundamental policy choices in the management of cultural diversity are:

1. whether one partner's culture should dominate the operation of the alliance or whether to strive for a balance of contributions from the partners' cultures;
2. whether to attempt an integration of the partners' cultures (with the aim of deriving synergy from them) or segregate their application within the alliance (with the aim of avoiding possible conflict and reducing the effort devoted towards cultural management).

These two dimensions of choice give rise to the four broad possibilities shown in Fig. 15.2. The first three are all options offering a basis for cultural fit, though not realizing the same level of benefit from the different cultures; the fourth possibility is one of failure, likely to lead to the early demise of the cooperation:

1. *synthesis*, which is a policy aiming at cultural integration on the basis of a melding of both or all partners' cultures;
2. *domination*, which is a policy aiming at cultural integration on the basis of dominance by one partner's culture;
3. *segmentation*, which is a policy aiming at an acceptable balance between the influence in the alliance of each partner's culture. Its 'segregation' variant does not

| | | Integration: Yes | Integration: No |
|---|---|---|---|
| Domination by one partner | No | Synthesis | Segmentation<br>1. segregation<br>2. pluralism |
| | Yes | Domination | Breakdown |

**Figure 15.2** Four options in the management of cultural diversity in alliances.

*Source*: Adapted from Tung (1993, Figure 1).

aim at any integration between partner cultures, whereas 'pluralism' does aim to have limited discourse and comparison between them;

4. *breakdown*, which is a policy adopted by one partner seeking domination that fails to secure integration on the basis of the other partner's acceptance.

*Synthesis*: This option aims at achieving the fullest possible fit between cultures. It is the policy best suited to optimizing bonding between alliance partners as well as to promoting learning between them. With synthesis, beneficial practices from each partner's culture are combined within their alliance to bring about an effective management system and deployment of resources. In effect this creates a new organizational culture for the alliance. We have already cited the example of combining US inventiveness with Japanese production efficiency and quality, which was potentially very attractive for both partners, though difficult to achieve in practice. Another example, from John Child's experience in running a Sino–European educational JV, concerns methods of communicating information. In the days before email and local area networks, he found it beneficial to combine the use of Chinese communication methods, such as word of mouth, blackboards outside the dining hall, and the occasional general meeting, with Western methods such as memoranda and minutes. The Chinese methods, which tended to be more personalized, had the merit of simplicity and speed, while the Western methods, which were more formal and impersonal, were used to follow up with precise details. The operation of the JV benefited from the contributions of each culture's approach, and the relationship between the two partners was also strengthened because each had in this way treated the other's culture with respect.

The key idea of cultural synthesis is that the 'positive aspects of the various cultures are preserved, combined, and expanded upon to create a new whole' (Tung 1993: 465). Its aim is to achieve synergy, namely a whole that is greater than the sum of its parts. The achievement of synergy requires that each partner organization and its staff understands and appreciates the contributions that the other's culture can offer to the cooperation. Like the process of 'integration' advocated by Mary Parker Follett for making constructive use of conflict (Graham 1995), synthesis does not ignore or suppress differences between partner cultures but requires that time and effort be devoted to discussing these openly in a spirit of mutual respect. Such discussion is, in turn, conducive to an exploration of how each culture can contribute to the progress of the alliance and how these contributions can progressively be combined in what emerges as a new alliance culture.

Cultural synthesis offers a number of potential advantages. As the result of working through cultural differences, synthesis should allow for their integration on an agreed basis that should enhance the quality of long-term cooperation between the partners. In recognizing the strong points of each cultural approach through a process of mutual discussion, synthesis maximizes the potential for mutual learning between the partners and their alliance staffs. In creating a new culture for alliances like JVs, if should also provide a new and distinctive identity for them that captures their members' loyalty and fosters a better cooperative working relationship. A policy of cultural synthesis should also create more flexibility for the alliance unit to adapt to local conditions such as what is acceptable to local markets, given that the host partner, or staff recruited locally for the alliance, understand these better. Although synthesis has a great deal to offer, it may incur problems. For instance, it can face resistance from those who feel that their own culture, and associated practices, is being compromised. This is quite likely to be the attitude of managers in large experienced MNC alliance partners who believe they have developed 'best practices'. Also synthesis takes more effort and time to achieve and implement than alternative approaches. It could therefore have a negative effect on productivity in the short term.

As with situations of asymmetric learning between alliance partners (see Chapter 13), synthesis may be rejected as an approach to managing cultural diversity in alliances where it is accepted that one partner has a general superiority in technical and managerial know-how and that both the alliance and the other partner(s) will therefore benefit from adopting this approach wholesale along with its cultural foundations. Indeed, dominance by one partner in areas of its key competence, where it is particularly anxious to safeguard its proprietary knowledge, may be a condition for its entering into an alliance at all. In these circumstances, a policy of domination will be adopted; a policy aiming at integration on the basis of dominance by one partner's culture.

*Domination*: Many MNCs have adopted a domination policy toward JVs with a smaller or less experienced partner. They enhance this through appointing their own managers to key positions and insisting on the application of their standardized operational and control systems (Rudman 2003). Another situation in which a policy of cultural domination by one partner is acceptable can arise when the other partner prefers to invest only a limited amount of capital, perhaps regarding royalties from technology transfer as a more secure future income stream. It may be quite content for its partner to manage the alliance according to its cultural norms, subject perhaps to the introduction of certain technical standards. These standards, and the training to support them, do of course introduce elements of the partner's own culture, but these may constitute a limited component within the alliance's management and organization as a whole (Child 2002).

Domination is a policy that gives rise to cultural fit in the sense that all the partners accept it and are prepared to work within its terms. However, the foundations for this acceptance can prove to be fragile over the longer term. While cultural dominance by one partner may be accepted by the weaker partner as a basis on which a desired alliance can proceed and achieve its economic goals, it could cause some resentment once those initial conditions have passed. This is particularly likely if the culturally dominated partner perceives that it is thereby placed in a position of subordination. As Tung (1993: 466) comments:

> On the surface, while the organization appears to function effectively, in reality, when members of a subordinate group unilaterally adapt to the dominant culture, with no reciprocal effort on the part of the dominant group to understand and/or accommodate to members of the subordinate group, it can be counterproductive in the long run, generating misunderstanding and feelings of mistrust.

One advantage of a cultural domination policy is that it provides a relatively quick route to introducing standardized policies and practices into an alliance. If those policies and practices are founded on the relevant partner's clear superiority of expertise and experience, then this can prove to be a significant competitive advantage for the alliance. So long as it is acceptable to the culturally passive partner, domination also provides the basis for the alliance to achieve a unified identity and to present a unified and consistent face to the external parties such as customers. On the other hand, resentment from members of the dominated culture can prove to be the Achilles Heel of the domination policy. It may also forgo valuable opportunities to learn from the other partner's culture and practices, especially in areas of activity where these could make a valuable contribution, and it could reduce the alliance's flexibility in adapting to local conditions

*Segmentation* is a policy that aims at an acceptable balance between the cultural inputs of alliance partners, but does not attempt to integrate them to any significant extent. The level of discourse and comparison between the cultures can vary between the minimal and the limited. The first alternative may be termed '*segregation*'. An example of segregation arises when, in an IJV, one partner introduces its systems for production and quality control, while the other (particularly if it is the host-country partner) continues to manage external transactions in the field of supply, distribution, and government relations according to its customary manner.

Cultural segregation has the advantage of not offending the sensibilities of either partner, so avoiding cultural conflicts. It permits the partners' own cultures and associated practices to remain within the alliance organization as strong subcultures. This could, in principle allow for greater flexibility within the areas of alliance activity allocated to each partner. Because conflict and disruption are avoided, segregation may also generate higher productivity, at least in the short run.

However, segregation can clearly be a suboptimal solution in other respects. It entails a separation of the tasks that each partner will manage within the scope of the cooperation, and this approach obviously reduces the opportunities for mutual learning between them to a very low level. It reduces opportunities to standardize practices within the alliance and, more importantly to make them mutually consistent. Segregation is therefore likely to lead to a poorly integrated and inefficient management system for the alliance, with continuing problems due to limited communications, and a sense of rivalry, between different functions within the organization. It is a policy of differentiation without the corresponding integration, that may well lead to fragmentation within an alliance. Segregation will also probably give rise to personal problems for people who are seconded to work in the alliance, especially if they are expatriates. It can create difficulties for an expatriate to acquire the local language or understand the behavioral norms of the country where the alliance operation is located. The expatriate and his or her family will tend to be isolated, possibly in a foreign 'ghetto', with a high chance of family stress and personal failure in the role.

Most cases of cultural segregation within alliances occur in the early days of their operation, especially when one partner can offer expertise but the other needs to handle a difficult and not easily accessible local environment. Some JVs established by foreign firms in Russia have adopted a high level of internal segregation, in a situation where supplies can be problematic and even conditional on achieving understandings with local mafia. Hertzfeld (1991), an experienced consultant, has also suggested that segregation is necessary for foreign JVs in Russia in order to avoid disputes over their leadership. If an alliance is to prosper, however, segregation must normally be regarded as an initial rather than a longer-term solution to the challenge of managing intercultural diversity.

*Pluralism* is a variant of cultural segmentation that attempts to avoid some of the problems associated with segregation. With pluralism, the different cultures brought to an alliance are respected and maintained, most likely through a division of labor and responsibility between the partners. However, an effort is made to build interfaces between the cultures and the areas of practice to which they are applied. Attention is also given to ways of initiating consideration of the ways in which the cultures offer unique benefits and learning opportunities. A policy of pluralism endeavors to complement cultural differentiation by a certain degree of 'integration' in these ways. It is unlikely to achieve as many benefits as cultural synthesis in the long run, but it may be a more acceptable and less costly approach in the shorter term, especially if the alliance is one between partners who do not have previous experience of working together and between whom mutual trust still has to be developed.

*Breakdown*: This is the fourth possibility, but one that is hardly a viable policy option. It can arise if one partner attempts to pursue a policy of domination against the wishes of the other partner(s) to an alliance. It is a condition in which the different groups in the alliance or JV are incapable of working with each other, and considerable tension and conflict will ensue so long as the alliance is kept in existence. Needless to say, the alliance's performance is likely to suffer badly from this state of affairs. Breakdown can develop out of a situation of segregation which one partner regards as not functional for the progress of the alliance and attempts to resolve through unilaterally introducing the norms and practices that follow from its culture. If segregation is handled with sensitivity, there is a good chance that it can be transformed into a state of intercultural synthesis, or perhaps domination if the nondominant partners believe that they will secure sufficient benefit from the change. If it is handled badly, then breakdown is the more likely outcome.

Table 15.1 summarizes the advantages and disadvantages of the first three policy options just discussed. These are the potentially viable ones, though the balance of advantage between them alters with circumstances and also depends on whether one takes a short or longer term view of the alliance.

## 15.5 Improving cultural fit

### Deciding on a policy

Much of the responsibility for improving cultural fit within an alliance falls upon its chief executive and other senior managers. As several of the preceding chapters have noted (especially Chapters 4 and 10), the general managers of an alliance occupy a pivotal position both in terms of managing the relations between partner companies and in terms of generating a sense of common purpose within the alliance's own organization. In deciding how to proceed, and which policy option to take as a guideline, they have to weigh up two major contingencies. The first concerns the substantive content of the cultures that are present within the alliance. The second concerns the flexibility that may be available for modifying or developing each culture in relation to the others.

**Table 15.1** Advantages and disadvantages of policy options for managing cultural diversity

| Advantages | Disadvantages |
|---|---|
| **Cultural synthesis (new culture)** | |
| • Permits an agreed integration of cultural differences that enhances quality of cooperation<br>• Maximizes potential for mutual learning<br>• Provides a new identity for joint ventures<br>• Creates more flexibility to adapt to local conditions | • May face resistance to change<br>• Takes more effort and time to implement<br>• Could have negative impact on productivity in the short term |
| **Cultural domination** | |
| • Allows for rapid introduction of standardized policies and practices<br>• Creates unified identity<br>• Provides single face to the external groups such as customers | • Can cause resentment from dominated cultures<br>• Forgoes opportunities to learn from other cultures<br>• Reduces flexibility in adapting to local conditions |
| **Cultural segmentation** | |
| **1. Segregation** | |
| • Avoids offending cultural sensibilities of each partner and avoids cultural conflicts<br>• Allows for stronger subcultures<br>• Gives greater flexibility within segregated areas of alliance activity<br>• Maintains productivity in the short run | • Reduces synergy gains, including opportunities for mutual learning from cultural diversity<br>• Reduces ability to standardize practices and achieve consistency between them<br>• Leads to poorly integrated management systems and substitutes rivalry for solidarity of purpose. Can lead to fragmentation within the alliance<br>• Creates personal isolation, especially for expatriates |
| **2. Pluralism** | |
| As for segregation but:<br>• reduces some of its disadvantages<br>• allows for comparisons between cultural approaches that encourage learning | • requires more effort and time than segregation |

*Source*: Adapted from Hewitt Associates, *Mergers and Acquisitions in Europe Survey Results 2003*. Amsterdam: Hewitt Associates, p. 30.

The content of cultures within an alliance needs to be assessed with regard to how they differ and to what degree. Each culture has an impact on people's attitudes and behavior, and an assessment of the practical corollaries of each culture forms the basis for an analysis of the advantages and problems it brings from the standpoint of achieving the alliance's objectives. This provides the groundwork for addressing the challenge of cultural 'selection'; in other words, how to harness the resources offered by each culture selectively, deciding which to retain and integrate or harmonize together.

The more the cultures differ, the more difficult it is likely to be to achieve a cultural 'fit' between the elements of each that it is desired to integrate. The greater the difference, the more that intercultural reconciliation poses a challenge. If reconciliation proves problematic, the decision may be made either to work with one culture (the domination option) or to permit cultural segregation, at least in the early stages of a cooperation.

The gap between cultures is one consideration when deciding on a management policy for a multicultural management alliance. Another is the potential flexibility of each culture in relation to the others. This concerns the extent to which the cultures brought to an alliance are deeply embedded and therefore difficult to modify in a process of integrating or reconciling them with the other cultures. The question here is how long-standing and deep-rooted the cultures are, and the nature of the 'cultural webs' sustaining them. The cultural web of an organization, according to Johnson (1990) consists of the structures of power and authority, control systems, routines and rituals, symbols, stories, and myths which represent the reality to which the members of that organization have become accustomed, and which in turn act to maintain and reinforce its dominant cultural paradigm (see Chapter 6). A similar analysis applies to the political structures, institutional bodies and their regulations, the routines and rituals, symbols, historical legends, and so forth that comprise the surrounding 'web' of a national culture.

The point of present relevance is that, the more entrenched the web sustaining a culture, the greater will be the resistance on the part of its members and the groups to which they belong (like shareholders, professional associations, labor unions, and nationalities) to any attempt at changing that culture. The longer the history of a culture and the more it is perceived by those who hold it to serve their personal interests well, the more entrenched it is likely to be. It is therefore vital to understanding the bases on which the cultures in an alliance are rooted when deciding on the policy to adopt towards them. An assessment of how the cultural webs are made up will indicate which contextual factors need to be addressed as part of the process of bringing cultures together within the alliance. For example, some members of the alliance may resist identification with the alliance because they perceive it is the partner organization from which they have been seconded, not the alliance's management, which continues to determine their long-term progression in terms of career and remuneration. With this reward system, the partner in question is continuing to enmesh its staff within its own cultural web through what is in effect a control system.

Clearly, in order to arrive at an assessment of the content of cultures that have to be managed in an alliance, it is incumbent on each partner, and the alliance's own managers, to gain sufficient understanding of the other's organizational and (where relevant) national culture. This understanding can be used to develop a tolerance for the other's culture by understanding its historical genesis and the rationales behind it. It will help to identify those aspects of the partners' cultures which provide potential strengths to the cooperation, or which indicate the necessity for one partner to alter its standard practices in the light of the local context. This identification can also point out those aspects of the partners' cultures that are not consistent with the effective operation of the alliance, so enabling attention and effort to be concentrated on a focused effort to change them. An example of this might be the culture of recruiting staff primarily on the basis of family connections. Last, but not least, it can offer some insight into the embeddedness of a partner's culture, particularly those aspects which are likely to be most resistant to change.

### 15.5.1 Specific issues

1. *Assisting personal cultural adjustment*

There are three issues which have to be managed in any intercultural strategic alliance: (1) the problem of personal cultural adjustment; (2) intercultural communication; and (3) the effectiveness of multicultural teams.

The scale of the problem of personal cross-cultural adjustment is indicated by the fact that a large proportion of expatriates end their assignments early. Black and Mendenhall (1990: 114) have summarized the extent of the problem: 'Studies have found that between 16 and 40 percent of all expatriate managers who are given foreign assignments end these assignments early because of their poor performance or their inability to adjust to the foreign environment . . . and as high as 50 percent of those who do not return early function at a low level of effectiveness.' While these figures include expatriates working in branches and subsidiaries as well as international alliances, they nevertheless clearly point to personal cross-cultural adjustment as an issue that alliance partners cannot afford to ignore. In addition to the fact that a manager who is failing to work well with colleagues from a different culture is very likely to generate misunderstanding and perhaps react aggressively, the simple financial costs of expatriate failure are also very high. To quote from Black and Mendenhall's review again, 'studies have estimated that the cost of a failed expatriate assignment is $50,000 to $150,000 . . . [it has also been] estimated that the direct costs to US firms of failed expatriate assignments is over $2 billion a year, and this does not include unmeasured losses such as damaged corporate reputations or lost business opportunities' (1990: 114). Since these are studies published in the 1970s and 1980s, costs will have risen substantially, probably to at least $500,000 for a failed expatriate assignment.

It is widely assumed that the selection of people with previous experience of working in international or interorganizational contexts, and the provision of 'anticipatory training' before sending people to new assignments in unfamiliar cultural environments, are two measures which can help reduce the adjustment problem. The assumption is that both will provide for realistic expectations that facilitate a person's anticipatory adjustment to a new assignment. In fact, evidence as to the effectiveness of either measure is rather mixed.

As with any prior experience, much depends on whether it was positive or not. There are, for instance, two forms of cultural adjustment that do not constitute particularly good experience for future assignments of the same nature. One is when adjustment to an unfamiliar cultural environment has been achieved through withdrawal into an expatriate community. Some Japanese expatriates in the USA experience little culture shock because they avoid contact with their American colleagues, a closed-minded mode of adjustment that does little to build a solid basis for interpartner collaboration or learning (Training 1993). The other is the attempt to cope by denigrating the other culture and aggressively insisting that things are done according to the expatriate's own national cultural norms, or those of his/her own organization. It is usually easy to find apparent confirmation for this negative and inflexible stance from other, disgruntled members of the expatriate ghetto. The selection of suitable staff is an important condition for successful intercultural adjustment. An organization must choose people who have open minds and flexible personalities, as well as those who have demonstrated a positive approach during their previous experience in alliances and/or international business.

Anticipatory training can assist adjustment to a different national culture if it is realistic, up to date, and offers language proficiency. Otherwise it may convey inaccurate knowledge and engender a false sense of confidence, which can actually impede the adjustment process. The trainer should therefore be someone who is from the country concerned and who has maintained regular contact with conditions in that country. Communication skills are a prerequisite both for effective collaboration within an alliance and for an individual to cope with the new local environment. For this reason, proficiency in a relevant language should be developed in anticipatory training, or looked for when selecting suitable candidates.

The provision of anticipatory training as comprehensive as this in its coverage of culture, environment, and language is somewhat of a tall order. It is costly and time-consuming. Some international alliance partners therefore seek to reduce the need for such training by appointing people to key alliance positions who have a cultural and linguistic affinity with members of the other partner's organization. For example, US firms with JVs in China often appoint Chinese-Americans, or even American-trained Chinese, as senior managers of those ventures. Also when first implementing a JV, the partner providing technology and managerial expertise may send in a strong team of expert expatriates for a limited period, such as six months, with assistance from colleagues who are familiar with the local language and culture. The idea is that the teams will get the alliance's operations and systems up and running as quickly as possible and then withdraw. The members of these teams in this way receive some protection from culture shock and their exposure to problems of cultural adjustment is limited. This approach is only available to a large well-resourced alliance partner, and, if not carefully explained to the other partner and implemented with its agreement, can create serious offence and loss of mutual confidence.

Ng (1996) highlights a different, but increasingly numerous, group of business people who are experiencing the challenge of personal cultural adjustment. In their case, the challenge arises from the fact that they are in a sense experiencing a massive input of anticipatory preparation for conducting international business outside their original cultures, and have to find ways of coping with the cultural duality this creates. These are the children of successful overseas Chinese entrepreneurs who are being sent, unaccompanied, to the West for their education, often at an early age. Others are going abroad to acquire a Western MBA, which will give them the organizational and managerial know-how that their expanding companies require. When they return to succeed their fathers in running their businesses, they will have acquired a very different cultural make-up. Ng comments that 'what is ironic is that a western education may cause complications to the unaccompanied minor's succession to the family businesses, to the extent that succession may never take place due to cultural differences between the parents and unaccompanied minors' (1996: 6). As he points out, the extent to which these successors can become biculturally competent, maintaining their personal identity while at the same time developing another positive identity and competence with another culture, will be vital for effective succession within the overseas Chinese family business.

2. *Ensuring adequate intercultural communication*

The importance of good communication in pursuing a cooperative strategy has been stressed throughout the preceding chapters. This refers to communication between the partners, between their personnel working in the joint organization, and between that organization and the parent's offices. Each of these lines of communication crosses boundaries of organizational and, often, national cultures. Referring to the latter, Mishler (1965: 555) notes that 'the greater the cultural differences, the greater is the likelihood that barriers to communication will arise and that misunderstandings will occur'.

A key to ensuring that these communications within alliances are placed on a good footing lies in the role of what Newman (1992*a*,*b*) calls the intercultural 'boundary-spanner'. Describing the successful establishment of a Sino–US JV, the Nantong Cellulose Fibers Company (NCFC), Newman comments that the venture 'owes its existence and operating performance to skilful boundary spanning'. He defines this as follows:

The process of boundary spanning builds a bridge between two different organizations or between two or more people coming from different cultures. Boundary spanners—the persons who perform the bridging activity—need several talents: (1) An empathetic understanding of the customs, values, beliefs, resources, and commitments of people and organizations on each side of the boundary; (2) understanding of the technical issues involved in the relationship; and (3) ability to explain and interpret both (1) and (2) to people on both sides of the boundary. Single persons who can be effective boundary spanners in foreign JV situations are rare. So often a person with technical knowledge has to be teamed up with one or two people who know local languages and cultures (Newman 1992*a*: 149).

In the case of the NCFC, the key boundary-spanner was a young bilingual and bicultural woman who was the daughter of American parents but had grown up in China; she had also worked for ten years on China trading matters and was very knowledgeable about Chinese government and business practices. She was therefore able to provide the US partner with perceptive insights about Chinese culture and institutional arrangements, and was a trusted interpreter of issues to both partners. Many other examples point to the key role that intercultural boundary-spanners play in assisting the creation and development of alliances either, as in the NCFC case, as externally appointed advisers or facilitators or as alliance general managers. Sir Alastair Morton's ability as chief executive of Eurotunnel to mobilize the cooperation of British and French partners in achieving one of the world's major engineering feats is an example of the latter. As Lorenz (1993: 12) commented:

[Eurotunnel] had to overcome a legion of differences between the French and British ways of doing business, Sir Alastair told a conference in London. These ranged from contrasting approaches to the control of capital expenditure, to an entirely different attitude to meetings. Whereas British managers attended them to thrash out decisions, he said, 'the French go to find out what the boss has decided to do'. That Eurotunnel has bridged such gaps is due, above all, to the openness and trust which Sir Alastair and his opposite number established early in the venture.

The key to adequate intercultural communication lies in a mutual willingness to understand why colleagues in an alliance may act in unfamiliar ways. This is where the availability of boundary-spanners and people with relevant experience, together with relevant anticipatory training, can make an important contribution. They will not, of course, make good a poor strategic fit or fundamental conflict of interests between the partners, but they can help to realize the potential of an inherently sound cooperative strategy.

3. *Improving the effectiveness of multicultural teams*

A great deal of the cooperation between partners actually works itself out in what may broadly be termed the 'multicultural team'. This refers to meetings between managers and staff in the alliance, called to make decisions and solve problems, as well as the groups in which some of these personnel work together everyday. The dynamics of such teams is, therefore, of crucial significance for the success of the alliance.

Salk (1992) conducted a particularly close and insightful study of bicultural management teams within three JVs: British–Italian, German–US, and French–German. While all of the teams experienced an initial period in which cultural differences and stereotyping were important motivators of behavior and relations among their members, as time went on relations within the teams evolved in different ways from this similar starting-point. After the initial phase, different contextual factors appeared to affect behavior within the teams. Thus, external threats tended to heighten tensions between members of the different nationalities, even though initially they were a unifying factor. Teams which focused on equality of numbers and influence rather than on level of experience or seniority also tended to display more conflict and lower trust, though what is cause and effect here must be in some doubt. Third, leadership by the JV general manager appeared to have some potential for pushing teams towards accepting a set of working practices and defusing different cultural identities. General managers were in a better position to exercise this influence if they could manage their own relations with parent companies so as to avoid frequent absence from the JV and so have time to interact with team members.

Salk (1993) draws out several practical implications from her research. The initial design of an alliance should adopt career and reward systems, office layouts, and other provisions which help members to identify with the alliance team. General managers should be sensitive to the ways in which their actions, pronouncements, and other symbolic behaviors foster expectations in team members. They should also look for ways to use features, such as overarching goals, external threats, different skills and contributions by team members, to foster identification with the team and mutual attraction among its members. It is particularly important for the framers of an alliance and its general manager to look for ways to create strong superordinate goals for the management team early in its life. Vehicles for doing this include the setting of performance goals and capitalizing on opportunities offered by market or other external conditions, so that external opportunities and threats remain unifying rather than become divisive factors.

Drummond's (1997) conclusions on the facilitators of learning within multicultural teams broadly support these recommendations. He found in two branches of Toshiba, one in Brazil and the other in the UK, that the setting of goals, the establishment of a framework for control and feedback (including performance goals), and office layouts that facilitated close contact between team members, all assisted the progress of such teams.

## 15.6 Summary

1. Culture is an elusive yet consequential phenomenon. The distance between partners' organizational and national cultures impacts on the ease with which they can cooperate. As Chapter 6 noted, while achieving strategic fit is more fundamental to the viability of an alliance, a good cultural fit optimizes the potential of the alliance and helps to avoid the threats to its continuation that arise from misunderstanding and antipathy.
2. Cultures, together with the institutional systems that regulate countries' economic, social, and political systems, give rise to differences in typical management practices and policy orientations. It is these differences that have to be accommodated when partners come together to form an alliance.
3. Cultures display themselves at different levels, ranging from rather superficial mannerisms to fundamental values. People are unlikely to change their underlying values, except as the result of personal or societal trauma.
4. Nevertheless, there is evidence that people can become sensitive to their own cultures and how these differ from others, and that they are prepared to adapt their customary behavior within clearly defined situations, such as their place of work, when they accept this is a worthwhile thing to do. There are, then, possibilities for achieving adaptation and accommodation between partners who come from different cultural traditions. Culture does not have to impose an insuperable constraint upon cooperation.
5. A mix of national or organizational cultures is not, however, simply a problematic feature of alliances; it can also bring positive benefits to cooperating organizations. The managerial and organizational practices that stem from different cultures represent competencies from which each partner can beneficially learn. Cultural diversity creates an opportunity to use the intrinsic worth of each partner's culture for the benefit of the alliance.
6. There are three main ways of accommodating cultural differences and the practices that stem from them. One partner's culture can be adopted as the dominant mode for the alliance. Alternatively, the partners' cultures and practices can coexist, but they are applied to different spheres of the alliance's operations. A third approach is the attempt to integrate partner practices and to derive synergy from this integration. This third approach is the most challenging but also the one likely to produce most benefit.
7. The chapter also set out guidelines for improving cultural fit. These are aimed at assisting personal adjustment to different cultures, promoting better communication between personnel from different cultures, and improving the effectiveness of teams composed of members from different cultures.

## 15.7 Questions for discussion

1. What is culture? How would you decide what was a culturally-determined aspect of a person's behavior?
2. What is the distinction between national and organizational culture, and how is it relevant to strategic alliances?
3. Cultural differences are often seen to create obstacles to cooperation within alliances. What benefits might a mix of cultures within an alliance bring to it?
4. What are the main options for managing cultural differences? What factors should inform the choice between them?
5. What specific practices could be recommended to alliance managers as ways of enhancing the benefits from cultural differences and reducing their downside?

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# 16 Emerging economies

## 16.1 What this chapter covers

This chapter begins by noting the growing attraction of emerging economies as hosts for FDI. While acquisitions are generally the favored mode of FDI into developed-country markets, cooperative forms such as JVs tend to be more prevalent in emerging economies. We then note the kinds of environment presented by major emerging economies or regions for the conduct of strategic alliances: China, India, South America and Central & Eastern Europe. In emerging economies, government policies and regulations tend to play a large part in defining the business environment and these are summarized in a framework that is useful for purposes of comparative analysis. The chapter then focuses on the level of alliances themselves formed with local emerging economy partners. It examines areas of likely compatibility and conflict in partner objectives, survival strategies that might be adopted by local partners or competitors, and the specific problems that can arise in managing an emerging economy alliance.

## 16.2 The importance of emerging economies

Developing countries contain approximately 80 percent of the world's consumers, and almost all of the world's population-based market growth will occur in them during the twenty-first century. From an economic point of view, the most significant developing countries are those whose economies are 'emerging' both in terms of growing market opportunity and in the sense that they are in 'transition' from the constraints of state administration and restrictions on foreign trade. These economies are now seeking to modernize rapidly with the assistance of foreign governments and companies.

Whereas the economic growth rates of developed industrial economies have settled around an annual norm of 3 percent or under, and their markets have become increasingly mature, the rates of annual growth in the so-called emerging economies of East and South Asia, and some countries of East-Central Europe, are typically double that figure. Latin America has exhibited fluctuating rates of growth, though they generally exceed those of the developed economies, while sub-Sahara African countries have mostly stagnated. In some emerging economies, like China, GDP growth has been sustained at an annual rate of around 10 percent. The annual growth rates of industrial production in certain emerging economies have been even higher, between 10 and 20 percent. The differential in emerging economy growth rates is likely to continue.

The faster rate of growth in emerging countries starts from a less-developed economic base, which means that they manifest a high level of demand for both consumer and industrial products and services. Their economies therefore offer the most significant opportunities for companies from the developed countries to expand their markets. In addition, certain emerging economies, most notably China for manufacturing and India for software and communication services, have also been attracting inward investment because they offer a highly competitive low-cost production or service-provision base for multinational companies (Financial Times 2004, The Economist 2004*c*). Others, such as oil-producing African countries and Brazil have attracted foreign investment in their raw material sources. These factors, coupled with the policies of economic liberalization and reform which many emerging countries have now adopted, have led to an increase in the share of worldwide FDI going to these countries, with China in the lead. In 2003, while inward FDI to the developed world fell for the third year running, that going to the developing world rose by 9 percent. On the other side of the coin, the East Asian economies, especially China, Korea, Singapore and Taiwan, are themselves growing in competitive significance and they are becoming increasing providers of FDI as their companies expand overseas (UNCTAD 2004).

While acquisitions are generally the favored mode of expansion into developed-country markets, cooperative forms such as JVs tend to be more prevalent in emerging economies. This is partly a result of host-government preferences for local firms to share in the ownership of foreign-funded ventures in the expectation that such participation will increase their opportunities to acquire new technology, management skills, and other expertise. It also reflects a frequently found preference among foreign investing companies, at least in the early years, to reduce their exposure to risk, and to co-opt the assistance of a local partner in navigating through an unfamiliar environment.

Previous chapters have commented on the fact that the formation and management of cooperative ventures in emerging economies present their own particular challenges. Firstly, the cultural and institutional features of the emerging economy are normally quite different from those of the foreign partner's home country and this creates additional complexity for that partner. Secondly, the nature of partner objectives and the achievement of complementarity between them differ from those applying to most alliances between partners from developed countries. Thirdly, the differences between emerging and developed countries in culture and environment, together with the fact that in some cases the emerging economy has a colonial legacy with the sensitivities attaching to this, can give rise to special difficulties in the process of managing alliances. This chapter examines these three challenges.

## 16.3 Key emerging economies

There are several ways in which the environments of emerging and transition economies differ from those in developed countries (Peng 2000). As Kohn and Austin (1996: 2690) comment, 'developing countries' contexts are complicated, continually in flux, and highly diverse'. This is due to a number of factors:

(1) their transition from traditional and bureaucratic modes of industrial governance and business transacting;

(2) the intrusion of politics into business affairs in conditions where there can be political instability at the macro-level and uncertainty because of corruption at the micro-level;

(3) distinctive cultural norms attached to rigid social structures;

(4) rapid population growth and large flows of population into urban areas;

(5) a high proportion of young people in the age structure often with different attitudes and motivations to their elders;

(6) weak infrastructure and limited technological sophistication;

(7) capital scarcity;

(8) exchange-rate volatility and/or restrictions.

Moreover, in large countries such as China, India, and Brazil, there are considerable regional differences along several of these dimensions within the one nation.

These factors create a high level of complexity facing a company that seeks to invest in an emerging economy. Gell-Mann (1995) makes a distinction between two types of complexity that it is helpful to apply to the emerging economy context. These are 'crude complexity' and 'effective complexity'. Crude complexity is a function of the number of elements in a system and the number of connections between them. It is in these terms that most management and organization theorists have referred to 'complex' organizations and 'complex' environments. Modern information technologies now provide considerable assistance towards coping with this kind of complexity, which does not therefore in principle pose a major problem for corporations. Effective complexity, by contrast, is a function of the irregularity and hence unpredictability of a system of elements and relationships. Some management theorists have referred to this type of complexity with reference to 'variability' or 'turbulence' in organizational environments. It is a much more potent source of uncertainty.

Emerging economies tend to be complex environments in both of these respects. Because they typically have a mixture of traditional and modern institutions, and often a combination of bureaucratic and market-based economies as well, these economies are complex in the 'crude' sense. There are usually more authorities, organizations, norms, and rules to cope with in order to get things done. A report by the World Bank on *Doing Business in 2004* clearly indicates how poorer countries tend to have more business regulations that discourage new investment and wealth creation. For example, in Haiti as of 2003 there is a wait of 203 days for permission to start a new business, while in Belarus nineteen separate paper-pushing procedures have to be endured (The Economist 2003). A large, well-resourced multinational corporation can, nevertheless, deploy the staff and other resources to manage this kind of complexity.

It is much more difficult, however, to cope with the high level of effective complexity that also tends to characterize emerging economies. This arises from factors like the absence of a clear legal framework, uncertainty about the interpretation of the laws that do exist, vacillation in the policies of governments torn between the aims of attracting foreign investment and protecting local industries, the part played by personal connections and relationships in business transactions, the widespread presence of corruption, and the vagaries of transportation, power, and other parts of the infrastructure. The combination of a bureaucratic business environment with relative poverty provides fertile ground for corruption. These features can make it quite difficult both to interpret and to predict the conditions under which business can be carried on. The difficulty is amplified by the rapid rate of change that most emerging economies are currently experiencing. It is obviously attractive for new entrants to this kind of environment to find a local partner who can help to manage the high level of uncertainty.

### 16.3.1 China

China is the largest emerging economy, with a population in 2004 of 1.3 billion. At the time of writing (2004) it had overtaken the USA to become the world's top destination for FDI. It is a country that exhibits both types of complexity. The existence of different industrial ownership systems—state, collective, and private—varying degrees of marketization (Boisot and Child 1996), many contrasting regions (Child and Stewart 1997), and significant generational differences in people's attitudes (Ralston et al. 1995) are aspects of China's 'crude' complexity. The challenges they present are those initially of understanding China as a business context and then taking account of the additional complications it poses for decision-making. However, once recognized and understood, it is possible to assess their implications with reasonable certainty.

Other characteristics of the Chinese context, on the other hand, generate 'effective' complexity in the system, which is far more difficult for foreign companies to handle (Child and Tse 2001). These include the need to negotiate with the many government agencies that are closely involved in business affairs, continuing political uncertainties, and the persistence of resource limitations. Governmental bodies are heavily involved in land use, labor administration, banking, and licensing. Laws and regulations are formulated centrally but administered locally, thus giving rise to ambiguity about what exactly the impact of government policy will be. Another area of ambiguity lies in the property rights Chinese government bodies enjoy over enterprises. Despite the objectives of the economic reform, many state and collective enterprises are beholden to governmental bodies including banks, especially for working capital and the enforcement of transactions. This dependence, which adds to uncertainty, can extend to the JVs which Chinese enterprises form with multinational companies.

The basic logic by which the Chinese economic system is ordered has idiosyncracies that also engender uncertainty for foreign companies. The system is characterized by low levels of codification, so that transactions contain tacit and implicit conditions (Boisot and Child 1996). The interpretation of the terms of transacting, and reliability of transactions, depend on personalized criteria and connections (known locally as '*guanxi*') that can readily give rise both to a distortion of economic rationality and to corruption. The investment in cultural sensitivity required, and in time to develop the necessary relationships, are themselves not easy to ascertain in advance, and this adds yet further uncertainty. The law in this milieu has limited coverage and is itself subject to uncertain interpretation. It has been said that 'China is subject to the "rule of man" rather than the "rule of law"' (The Economist, 2004*a*: 11). Nevertheless, there is evidence that, as the Chinese economy experiences greater market-based competition and becomes more integrated into the world economy, the economic significance of *guanxi* is declining (Guthrie 1998). This is especially the case in JVs with foreign firms, where formalized and transparent contractual principles are accepted, and even welcomed, by Chinese partners (Luo 2002).

A major step forward towards increasing transparency and reducing the uncertainties of China as a business environment was the country's accession to the WTO in December 2001. The terms of China's WTO membership are easing some of the restrictions previously imposed on foreign companies. Foreign investment restrictions are being reduced, with certain sectors previously closed to foreign investment, such as financial services and telecoms now being opened up. However, the ownership share that foreign companies are allowed to possess remains restricted in areas of business. For instance, it is restricted to 49 percent in telecommunications and to 50 percent in life insurance, while sole foreign ownership is not permitted in automobiles and banking. In the restricted sectors, JVs and other forms of alliance will remain the norm. Possibly the main threat to the maintenance of foreign JVs with Chinese partners will arise in industries such as automobiles, where the reduction of tariff barriers and discriminatory taxes mandated by the terms of WTO membership may mean that direct imports become more competitive than autos produced by JVs located in China.

Opposition persists, however, to foreign competition both at local levels of government and from regulatory agencies seeking to protect domestic companies. For example, in banking, new regulations have been passed that limit foreign banks to opening only one new branch per year, together with an imposition of higher than expected capital requirements. In telecoms new rules have been introduced that stiffen requirements facing new entrants to the sector. The issuing of mobile telephony permits has been delayed, and opportunities for foreign companies to form JVs have been seriously limited by a requirement for Chinese partners to put in a large minimum amount of capital.

Although many foreign investors find China a profitable investment environment, with good longer-term prospects, others nevertheless face considerable difficulties in managing their ventures in China. This conclusion, reached from investigations conducted in the 1990s (e.g. Lu et al. 1997; Vanhonacker 1997), remains valid according to more recent evidence (e.g. The Economist 2004*a*). Unexpected changes in government laws and regulations, plus the vagaries of their interpretation at the local level, are a major headache for most foreign managers in China. The still considerable governmental bureaucracy, combined with regulatory ambiguity, generates legal and business risks. On the resource side, there continues to be a shortage of two key business resources—namely, domestic working capital (much of it being administratively redirected to propping up ailing state-owned enterprises), and high-quality, well-trained managers. The South, especially Guangdong Province, is also now experiencing shortages of cheap labor. When the availability of key resources cannot be taken for granted, significant elements of uncertainty are injected into the business environment. Despite the huge investment now being pumped into transportation infrastructure, logistical problems also continue and these generate additional uncertainties.

Companies in the consumer-goods sector, marketing international brands, face the problem of counterfeiting and copyright piracy. While this has received most attention in connection with compact discs and computer software, the CEO of one large US soap and toiletries corporation told John Child that he considered it to be the most serious problem his company faces in China. The authorities have taken some steps to reduce the problem—for example by registering trademarks—but enforcement at the local level continues to be variable.

Human-resource issues also present a significant challenge, with problems of relationships between Chinese and foreign personnel often mentioned (Lu et al. 1997; Clissold 2004). Indeed, the major frustration experienced by Chinese JV managers concerns the behavior of their foreign colleagues and how this can sour the relationship between them. In conversations with John Child, many expressed the view that foreign managers were arrogant and insensitive, and failed either to understand the Chinese environment or to consult them about this and other matters. Such problems can normally be overcome if efforts are made to create trust, improve interpersonal communication, and encourage shared decision-making. Another major issue, arising in most emerging economies, concerns the extent to which foreign firms with local JV should attempt to introduce their own 'international' HRM practices rather than adapting to local ones (Bjorkman and Lu 2001).

A less tractable problem is the shortage of competent local managers available to the rapidly growing numbers of Sino–foreign JVs and foreign subsidiaries. Local managers who are bicultural, bilingual, bi-educational (PRC and Western), and bifunctional (business and technical) are the key to success, but, despite the growth of MBA graduates, are still difficult to find and retain. This has brought to the fore issues of motivation and human-resource development, against a backdrop of high labor mobility between companies that are bidding for good Chinese managers with high salaries and other benefits. This competitive bidding for high-quality local managers can involve foreign companies in practices they may prefer to avoid elsewhere, such as the transfer of housing rights to staff after a given number of years of satisfactory service.

### 16.3.2 India

India is another of the world's largest countries, with a population estimated at 1.09 billion in 2004, second only to China's. After its independence in 1947, India embarked on a long period of planned inward-looking development, which bred a Byzantine system of controls that became known as the 'permit-raj' (Wolf 1997*a*). As a result, India fell seriously behind the economic progress of other developing countries. For example, in 1947 India's per capita income was roughly the same as China's, but by the mid-1990s China's was approximately double.

India introduced economic reforms in 1991, aimed at liberalizing the market and opening up the country to foreign investment and competition. Foreign firms may now own up to 51 percent of an Indian company's assets, except in a few consumer-goods industries, and they are officially granted considerable freedom in making strategic and operational decisions. Investment and production are now fed from licensing in most industries, while restrictions on capital markets and trade have been eased. More sectors have also been opened up to private investors.

India is, in some respects, a less complex country than China for foreign firms seeking to work with local partners. It exhibits crude complexity, which is relatively predictable, rather than effective complexity, which is less so. On the positive side, India has well-trained managers, uses English as the language of business and central administration, and has a relatively developed infrastructure which includes a large private sector and established financial institutions. These benefits are, however, somewhat offset by the considerable rigidities imposed by legislation, as in the field of employment, by a constraining government bureaucracy, and by cultural conservatism which is linked to a high degree of social stratification in society and centralization within firms (Tayeb 1996; Wolf 1997*b*).

Nevertheless, India has so far proved to be a far less attractive environment for foreign direct investment than the other giant of the developing world, China. In 2002, for instance, China attracted seven times more FDI than India. In contrast to China, where most inward FDI has gone to a broad range of manufacturing industries, in the case of India most has gone to services, electronics, electrical equipment and engineering, and computer industries. There are various factors that help to account for the much more limited involvement of foreign firms in India's economy. One is India's slower rate of economic growth and more limited consumer purchasing power, although both have accelerated in recent years. A second factor concerns India's institutional environment. It liberalized the conditions attached to inward FDI much later than China, and it continues to have more restrictive labor laws, a less favorable tax regime, and many bureaucratic obstacles. This may have encouraged outsourcing to Indian firms rather than direct partnerships with them. Third, while India has a good pool of technical manpower, particularly in IT, and has better English language skills, overall its literacy and education levels do not compare favorably with China's. Fourth, compared to the Chinese, there are fewer overseas Indian business people with the ability and interest to invest in their country of origin, including the formation of partnerships with local entrepreneurs (UNCTAD 2003: Box II.4; The Economist 2004*b*).

### 16.3.3 South America

A third significant emerging region is South America, with an overall population of 345 million in 2000 (Brea 2003). South America's population is growing rapidly and it is widely agreed that the region has the potential to transform itself into one of the world's most dynamic areas. In the attempt to encourage this transformation, South American countries have since the 1980s been moving toward an economic model based on trade liberalization, the privatization of state industries, and the promotion of nontraditional exports including manufactured products. Foreign companies significantly increased their inward investment to the region during the 1990s. During that period, the region as a whole experienced growth, and improvements were achieved in both inflation and the control of public finances. However, Argentina, Brazil and other countries borrowed heavily and faced huge international debts by the early twenty-first century. Argentina and Venezuela experienced catastrophic economic crises at the start of the 2000s, and the whole region underwent several lean years from which it is just emerging at the time of writing (2004).

On the whole, the South American environment presents considerable effective complexity, indeed perplexity, to companies seeking to pursue a cooperative strategy there. Unpredictability also arises from the tensions produced by the contradictions that characterize Latin American business environments (Rodrigues 2002). Examples are the contradictions between a widespread fascination with novelty and the persistence of a traditional management style, between an excessive preoccupation with formal bureaucratic control within organizations and public life and decision-making being in reality influenced by personal relationships, between a professed concern with rules and norms and their disregard in practice. These contradictions would appear to have both reflected and contributed to the region's political instability, its oscillation between indigenous and modern Western values, and its excessive state intervention which has so far injected inconsistency as much as stability into the business context. The persistence of high levels of unemployment and poverty in most South American countries further helps to foster political tensions and uncertainty.

It is, of course, difficult to generalize across all the many countries that make up South America. Chile is perhaps the most notable exception to the uncertain environment just portrayed. Brazil is by far the largest of the South American economies with a population of 179 million in 2004 and, in the long run, is predicted to become an increasingly important world host for foreign investment and alliance activity. The following paragraphs therefore focus on Brazil.

The cultural profile of the Brazilian that emerges from both local and comparative studies is one of a strong respect for authority and high-power distance, personalism, low individualism, openness to change and a lack of conservatism, and a relatively high avoidance of uncertainty (Amado and Brasil 1997; Hickson and Pugh 2001; Rodrigues and Barros 2002). The term 'personalism' signifies that Brazilians feel protected by ties of family and friendship, and tend to experience discomfort in impersonal and formal settings. It can readily extend to the bending of rules on the basis of personal favor. Another flexibility that characterizes Brazilian behavior is an elastic view of time. The concept of time as a scarce resource to be managed has not yet been accepted even in urban life.

De Oliveira's (1992) comparison of decision-making in Brazilian and English organizations tends to confirm the implication, which Rodrigues has drawn for Latin America in general (2002) and Brazil in particular (Rodrigues and Barros 2002), that foreign managers entering partnerships there would need to come to terms with the socially intensive nature of local management practice. This is liable to include the exercise of high influence by people in authority, the disregard of formal rules, and the intrusion of personal relationships into decision-making. The positive side to this personalism and sociability is that foreigners are genuinely welcomed in Brazil and it is fairly easy to form relationships.

In the case of Brazil, Rodrigues and Barros (2002) distinguish certain characteristics of management in Brazil which derive from its history and culture, though they also caution that these vary as between the country's different regions:

- 'Decision making in Brazilian organizations in general is concentrated around the chief executive. . . . As Brazilians do not make elaborate or systematic studies of alternatives or of the projected consequences of a decision, and do not spend much effort collecting information, decisions can be made more quickly than in European or Japanese organizations. But this can lead to unfortunate consequences. . . . Making and then reversing a decision is common in public as well as in private concerns.'
- 'Brazilians do not dedicate their time solely to one thing or one person. People are usually late for meetings, conferences and other occasions . . . Attention is given to problems and people as they come and go . . . Long-term planning is considered a waste of time, except for multinationals.'
- 'As friendship is very important and the feeling of belonging to a certain organization or group is common, it stimulates the feeling of loyalty to a manager or superior as a means of protection or retribution.'
- 'In general, priority is given to social contacts rather than to tasks, and to personal rather than to formal communications. Informality and lack of structure result in inefficiency and the wasting of time and resources. However, Brazilians are good communicators on a personal level and do pay attention to what other people have to say. This allows quick communication and rapid diffusion of technology and information. It allows room for creativity and unobstructed change.' (Rodrigues and Barros 2002: 534, 535, 536, 537)

### 16.3.4 Central and Eastern Europe

Another major emerging economic region is that of 'Central and Eastern Europe' (CEE), which is a misleading designation because its component countries are far from homogeneous. In particular, it is necessary to make a distinction between the nations of Central Europe (especially the Baltic States, Croatia, the Czech Republic, Hungary, Poland, Slovakia, and Slovenia—all but one of which are now members of the EC) and the others that belonged to the COMECON bloc. The former experienced a shorter period of Communist rule and they had previously belonged to the central European cultural tradition with at least some urban development and its accompaniment of bourgeois institutions.[1]

These CEE nations have taken economic and political reform much further and they are now benefiting from economic growth. Inflows of FDI to them have climbed steadily since 1996, with the slight exception of 2001. In those countries joining the EU in 2004, the expectation of EU membership, coupled with their economic reforms, low labor costs and generally high skills levels, have all been attractors for foreign investment. Some of this has taken the form of JVs, though most has been effected through the purchase of privatized enterprises plus greenfield expansion investment (UNCTAD 2003).

[1] The three Baltic states had been part of Russia from the eighteenth century until 1920, and were then forcibly incorporated into the Soviet Union from 1940 to 1991. However, they consistently struggled for their independence when the opportunity arose. They were not as integrated into either Russia or the Soviet Union as were, for example, Belarus and the Ukraine.

CEE companies are reported to exhibit manifestations of their former management style, such as a reluctance to assume individual decision-making responsibility and an excessively dependent attitude, and these can lead to problems in relations with foreign business partners (Meyer 2001). Nevertheless, these countries are also producing their own successful entrepreneurs and the state has now withdrawn considerably from both economic ownership and direct economic governance (EBRD 2003).

The situation in the former Soviet Union (excluding the Baltic States) and in those Eastern European countries which have not been part of the West-Central European tradition, such as Bulgaria, Romania, and Serbia, is less encouraging both from a market-growth perspective and from that of building a business environment based on the rule of law and dependable regulations affording would-be foreign partners an acceptable level of risk. For instance, while Russia has attained impressive rates of economic growth, it has consistently been awarded a high political risk rating among major emerging economies. This has arisen largely because the transformation away from central economic planning and governance led to an institutional vacuum in the absence of any alternative model in the country's living memory. The political consequences of this vacuum, during which private entrepreneurs often acquired formerly state assets at ridiculously low prices, became very evident in 2004 with the government's apparent willingness to bankrupt one such entrepreneurially-led company—Yukos, the country's largest oil producer. Therefore despite some progress toward reform, Puffer's comments remain generally valid (1995: 3019):

> Managers [in Russia] must feel their way and operate by trial and error until an appropriate economic, political, and social infrastructure is created. New institutions, such as banks, industry associations, and regulatory bodies need to be created, new laws on taxation, environmental protection, business ethics, and labor standards need to be passed and enforced and a new work ethic and a retrained labor force must be achieved.

## 16.4 A framework for assessing the emerging economy context

It has become clear that in emerging economies the role of government and its institutions, in the form of bureaucracy and politics, tends to constitute a major aspect of the business environment (Peng 2000). This can generate considerable uncertainties for foreign business, and can make the relationship with alliance partners all the more difficult to manage. In China, for example, government officials not only control the issuing of licenses essential to business operations; they can also restrict a JV's freedom of operation indirectly through the dependence that the Chinese partner company is likely to have upon their goodwill—even if it is a nonstate enterprise.

Table 16.1 lists the main areas of public policy, and corresponding policy instruments, in a framework that can usefully be applied to an assessment of the emerging economy context facing potential foreign investors, as well as the context for those already engaged in alliances with local companies. Within each of the policy areas, fiscal, trade, foreign investment and sector-related, legal, administrative, and market-intervention

**Table 16.1** Policy areas and instruments

| | Policy areas | | | |
|---|---|---|---|---|
| **Policy instruments** | Fiscal | Trade | Foreign investment | Sectoral |
| Legal | Tax rates<br>Subsidies | Government import controls | Ownership laws | Land tenure laws |
| Administrative | Public service fees | Import quotas and tariffs | Profit and capital repatriation | Industrial licensing |
| | Tax collection | Exchange rates and control | Investment approvals | Resource concessions |
| Direct Market Operations | Government purchases | Government imports | Joint venture partnerships | Government research |
| | Government sales | Government exports | Sale of state enterprise to foreign investors | Sectoral state enterprises |

policy instruments are likely to be in force. While foreign investment is but one of the four policy areas identified, the others will also have an impact upon business. In the case of each area of policy, the question needs to be asked 'how transparent and predictable is the application of policy instruments in this country?'

## 16.5 Partner objectives

When one of the partners in an alliance comes from an emerging country and the other from a highly developed economy, their configuration of objectives for adopting a cooperative strategy will almost certainly differ from that in the case of partners from two developed countries. Alliances between developed-country partners tend to be based upon expected economies, reductions of risk, opportunities for mutually increasing market power, and learning (Dussauge and Garrette 1999). Very often, both partners seek, and expect to obtain, quite similar benefits from their cooperation. In cooperation agreements between companies from emerging and developed countries, the difference in the nature of their respective objectives in forming an alliance is generally much greater.

In this latter case, the partner from the developed country will often regard an alliance as an opportunity to enter, or more effectively develop, a new market with high growth potential and with good prospects of profitability in the medium to long term once early set-up and learning costs have been absorbed. The availability of low-cost raw materials and/or low-cost labor may also be an important incentive, and this has become an increasingly important motive for multinational corporations that have developed global value and supply chains. Tax and other incentives that may be offered by the emerging country's authorities are welcome, of course, but are not usually of basic significance in the decision to form an alliance. The choice of alliance form, particularly the decision whether to commit capital or not, is likely to depend on the partner's assessment of risk in relation to potential return from the investment, on its requirements to possess control rights in the alliance, and on the host government's policies and regulations (Child and Rodrigues 2004).

The partner from the emerging economy is likely to place opportunities to transfer technology and expertise from the foreign partner high on its list of objectives for adopting a cooperative strategy. It, and even more its government, will also almost certainly value the employment and up-skilling opportunities offered by the foreign investment. Indeed, in many cases the injection of foreign capital may be the life-saver for ailing uncompetitive local firms, which may, ironically, have been forced into difficulties by the very opening-up and liberalization of their economies.

An area of conflict between alliance partners from emerging and developed economies is likely to be over the alliance's net contribution to the emerging country's foreign trade. Many emerging country companies are eager to use cooperation with internationally experienced firms as a means to learning how to export on the world market, with the benefit of combining lower-factor costs with the technological and managerial advantages supplied by the foreign partner. The developed-country partner, on the other hand, is normally more concerned about the alliance as a means of penetrating, and building up a strong position in, the domestic market of the emerging economy. In some cases, this conflict can be avoided because the developed-country partner shares an export objective, and has the intention of using the cooperation as a base for exporting out to other countries in the region.

There are likely to be both harmonies and conflicts between the partner priorities of alliances between companies from developed and from emerging countries. Figure 16.1 illustrates the areas of likely harmony, while Figure 16.2 summarizes priorities that are likely to be in some degree of conflict.

## 16.6 Emerging country partner survival strategies

It is particularly difficult to find pairings between partners of equal strength in the case of alliances between companies from developed and emerging countries. Such alliances are almost invariably located in the emerging economy. The local partner may have relatively little to offer its international partner in terms of technology, management systems, supply-chain networks, or even bargaining power with host country governmental agencies. The invisible assets that local partners can offer, such as knowledge of the market and of the institutional set-up, are ones that an international partner can in due course acquire for itself. In fact, a multinational corporation may well decide at an early stage to invest in establishing its own distribution system and marketing operation if it turns out that the local partner can only offer access to a regional rather than the national market. Local partners often can only offer a restricted coverage of the market in larger emerging economies such as Brazil, China and India. By transferring advanced practices and technologies, and creating new employment, the MNC may also rapidly establish goodwill with governmental and other regulatory authorities. For example, international chemical companies have played an important

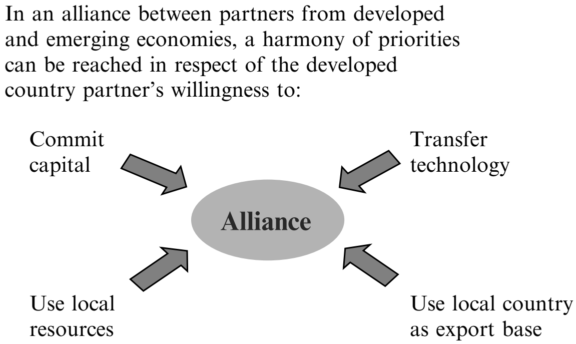


**Figure 16.1** Areas of harmony between developed and emerging economy alliance partners.

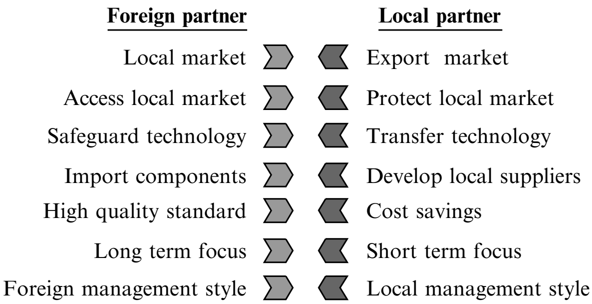


**Figure 16.2** Conflicting priorities between developed and emerging economy partners.

role in assisting China's environmental protection agencies with technical advice and assistance and in so doing secured significant influence with those agencies (Child and Tsai 2005).

Many MNCs therefore enter into emerging economy alliances regarding them as a short term arrangement. From an MNC's perspective, an alliance with an emerging economy partner can be regarded as a relatively low risk trial measure. It affords it the means of dipping its toe into the water and assessing whether the potential attractions of entering the economy, or expanding within it, are realizable and whether they adequately offset the costs and risks of so doing. As just mentioned, the alliance can also be used as a means through which to gain familiarity with local conditions. If the trial and learning process prove to be successful, the MNC may then decide to invest further in the alliance, increasing its equity share and eventually assuming full ownership and legal control. It is almost always in a superior financial position to increase its equity stake in this way and local partners may accept being bought out so long as the price is right. The MNC itself will be attracted by the prospect of moving to a dominant equity position, if not outright ownership. For this increases both its basis for overall control of the alliance, allows for a better integration of the alliance's operations into its global system, and increases its share of the return from a profitable venture. Because of these considerations, MNCs are generally more interested in dominance than long-term partnership. In both Brazil and China, the trend has been for MNCs to establish wholly-owned subsidiaries rather than JVs, or to move towards majority ownership in the JVs they have established (National Bureau of Statistics 2004; Duarte 2001).

Local companies in emerging economies are in many cases at a potential disadvantage in their partnerships with international companies. It is therefore appropriate for them to consider survival strategies, unless they simply wish to sell out. Dawar and Frost (1999) suggest four such strategies that it may be possible for local emerging economy companies to adopt to protect themselves against competitors from advanced industrial countries. These are:

1. *The Dodger.* This is a strategy suited to a situation in which there are high pressures towards globalization in the industry, but where the emerging economy firm's competitive assets are customized to the local market. Here it is suggested that the firm focuses on a locally oriented link in the value chain through entering into a JV with an MNC or, if that it not possible, selling out to an MNC.
2. *The Defender.* This is a strategy suited to a situation in which there are low pressures towards globalization in the industry, and where the emerging economy firm's competitive assets are customized to the local market. Here it is suggested that the firm focuses on leveraging local assets in segments of the market where MNCs are weak. An alliance with a foreign partner could assist this strategy if, for example, the foreign partner enables the local firm to extend its product range and thereby increase its presence in its chosen market segments.
3. *The Contender.* This is a strategy suited to a situation in which there are high pressures towards globalization in the industry, and where the emerging economy firm's competitive assets are transferable abroad. Here it is suggested that the firm focuses on upgrading its capabilities to match MNCs globally, often by keeping to niche markets. A suitable alliance can assist a contending strategy, by providing the local firm with relevant expertise—such as learning how to export and to produce to international standards. An alliance with medium sized-firms abroad might also enable both to compete more effectively in their respective geographical markets.
4. *The Extender.* This is a strategy suited to a situation in which there are low pressures towards globalization in the industry, but where the emerging economy firm's competitive assets are transferable abroad. Here it is suggested that the firm focuses on expanding into markets similar to those of the home country, applying competencies developed at home. Again alliances could assist in at least the initial entry into overseas markets—for example, by providing access to suitable distribution and after-sales servicing networks.

Dawar and Frost argue that emerging economy companies using any of the four strategies can benefit from forming alliances, but that the nature and objectives of the alliance will vary depending on the strategy they adopt.

## 16.7 Specific management issues

It has become abundantly clear during the course of reading this book that managing the alliances that put cooperative strategies into practice is a difficult task. Some difficulties arise from features that alliances anywhere have in common, such as tensions between the different partners' objectives and contrasts between their approaches to management. Other problems are likely to be more prevalent for alliances located in emerging economies.

These are illustrated by the experiences of some, though certainly not all, Sino–foreign JVs. Clissold (2004) provides one of the most graphic accounts of the problems that can lead to catastrophic failures of investment ventures in China. The managerial difficulties these ventures tend to experience fall into three main categories. The first comprises problems that arise because of differences between the objectives that the partners attach to their alliance. Problems of this kind had occurred in under one-quarter of the sixty-seven Sino–foreign alliances studied by Child and his colleagues (Lu et al. 1997). Chinese managers mentioned the problem of divergent objectives more often than their foreign counterparts, probably because in most JVs the foreign partner was in reality occupying the driving seat and steering their policies. Overall, however, divergence between partner objectives was not such a salient source of difficulty, and we have seen that there is often a high degree of complementarity between such objectives in developed–emerging economy partnerships. A thorough examination of strategic issues during the negotiations to form an alliance should, in fact, identify and resolve any significant incompatibilities between partner objectives, unless one side has a hidden agenda, which can sometimes be the case.

The second category comprises problems caused directly by the emerging-economy environments in which the alliances operate. Two main aspects are prominent in the case of China—the institutional and the infrastructural. Problems connected with the institutional environment are attributable to ambiguous laws and regulations, and to the ineffective and/or corrupt workings of the government bureaucracy. As might be expected, it was the foreign JV managers who overwhelmingly experienced these as frustrating problems, with about one-third singling them out as major difficulties. A more recent survey of Hong Kong companies with operations in Mainland China found that most also expressed great concern with regulations there and especially with the conduct of government officials in applying them (Child et al. 2000). Nevertheless, it is fair to say that local Chinese business partners also find external bureaucratic rigidities quite frustrating, and they are aware of losing face when they are unable to deal with them. Infrastructural problems are a continuing feature of the Chinese environment, but considerable improvements have been made in recent years and they are no longer among the most frequently mentioned sources of difficulty. Unlike the other two problem categories, the deficiencies in emerging-country environments are not necessarily a source of division between the partners and their staff in the venture; indeed, to a large extent they present both parties with a common challenge.

The third, and most frequently mentioned, area of difficulty concerns problems in the internal process of JV management. About two-thirds of the Chinese managers had experienced problems arising from what they saw as the unacceptable behavior of their foreign colleagues. This unacceptable behavior included arrogance, an unwillingness to listen, the lack of consultation, and a poor understanding of the Chinese environment and how things had to be accomplished within that context. Other related problems were attributed to specifically cultural differences between the partners' managers, particularly with respect to ways of conducting business. Here the main complaint was made by foreign managers, who were seeking to move the JV away from traditional norms and practices. Similarly, the area of HRM tended to be identified as a difficult area more frequently by foreign managers, many of whom were seeking to make changes to HRM practice. Language and communication barriers were also mentioned, but only in about one-quarter of the JVs.

The sensitivity of Chinese managers to what they perceive as the arrogance of foreign counterparts in an alliance, and the feeling of threat that arises when foreign companies enter emerging economies with a mission to bring modern management with them, are echoed in some of the experiences reported from Eastern Europe. For example, Simon and Davies (1996) examined the process of knowledge transfer from foreign investing firms to their JVs with local firms in Hungary. They found that a major barrier to learning among the Hungarian managers stemmed from the threat that the foreign partnership, and the way in which it was being implemented, posed to their social identities. In the unsettling conditions of radical organizational change, and with expatriate managers often being perceived as arrogant and controlling, the knowledge transfer that actually took place amounted to reluctant compliance rather than acceptance and learning. Local managers used the metaphor of 'colonization' quite frequently to express how they felt in this situation.

Quite apart from the loss of goodwill and motivation which arises in this kind of situation, knowledge of potential value for the alliance to adjust to its emerging economy conditions was likely to be withheld and lost:

> foreign managers themselves may have much to learn about these local factors. Culturally and institutionally-specific knowledge falling into this category has a vital bearing on many important aspects of management both in terms of organizational systems and strategy. These include organization and human resource management within a firm, and marketing, strategy and public relations looking outward from the firm. . . . The remarks just made suggest that Eastern European managers should unlearn less than might be assumed either by Western advisors or the members of foreign companies which have located in Eastern Europe. Presumptions that Eastern Europe has failed, and that its managers therefore have little to offer and should be regarded simply as 'learners', are likely to mislead on the matter. Tacit knowledge deriving from close familiarity with the Eastern European context could be of the utmost value for Western partners who lack this familiarity and sureness of touch, yet it could easily be unrecognized or dismissed as inappropriate by those who assume that their competence is necessarily superior. (Child and Czeglédy 1996: 173–4)

The unfamiliarity of many emerging-economy environments to the managers of international investing companies indicates a need to keep open both their minds and the channels of communication with their partners, each of which is vital if they are to learn about those contexts. The temptation is to do neither and, instead, to act on the assumption that their know-how, technologies, and products or services are sufficiently 'advanced' to mean that the challenge should be defined as one of how to get their emerging-economy partners to accept and understand these supposedly advantageous inputs rather than one of learning anything significant from them. This approach can overlook the valuable contributions that local partners can offer, such as a deeper understanding of host-country people's motivations, the contribution local brands may make to market penetration, and the flexibility that local entrepreneurs can offer an alliance in sectors with a high turnover of local firms and fluid conditions.

Beamish (1988) presents a comparison of two North American JVs established in the Caribbean region that points to the limitations of this one-sided policy. Each had formed its JV with well-established local private firms which had had previous experience with multinationals. Beamish describes (1988: 71) how, despite the fact that both JVs were doing well in terms of return on equity, the failure of one ('Beta') to encourage local participation threatened the future of the cooperation:

> The Alpha joint venture was entered into voluntarily by the foreign MNE. It wanted a partner with local knowledge; it maintained regular communication with the partner; and it shared the decision-making and the profits. Both partners were satisfied with Alpha's performance and its prospects for continued success.
>
> The Beta joint venture was entered into preemptively by the foreign MNE. It wanted a local partner only because of a perception that it would be better off with the local government if it had one. No contribution was expected from the local partner for local market knowledge or managers. No specific need for, or commitment to, the local partner was demonstrated by the MNE. The local partner was dissatisfied with this arrangement. This joint venture had significant problems to resolve in order to survive.

These arguments in favor of encouraging local participation in emerging-economy ventures are, however, strenuously challenged by the view that such participation is often only helpful in the early stages when foreign firms need local support to set up in an unfamiliar environment, or when they are 'forced' into JVs by the policies of host governments. Such firms, it is argued, will go through a period of initial dependence on the help of local partners. However, this dependence will progressively reduce as they acquire their own knowledge of the environment and form their own relationships within it. This implies that their need to wrestle with the difficulties of partnership progressively reduces. Vanhonacker (1997) advanced this argument for foreign firms entering China, a context in which there is a strong trend towards establishing wholly owned foreign enterprises (WFOEs) rather than alliances with Chinese partners: 'pioneering companies, frustrated by the limitations and underperformance of EJVs, have begun experimenting with WFOEs. . . . foreign investors are finding that WFOEs, because of the flexibility and managerial control they deliver, make an excellent fit with China's competitive situation today' (1997: 131). Vanhonacker reports that foreign investors in China are finding that the expectations of Chinese partners do not match theirs in several respects. First, Chinese companies do not have the experience to keep up with the speed and scope of change in the Chinese market. Second, they expect their foreign partners to share advanced, proprietary technology which those partners are reluctant to give away for fear that it will be copied. Third, Chinese partners look for a much shorter-term profit return than do most foreign partners who often wish to reinvest JV profits to fund further expansion. The marked shift away from channeling new foreign investment to China through alliances and in favor of sole foreign ownership, except where regulations do not permit this, indicates that many foreign companies take much the same view as Vanhonacker.

Prahalad (1997), in rather similar vein, expressed the opinion that all JVs in transitional economies are inherently unstable, and that one partner is going to buy out the other eventually. He cited India's experience since the mid-1980s. When India first moved away from a protected market and opened to foreign investment in 1983, multinational companies looked to local partners to serve as 'escorts' through the bureaucratic maze of the 'permit-raj'. At this stage, the local partner was needed to offer a lever on the government bureaucracy, and the MNC was interested in production for the local Indian market. Following the economic reforms of 1991, MNCs had progressively less need for their local partners and were able to move to majority ownership. They had by this time often established their own direct relations with the bureaucracy and also acquired good knowledge of the local market. Now they were willing to invest large sums into India, and were beginning to use that country as a source of competencies to produce for the world market. Indian firms could not match the large investments made by foreign partners, and they had no knowledge of the world market. With the reform, the connections that local firms had with a less-interventionist bureaucracy also became less relevant. Prahalad's prediction for India and many other emerging economies is that (*a*) many JVs will be dissolved, (*b*) MNCs will see JVs with local partners as temporary arrangements, and (*c*) MNCs will compete with local firms in their domestic markets.

These predictions are being made for China and India, and there appear to be similar developments in Brazil and the CEE as well. They clearly present the significant political issue of MNC power for host-country governments. Questions arise as to the long-term political acceptability of moves by MNCs away from cooperation towards unilateral dominance. Host governments may therefore plan to reduce eventually the role of foreign companies in their economies, and may succeed despite globalization if their economies are sufficiently large. For instance, China's official plans for developing its main industrial sectors acknowledge a period of dependence on foreign companies for introducing advanced production capabilities and subsequently R&D competencies, over a period of ten to fifteen years—following which, it is not clear that foreign firms are intended to retain a significant role. It therefore remains a matter for debate as to whether the best way for foreign firms to ensure a continuing role is to establish a position of dominance in their China sectors or to develop partnerships which both sides value and wish to maintain.

The point noted earlier also remains—namely, that policies of go-it-alone or domination over local partners eschew the assistance that a successful cooperative strategy can offer, given the uncertainties in emerging-economy environments. They assume that the foreign investor is large or confident enough not to share the risks of operating in such environments with chosen partners, and this clearly will not always be the case.

## 16.7 Summary

1. Emerging markets are clearly attractive for companies from mature economies, and cooperation with local firms offers an entry route into them.
2. The environments they present to business are, however, usually complex and in flux. They often lack well-developed legal systems and market infrastructures. Their cultures and institutions are distinct from those of the highly industrialized countries, and so correspondingly are their business practices, even though some convergence may now be under way.
3. These features obviously add to the difficulties of getting the process of cooperation with local firms under way, especially for small and medium-sized firms that may not have the resources to spend the time and effort to do this on their own.
4. The objectives of prospective partners from developed and emerging economies are, nevertheless, often reasonably compatible—at least in the short to medium term. Initially, there is usually a strategic fit between the foreign partner's wish to develop markets and the local partner's desire to acquire competence, to underwrite financial survival, and to share in market expansion. There are, however, liable to be issues of access to and control over proprietary resources, especially advanced technology and local distribution networks.
5. In the longer term, it is not clear that foreign investors will necessarily regard a strategy of cooperation with local emerging-economy firms as desirable or even necessary, especially as they absorb the country into their global market strategies and production networks. Equally, the authorities in some countries, such as China, may eventually seek to eliminate their reliance on foreign firms.

## 16.8 Questions for discussion

1. Why are emerging economies attracting an increasing amount of FDI?
2. What are the salient contrasts between the major emerging economies and regions?
3. What are the factors that favor initial entry to emerging economies through JVs or other forms of partnership, rather than through wholly-owned subsidiaries?
4. How are the objectives of foreign and local partners likely to diverge in the case of alliances located in emerging economies?
5. Institutional difficulties are often cited in connection with investing in emerging economies. What are these, and how are they likely to effect the management of joint ventures in such economies?

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# PART IV PERFORMANCE AND EVOLUTION

The final part of this book deals with the ultimate tests for a cooperative strategy and its implementation through strategic alliances. Namely, do such alliances achieve levels of performance that is satisfactory for their partners, and are they capable of evolving over time? In practice, it is not easy to apply these tests. It is far from straightforward to assess alliance performance, and the notion of evolution begs the question of whether alliances are expected to evolve at all beyond their original purposes and, if so, toward what.

Many alliances are considered to fail and relatively few evolve beyond their first five years or so into permanent long-term arrangements. Alliance performance and evolution are intimately connected. Unless an alliance is performing well, it is unlikely that its partners will wish to invest in its further development, permitting it to take on new projects and to enlarge its scope. At the same time, alliances that do not evolve into something greater than was envisaged at their initial establishment are likely to atrophy into arrangements of declining importance to the partners.

Chapter 17 focuses on alliance performance, including its assessment. Chapter 18 addresses evolution and the qualities in an alliance that can sustain it.

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# 17 Alliance performance

## 17.1 What this chapter covers

This chapter begins by noting the widely held view that strategic alliances are hazardous undertakings and highly susceptible to failure. This means that it is vital for business managers to be able to assess the performance of alliances they are undertaking, the more so when such alliances are highly strategic. The chapter examines how alliance performance may be assessed, first from the perspective of the alliance as an entity and then from the perspective of its partner or parent companies. This then leads on to a consideration of antecedent conditions: those emanating from the external environment, those arising from the initial conditions laid down for the alliance, and those concerned with the way the alliance evolves over time. These dynamic and evolutionary processes are associated with the capacity to learn, and are considered further in the next chapter.

## 17.2 The need to assess alliance performance

We have established that the use of cooperative strategies—of alliances and JVs—has become an increasingly popular strategic option with the dawn of the Twenty-first Century. This condition suggests that cooperation has clear advantages, not just in gathering inputs or in conserving resources as have been presented in previous chapters, but in improving the performance of those companies that use alliances. Yet the evidence for overwhelming financial or economic success is rather limited.

A variety of studies observe that more than half of cooperative ventures seem to terminate prematurely, suggesting that the alliance or JV has failed to generate expected levels of performance or has failed to help one or more of the parent or partner firms to improve *its* performance. However, many alliances may terminate early because they have achieved their purpose faster than expected or because they have the opportunity for a favorable acquisition or merger. Academic studies of alliance performance suffer from a variety of problems that will be discussed in this chapter, including measurement concerns, data availability (or lack thereof), uncertain strategic objectives, nonfinancial goals, competing objectives, and other concerns that reflect the complexity of cooperative relationships. At the same time, the continued and increasing use of cooperative strategies suggests that business practitioners find considerable value in alliances and JVs, despite frequent failure. We consider that this situation may reflect the considerable return on investments of capital and effort from successful cooperative ventures and may also reflect the increasing importance of the option value of having many ventures, of which only a very few are actually expected to pay off for the investing firm. Indeed, from a real options perspective, we should expect that most alliances will be terminated—most will be shut down, and the few that prove to have strong potential will be acquired. If survival of the venture has limited value in assessing performance outcomes because of these options effects, understanding performance is made more difficult, even as the ventures actually fulfill their purpose.

From the perspective of the business manager, the need to assess the performance of alliances accurately is as obvious as the need to be able to assess the performance of any unit accurately—and the more strategically important the alliance, the more critical is this need. Even if the alliance is seen as an option on a new strategic direction, the parent managers must be able to assess its option value, hardly a simple process for a real, as opposed to financial, option. Managers can access data that is not subsequently available to researchers, such as unconsolidated financial reports from individual cooperative ventures. However, they may have similar difficulties with relating measurable performance to strategic objectives. When the purposes of the alliance are complex or involve investigating opportunities rather than short-term profits, success and failure may well be hard to separate. And when seen from the perspectives of both parents, conflicting objectives may make failure from one side appear to be success from the other.

Nevertheless, as Anderson (1990) has described for JVs, performance assessment is needed to determine individual compensation levels, to determine further resource commitments or the appropriateness of option exercise, to assess the need for intervention by the parent, and to understand the partner's view of the alliance. Anderson found that most JVs were evaluated much like other divisions, despite very different goals, risks, and levels of uncertainty. We have made a variety of arguments for why cooperative strategies should be valuable. This chapter will consider the evidence for why or why not alliances actually are valuable to business organizations and how this might be determined.

## 17.3 Measuring performance

### 17.3.1 Two perspectives

There are two main perspectives on alliance performance, deriving from a distinction originally made by Seashore and Yuchtman (1967). The first focuses on the alliance unit itself and takes as its criterion the health of the alliance in respect of its viability as an operational 'system'. 'System performance' is therefore defined as the extent to which an alliance performs well as a business unit. The second perspective takes as its criterion the extent to which the 'goals' expressed in the parent companies' objectives for the venture are met. 'Goal performance' is therefore defined as the extent to which the objectives that each parent company has in forming an alliance are realized in practice. Bleeke and Ernst

(1993) consider that an alliance is successful if it passes two tests that broadly accord with these two performance perspectives. One test is that both partners recover their financial costs of capital; the other test is that both achieve their strategic objectives.

The system perspective on alliance performance should, in principle, apply best to JVs that are established as separate legal entities to operate as viable business units. In the course of time, JVs may increasingly formulate their own strategies as a condition for prospering in their own environments, and this is the basis on which they can satisfy parent goals as well. Lyles and Reger (1993) provide a case study of how an international JV developed in this way. The argument that JVs are expected to hold their own under competitive conditions speaks in favor of evaluating their performance on the same basis as unitary firms. This also avoids the complication that parent goals for JVs can conflict or may become obsolete. Moreover, parent goals can amount to aspirations that are not expressed in terms of resources actually committed to a JV, and applying indicators of its 'health' as a system may reveal this gap.

By contrast, one of the arguments in favor of applying the goal perspective is that alliances are formed for a variety of reasons, and it is therefore not legitimate to assess their performance by reference to a sole indicator and/or in a way that prejudges parent company objectives. Goal attainment has underlain many interpretations of alliance performance (Ariño 2003), partly for this reason and also due to the difficulty of devising suitable indicators of system performance. Some previous studies have examined alliance performance from the viewpoint of a single partner, normally using perceptual measures applied to the attainment of that partner's goals (Beamish and Delios, 1997). A lesser number have included performance evaluations in terms of an assessment of both or all partners' goal attainment, arguing that only when each partner is satisfied can the alliance be considered successful (e.g., Beamish 1984; Hill and Hellriegel 1994; Schaan 1983). A problem is that many alliances are asymmetric in partner objectives and/or power, which means that the partners are unlikely to meet their objectives to a similar extent. This may indicate that the alliance has failed in terms of one partner's goal attainment, but it does not necessarily mean that the alliance has failed either in terms of another partner's criteria or as a business unit.

Since each perspective throws light upon different aspects of alliance performance, there is a strong case for adopting both. The conceptual objection to system criteria that they may not adequately reflect parent goals for an alliance is best addressed through a comparison of both goal and system criteria. Only this will indicate if they provide different interpretations and, if so, to what extent. We now consider each approach in more detail.

### 17.3.2 Performance of the alliance as an entity

Performance measures in most studies of businesses make the assumption that the ultimate goal of such organizations is to increase the wealth of shareholders through ongoing and increasing profitability. At the corporate level, both market value and profitability are relatively easy to measure and commonly reported. However, measuring the performance of cooperative ventures using these measures is considerably more difficult—if not impossible. Direct market value assessments for cooperative ventures are seldom possible. The vast majority of alliances is made up of informal or contractual arrangements, and these provide no actual entity to measure. EJVs, while they are independent organizational entities, are usually owned by their parent firms rather than being listed separately on an exchange. Therefore, much as in the situation of valuing an alliance when deciding whether or not to take on a partner, no direct measures of market value are possible and the assessment of value by the marketplace is not available. Likewise, profits and other financial data from alliances or JVs are most often reported only in consolidated statements from the parents rather than separately. Exceptionally, a recent study by Luo (2002) of IJVs in China does use profitability measures available from Chinese government databases based on mandatory reporting.

Many cooperative ventures combine multiple exchanges of value, including expense items such as licensing or support fees, transfer payments, and dividends. This makes assessment of financial benefits complex at best. In addition, we have seen that many alliances are organized not for the purpose of immediate access to new markets, for which profitability might be a relevant measure, but to combine research or marketing efforts, to provide technical or managerial assistance, to reduce costs through increasing scale or scope of operations or access to lower cost inputs, to preempt competitors and the like. Financial gains from such partnerships are indirect at best, and unlikely to be relevant to the assessed performance of the venture. What we find is that through irrelevance and unavailability, common measures of economic performance often are not useful for alliance performance. Even when profitability measures are available, as for corporate managers, Anderson (1990) tells us that high risks and levels of uncertainty make such measures questionable for determining the ultimate value of a venture. And when an alliance is more accurately seen as a real option on a future strategic position, short-term financial measures are inappropriate in assessing value. While researchers are working to apply financial options pricing models to real options, pricing the potential of a very new technology, such as biotechnology or the internet firms of the 1990s, with precision is quite difficult if not impossible.

Quantifiable or objective measures of JV success and failure are found in the academic literature, however. Most of these involve measures of survivability, longevity, or stability. Termination of an alliance or JV is an observable event, and the likelihood or probability of termination can be related to various conditions in the environment, the parents, or the alliance for a large sample of cooperative ventures observed over time. Longitudinal studies can also provide data on the length of time that any given venture is in existence, another measure that can be tied to various input variables to observe what factors might effect longevity. As a final related measure, changes in the ownership or control structure for ventures, particularly for EJVs, can be observed and related to various explanatory measures.

The assumption in all such studies is that termination, shortened life spans, or changes in partner/parent relations reflect dissatisfaction with performance and failure of the cooperative strategy. Continued existence, longer life, and stability are assumed to reflect success. The great concern with this assumption is that many cooperative ventures, particularly contractual ventures, are established for a particular purpose or with a specific period or end date. Such ventures may well end regardless of assessed performance, or their termination may even reflect success—the objective is gained, so the operation dissolves. Thus, an R&D alliance has no particular reason to persist once the product or process under investigation is developed. A short life span would actually reflect efficient operation rather than failure. And, as discussed previously, if the strategic purpose of the venture is to provide an option on a possible major investment, good performance is likely to result in the venture terminating through buyout by one partner (and concurrent withdrawal by the other). A simplistic study would likely see this as venture failure rather than strategic success. A few studies explicitly take into account the possibility of termination with success, but large sample studies often cannot determine the strategic circumstances surrounding an alliance failure. Of greater interest is the option to terminate an unpromising venture. While the alliance may show poor operational performance or fail to promise much for the future, the opportunity to withdraw from an unpromising investment at a low cost may still be seen as a strategic success.

If objective measures are either not available or are of questionable reliability, can other measures suffice? Researchers have developed a number of subjective measures of performance and used them in many studies. These measures typically ask respondents questions along the line of 'How would you rate the alliance's (JV's) performance?', often with the additional consideration '. . . in relation to your initial expectations for it?' In many studies, the general question is supplemented with similar questions relating to specific areas of performance (financial, market share, product development, etc.). These are often consolidated in some fashion and used as an alternative or supplemental measure to the general case. In a recent study (Robins et al. SMJ 2002), though, ratings of performance in specific areas were found to explain the perceived level of overall performance. One study (Geringer and Hébert 1991) is widely cited for having established that subjective and objective measures of performance are correlated, as well as showing that subjective measures based on input from managers at multiple parent firms and the JV general manager were correlated. This study suggests that the various measures of performance tied to survival or longevity and to satisfaction, both general and specific, can be substituted freely. It and subsequent studies have resulted in widespread use of subjective measures of performance of cooperative ventures. The issue remains, though, that satisfaction with the strategic outcome of an alliance investment may not be directly related to satisfaction with the performance of the alliance as an entity.

### 17.3.3 The parental view of performance

Anderson (1990) argues that the performance of JVs, at least, should be measured independently to maintain objective criteria. However, a key aspect of alliances, particularly of nonequity alliances in which no new entity is created and in real options situations, is that they are formed as a means to an end for the partners/parents, not as ends in themselves. A venture that is meeting its own criteria, while hurting the interests of the parent, can hardly be seen as a successful strategic choice. This consideration speaks in favor of the goal perspective, in which the performance of the alliance is assessed from the standpoint of the parents or partners.

Therefore, one valid and potentially valuable measure of performance is how the cooperative venture affects the performance of the parent/partner firms. One study

(Singh and Mitchell 1996) takes this approach by examining the impact of partnership terminations on one parent firm's ability to stay in the business line in which the partnership was established. This study suggests that cooperative strategies are often important parts of a business strategy, and that their failures, if not replaced by new collaborations, are significant to driving parents from a line of business. While not the theoretical perspective of the study, this outcome suggests that venture failure indeed may be associated with exercising the option to withdraw from a line of business.

Other studies have examined various traditional measures of parent performance with alliance involvement as one explanatory variable. Several more recent studies have used event studies of abnormal stock market gains to judge the impact of announced cooperative ventures on the share prices of parent firms. Various conditions were shown to influence these share prices (see below), but of note here is that the market does seem to be concerned with the effects of different cooperative strategies and their contexts on the performance of parent firms. One such model also considered long-term success rates and managerial assessments of performance based on subjective scores on multiple dimensions (harmony between partners, extent to which the parent's objectives were met, extent to which the alliance enhanced the competitive position of the parent, and the extent to which the parent acquired valuable capabilities through the alliance). The market's *ex ante* assessment and the *ex post* managerial assessments of performance were significantly and positively correlated, and the results held up for both equity and non-equity alliances, though they were weaker in the nonequity cases. Yet other studies focus on certain nonfinancial goals ascribed to alliances, such as organizational learning, and specifically measure the extent to which such goals are attained, typically through a survey or interview methodology using subjective scores or by measuring variables other than economic performance. Anderson (1990) provides a model used by DuPont, one that combines an assortment of economic and behavioral measures of performance, adjusted to the circumstances of each venture, to evaluate their alliances.

All measures of parental performance assume that the alliance in question is strategically important to that parent and that its performance will therefore be reflected in parental performance. This may not be the actual case, at least not for all partners. A problem with assessment of performance from either alliance or parent perspective in a complex cooperative arrangement is that all parties may not agree. A JV that is successfully penetrating a market may be cannibalizing sales of one parent while improving the prospects of the other. One parent may learn more about the internal operations of the other than vice versa in an R&D partnership, leading to very different assessments of the ultimate value of the collaboration. A small firm may be totally reliant on a marketing and distribution agreement to sell its output, while its larger partner may have various alternative sources of supply, giving the partners different frameworks to assess risk, time horizons, the importance of profitability versus market share, and so forth. Equally, the smaller partner may be hoping for a buyout (the exercise of the large firm's call option on its technology), while the larger parent may be happy to defer its exercise decision indefinitely.

In short, assessing performance in alliances is difficult for both researchers and managers. There are problems as to appropriate criteria, and problems of finding suitable indicators and data.

## 17.4 Antecedents and causes of performance differences

Measuring performance of alliances is tricky. However, in the face of large numbers of terminations and expressions of dissatisfaction with cooperative ventures, understanding the drivers of performance is vitally important to both researchers and practitioners. As can be seen from the discussion of measures of performance in the previous section, much work has been done to define the causes of success in cooperative ventures. This literature seems to have fallen into three camps. First is the attribution of performance determination to the exogenous conditions surrounding the alliance—the overall economic conditions, the level of government support, the number of competitors, and other essentially external conditions that relate to the market power or strategic behavior model of alliances and JVs (Kogut 1988, and see Chapters 2 and 3). Second is the attribution of success or failure (or managerial satisfaction) to the conditions of the alliance transaction itself. Early studies in this vein (Killing 1983; Beamish 1985) focus on the role of ownership positions in EJVs. Most such studies look to transaction cost explanations concerning the efficiency of the original transaction design in avoiding transactional failure through the opportunism of one or both partners. Resource based models also tend to address initial conditions—if the proper balance of inputs and controls is determined, the alliance should be more viable and stable.

Third, newer dynamic models point to the nature of alliance implementation and management as having performance effects. For instance, learning effects are seen as both positive and negative influences on performance. If one firm learns more from the other than vice versa, the venture is likely to be ended either because the one partner feels betrayed or the other feels that it no longer needs the alliance. On the other hand, if joint learning is enhanced by the alliance, such that both partners feel that they are learning from the association and that they are coming to understand their partners, then learning may enhance performance and longevity of alliances. And, of course, options models consider the expected value of future possibilities arising from buying or terminating the alliance as the key to evaluating performance at any time.

### 17.4.1 The role of the external environment

First let us consider the exogenous aspect of performance. Early models of JVs (contractual alliances were seldom addressed) tended to see cooperative ventures as second best solutions, forced on firms when markets were imperfect. This was particularly true of IJVs, often considered (and with justification) to be the result of government pressures in controlled foreign (which generally means non-American) markets. And, indeed, various countries over the years have set up barriers to imports, in order to protect foreign currency reserves and jobs, and have also forbidden or at least discouraged wholly owned investments, for fear of foreign domination. Such cooperative ventures, having no solid economic basis, have often failed to deliver strong economic performance but have stayed in place in order to provide access to the market or to the resources produced. If restrictions are lifted, such alliances typically unravel quickly.

In other cases, research has established that firms tend to use alliances when they are investing in culturally distant markets. As the foreign parent learns about the host market, and if the local regulatory body permits, it is likely to take over a venture that is doing well in the local market—success breeds 'failure'. In cases of strategic behavior where cooperative ventures were intended to block, co-opt, conspire with, or otherwise pervert competitive relations with a rival, performance must be judged against strategic goals that may be illegal or at most marginal, rather than direct, economic benefits. Survival can be expected as long as the venture is useful, but not any longer than that. When alliances and JVs are formed in response to such external forces and manipulations, they can be successful only as they ward off competitive or regulatory consequences. Termination may reflect an unsuccessful strategy or changes in the external environment. Whether the environment changes to a more favorable investment climate, resulting in a buyout, or to something even less desirable, resulting in abandonment of the venture, the strategy of protecting position with minimum investment may be seen as successful.

### 17.4.2 The role of initial conditions

The question of partner control normally looms large among the initial conditions laid down when an alliance is formed. Chapter 11 explored some of the research that has investigated the relation of alliance control to performance. Killing (1983) showed that in JVs between firms from industrialized countries, where partners were likely to have similar skill levels, dominant control or independence of the JV appeared to lead to success. Beamish showed that unequal ownership, with the local partner having the higher level of ownership, and shared control, seemed to lead to greater success among JVs between developed and developing country firms, where local adaptation was critical. These conditions were also related by Beamish to the strategic drivers of alliance—need for skills or assets in developed country alliances and government pressure in developing countries.

The resource-based view of the firm emphasizes the contribution that possession of key resources and competencies can make to the performance of firms (see Chapter 2). This suggests that how adequately an alliance is resourced and the partners' contributions to this is another important initial condition expected to bear upon its level of success. Harrigan (1988) found that complementarities in resource inputs and industry relatedness tended to lead to longer lasting and more satisfactory cooperative strategies. In developing and transition economies, where production technology, expertise, and training supplied by foreign alliance partners is still usually superior in quality to that available from local sources, the provision of these resources by international partners may be crucial for the success of their alliances (Lyles et al. 1999; Steensma and Lyles 2000; Peng 2000).

Mjoen and Tallman (1997) examined performance success from the perspective of the foreign parent, taking account of control and resource input. They suggest a causal chain from resource input to specific control of that resource or a related activity, to perceived overall control, to satisfaction with the performance of the JV. They tie the control measures to increased bargaining power in the transaction negotiation, and success is largely connected to the perception that the firm can bargain to protect its specific resource investment in the JV. While a bit more sophisticated, this analysis, and many others from the same time frame, is inherently limited by its stated and unstated assumptions. The analysis is related in large part to the originating transaction that formed the alliance. Performance is measured by managerial perception of success, and the explicit link to ownership or control appears to assume that not losing key resources in the face of anticipated or feared opportunism is cause for satisfaction.

Child and Yan (2003) also examined how the combination of resource provision and control was related to the performance of Sino–foreign IJVs located in China. They used managerial perceptions of both JV economic (system) performance and partner goal attainment. These researchers postulated that in the context of developing and transition economies, the quality of resource provision in the form of plant and operational inputs was particularly crucial for IJV success and that this provision was likely to come primarily from the foreign partner(s). They also noted the widespread assumption that dominant control by the foreign parent would contribute to higher levels of JV performance, despite conflicting evidence on this point. Their findings point to a more subtle interdependence between resource-provision, control and performance. They concluded that:

> an approach to control permitting the combination of foreign leadership in resourcing, through the transfer of technology and expertise, with local participation in decision making will be conducive to better performance. This permits a degree of leadership by international firms consistent with the effective transfer of what they can offer by way of superior resources, but which is not taken to the point where foreign dominance creates a barrier to contributions from the local partner or its ability to learn. (Child and Yan 2003: 309)

This conclusion appears to be compatible with that reached by Choi and Beamish (2004) from a study of seventy-one IJVs between Korean and foreign multinational partners. They found that those IJVs where there was 'split control' by which each partner chose the activities to control in which they had complementary skills or resources, performed better than IJVs with other control configurations. It is further supported by the findings of Robins et al. (2002), who found that performance satisfaction with international alliances in Mexico were tied to specific resource strategies for the American partner, the Mexican partner, and the operational managers in the alliance itself.

### 17.4.3 Dynamic and evolutionary processes

Certainly the initial conditions of the transaction are relevant to the issues of performance and success or failure of the alliance, but a static model in which transactional conditions at the outset are assumed to drive outcomes many years later is both unlikely and out of date. As we discuss further in Chapter 18 newer dynamic and evolutionary models of organizations that focus on knowledge resources and capabilities and the potential for learning and adaptation suggest that transactions are not single points in time, but rather are processes (Doz 1996; Ariňo and de la Torre 1998). As a consequence, both internal and external conditions and their effects on performance change over time.

A dynamic capabilities perspective on alliances would suggest that any alliance which persists for an extended period of time will develop new routines and capabilities for managing alliance processes as well as for product generation. Likewise, parent firms will develop capabilities for alliance formation (partner selection, negotiation, structuring, etc.) and management (financing, partner relations, negotiation and re-negotiation, joint decision making, relationship-building, and so forth) both in general and with respect to their specific alliances and partners. This perspective reflects both evolutionary economic theory and organizational learning theory. That is, new routines and capabilities will evolve out of old as variation, selection, and retention act on the business processes of the alliance system—an evolutionary system driven by performance. At the same time, companies involved in alliances will engage in learning activities, including internal development, the inward transfer of management systems and practices, selective hiring, and alliance and acquisition of specific target firms. Through these active and evolutionary processes, firms will develop new competencies at operating alliances and alliances will gain new competencies at operating their businesses. If selection and retention are driven by environmental scarcity, their net effect will be to improve the performance of organizational systems that survive beyond initial startup.

Empirical evidence for the role of capability development in driving alliance performance has likewise evolved over recent years. Three aspects of learning have been noted as likely to enhance the chances of alliance success (Child and Yan 2003). The first is *learning from previous experience*. This is the transfer to a new alliance of relevant knowledge acquired by parent/partner personnel from their previous experience of forming and managing alliances. Several pieces of research have shown (Anand and Khanna 2000) that previous alliance experience is an important, if not the most important, factor in predicting successful processes in subsequent alliances. The second is *formation learning*. This takes place in the process of seeking and negotiating terms with new partners. The more care that potential partners take to learn about each other and to assess their suitability, the greater the chance that the alliance will be based on a sound strategic, resource, and cultural fit. The third aspect of learning is *operational learning*. This is learning how to work and relate effectively with one or more partners in the implementation and development of the alliance. The duration of an alliance is connected to operational learning in that a longer operational history affords more time to establish sound processes and relationships, while at the same time superior operational learning per se provides a sounder basis for the alliance to continue to develop over time.

This suggests that firms develop capabilities from previous experience, during alliance formation (the initial transaction) and during alliance management (ongoing processes). Exactly what these capabilities are is less clear. Some authors suggest that incremental learning in an evolutionary setting builds superior routines, presumably for a specific alliance or alliances, but able to be generalized to some extent to all alliances. Others expand the concept into higher order learning and the development of generalized 'combinative capabilities' (Zander and Kogut 1995) or architectural competencies in organizing various activities (Henderson and Cockburn 1994).

Dyer and Singh (1998) point to the development of relational capabilities, or skills at developing and maintaining social relationships between partners, as critical to alliance success, a view supported by the empirical work of Yan and Gray (1996). Differences in the partners' national, organizational or professional cultures, while representing potential complementary contributions in terms of knowledge and sensitivity to local environments, can be an obstacle to the development of relational capabilities (see also Chapter 15). The more that cultural differences bear on partner cooperation to perform the alliance's primary value-creating activities, the more they are likely to impact on alliance performance (Pothukuchi et al. 2002; Simon and Lane 2004).

These ideas from Dyer, and additional concepts from Gulati (1998) to establish the importance of relationships and trust within alliance networks to persistence and performance, are tied to capability evolution within specific alliance frameworks, but these are difficult constructs to measure exactly. Kale et al. (2000) have developed measures of relational capital in alliances and show that it fosters learning and conflict management (control of opportunism) in alliances. They suppose that these aspects of a dynamic system will improve performance, although they do not explicitly test this. Combined with Anand and Khanna's evidence that learning improves market performance, however, relational capital appears to be an important aspect of success in ongoing alliances.

Finally, Kale et al. (2002) show that firms which institutionalize alliance capabilities with dedicated alliance functions in the partner companies show both higher managerial assessments of performance and more positive stock market responses to alliance announcements, even when experience is included separately. They also find that such functions evolve over time, as we noted in Chapter 13 to be the case with the RBS–Banco Santander alliance. These functions provide expertise and organized tools for alliance planning, partner selection, negotiation, management, and termination (Kale et al. 2002) and they adapt to the needs and capabilities of the partner company.

It appears that alliance success is tied to developing and formalizing skills in building alliances and alliance relationships. In a recent article, Poppo and Zenger (2002), report that contractual complexity/completeness and relational governance are complementary determinants of performance in outsourced Information Systems contracts. Outsourced IS management requires a detailed understanding of the customer's needs and frequent adaptation to a rapidly changing technology. They determine that the large investments in specialized assets required for IS drives complex contracts, while rapid technological change necessitates ongoing relational governance as an adaptive mechanism. These different drivers suggest that contracts and relationships support performance through different functional means, permitting them to act as complements rather than substitutes in improving performance in such alliances.

This body of research suggests that alliance success is tied to two issues. One is the development of generalized alliance capabilities or functions, which should improve the odds of success for a parent firm in any alliance. The second is the development of transaction specific relationships, which should improve the level of trust and the efficiency of operation of individual alliance relationships. Such highly transaction specific capabilities should help build general skills, and also provide a separate avenue to success in particular alliances. The evolutionary perspective views alliance success as tied to an ability to continually adapt cooperative ventures to a changing environment, both as an embedded capability and through formal structural adaptations (Doz 1996). In this model, exogenous conditions have an impact on the structure of the alliance, only causing failure if adaptation is not possible or not economically viable. Likewise, initial conditions set up failure more through their ability to constrain adaptation than through their specific terms. The success of long-term cooperative ventures is most affected by the flexibility and adaptability of the relationship.

Real options models, too, are dynamic, in that the value of an option is constantly revised in the light of new information. As the parent firms learn more about the technology or line of business on which the alliance provides a real call option, the value of the option changes and the likelihood and immediacy of exercising the option also change. Unlike a financial option, where the strike price is established at the outcome and the value of the underlying asset is known by watching its market price, most alliances do not establish a specific buyout price (this is negotiated at the time of the proposed acquisition) and the value of the underlying assets is also negotiated since no efficient external market exists. Depending on relative valuations and bargaining power of the partners, much as we saw in Chapter 7, a parent might or might not acquire the venture, regardless of the conditions set at the origin of the alliance.

## 17.5 Conclusion

Performance in cooperative strategies is a more complicated concept than in simple market transactions—straight value for money—or in cases of wholly owned divisions or subsidiaries. In the first place, the goals and objectives of alliances and JVs are often unclear. With two or more parent firms with their individual aims, alliance managers are likely to find that their principal stakeholders have only partially compatible expectations and assessment scales. With short-term financial goals often only a minor consideration for a cooperative venture, managers on all sides have not only to measure performance, but to consider the true goals of the venture in determining just what should be measured in the first place. Such high levels of uncertainty about considerations that are typically assumed in studies of business organizations mean that researchers are placed at great disadvantage in trying to evaluate the success of various alternative cooperative strategies and organizations. This makes authoritative conclusions difficult, and leaves managers with little assistance in making decisions about the likelihood of success in different ventures.

The result is that many antecedents prove to have occasional effects in predicting alliance performance, but few are consistent across a wide range of situations. On the other hand, these problems reflect the multifaceted utility of cooperative ventures. They can successfully reduce risks in unstable markets. They provide an opportunity to learn new technologies and management processes. They offer less expensive options to major investments in unproven but promising businesses, products, or technologies. They permit a firm to access inputs or markets without having to develop internally all the expertise needed to move a product through the value-added chain to market. And we do see that the equity markets find value in alliances, particularly for firms with some record of having previously extracted value from alliances. While relatively qualitative and tightly bound to specific conditions, assessment of performance of alliances seemingly is feasible, and even when inaccurate will tend to be less costly than an accurate but negative assessment of the value of having invested in a wholly owned alternative. Uncertainty of performance assessment does not, and probably should not, discourage the use of cooperative strategies. This is most true in the still emerging markets of the new information economy and in newly developing parts of the world.

Moreover, there has been progress in identifying the factors that are likely to contribute positively to alliance performance. In this chapter, we identified three categories of such factors, pertaining respectively to the external environment, initial conditions, and dynamic evolutionary processes. There is now a requirement for research that examines the performance effects of all three categories both separately and in combination.

The problem of measurement also remains. We believe that the record of empirical research into performance of cooperative strategies suggests that measurement is possible, but must be carefully considered. Survival measures seem unlikely to be appropriate, except in the most narrowly defined circumstances. Subjective measures of satisfaction, whether for academic studies or managerial assessments, are probably much more appropriate than the 'hard' financial measures used in most management studies. Since the motivations and objectives are likely to be complex and interdependent, explicit assessments are likely to be rigorous but also either irrelevant or incomplete. Unless the alliance has narrow, clear, measurable goals, subjective assessments seem more likely to be valid, if imprecise. For the same reasons, multiple measures should be considered. Subjective success on multiple fronts should be assessed, rather than a single universal statement of satisfaction. Likewise, satisfaction must be measured according to the present situation and future expectations, not original strategic goals. A venture may well have reached a highly favorable situation through opportunism, luck, and hard work that has little or no relation to the original venture concept. This must not be assessed as a negative outcome but recognized as a key benefit of the flexibility provided through alliance strategies.

## 17.6 Summary

1. Assessing the performance of strategic alliances is notoriously difficult. To attempt an assessment in conventional financial terms could be to miss the intentions (goals) held by partners when forming an alliance. These are sometimes highly specific and short-term in nature. It is therefore useful to keep in mind the distinction between 'system' and 'goal' criteria for alliance performance.
2. Because of their hybrid nature, alliances are also complex constructions both in purpose and in management. This lends them a fragile nature and they often fail to survive for many years. Stability and survival have often been taken as indicators of alliance performance, but these can misleadingly exaggerate the incidence of alliance failure, given that some partnerships cease when their specific objective has been accomplished, while others transform by agreement into a purchase by one partner of the other.

3. While the complexity of alliances and their purposes render performance assessment and prediction hazardous, they at the same time reflect the multifaceted utility that they can provide for their partners.
4. Uncertainty of performance assessment therefore does not, and probably should not, discourage the use of cooperative strategies. This is most true in the still emerging markets of the new information economy and in newly developing parts of the world.
5. Moreover, there has been progress in identifying the factors that are likely to contribute positively to alliance performance. In this chapter, we identified three categories of such factors, pertaining respectively to the external environment, initial conditions, and dynamic evolutionary processes.

## 17.7 Questions for discussion

1. What are the implications of distinguishing between 'system' and 'goal' criteria for assessing the performance of alliances?
2. Do you think that too pessimistic a view has generally been taken about the success of alliances?
3. Does a tendency toward pessimism about their performance reflect the adoption of too narrow a view of the utility of most alliances?
4. What assessment would you make of the relative contribution to alliance performance of external environment, initial conditions, and dynamic evolutionary processes?
5. What practical guidelines for companies forming and managing alliances follow from each of these three factors?

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# 18 The evolving alliance

## 18.1 What this chapter covers

This chapter discusses the evolution or mature development of cooperative arrangements as a condition for their success. It stresses that alliances which do not evolve into something greater than was envisaged at their initial establishment are likely to atrophy into arrangements of little abiding importance to the partners or indeed break up altogether. For successful evolution to take place, the alliance has to possess certain qualities. The capacity to achieve flexible adjustment, the maintenance of balanced development between the partners, the ability to take on new projects, and the development of trust are each conducive to successful alliance evolution. These characteristics reflect a process of learning by the partners, through which they recognize when to make adjustments and how to implement them. The chapter begins by noting a number of evolutionary schemata suggesting the stages through which alliances develop. It then considers some of the possible outcomes to which the evolutionary paths of alliance development can lead. A third section examines the predominantly internal factors which can affect the patterns of alliance evolution, and which are therefore relevant to management policy.

## 18.2 Patterns of alliance evolution

Alliances do not stand still, at least if they are to survive. As partnerships, often formed in response to challenging competitive conditions, they are founded upon relationships that have a dynamic of their own and are subject to the influence of external changes bearing not only directly upon the alliance but also on the parents separately. They have to transform and adapt with a sense of direction. The main exceptions are those partnerships, such as oil-exploration consortia, which are designed for one-off purposes rather than to evolve into long-term relationships. Thus, only 4 percent of these partnerships in the petroleum industry normally last longer than five years, according to a 1995 survey published in the Oil and Gas Journal (cited in De Rond and Faulkner 1997).

For most alliances, however, the choice appears to be to evolve or to fail. How cooperation evolves is a question that has received limited attention from scholars (Ring and Van de Ven 1994; Doz 1996). The evolution of alliances can proceed along different paths and lead to quite different outcomes. It can incur periodic crises and often leads to termination of the cooperation. Experience of JVs with US partners suggests that there are two critical periods in their existence. The first comes at about two or three years of life, by which time an unsatisfactory relationship should have become evident. The second comes after about five or six years of alliance life, by which time one partner may be ready to move onto another arrangement. This could be disengagement from, or take over of, the other partner. It has been estimated that the median life span for alliances is only about seven years and that nearly 80 percent of JVs eventually end in a sale by one of the partners (Bleeke and Ernst 1995).

Evolution in relation to strategic alliances needs careful definition. As a scientific term evolution calls to mind, most prominently, the Darwinian/Lamarckian debate over the possibility of passing on acquired characteristics genetically. Lamarck believed this to be possible. So, if someone were to develop a particular skill, such as piano-playing, his heirs would be more genetically disposed to be good piano players. Darwin denied this, claiming that species evolved by natural selection such that the animals with the best fit with the environment were the ones that survived and continued the species through their progeny. Clearly genetic change, if it were possible, would come about far more rapidly if Lamarck were right than under Darwinian rules. However, Darwin won the scientific debate.

Evolution in this sense can, of course, be used only as a metaphorical term in the study of management, since companies do not breed in a genetic sense. As such, the scientifically discredited Lamarckian theory returns as a useful concept. It is perfectly possible to conceive of companies learning, adapting, and then passing on their knowledge or know-how to future generations of managers, thus giving their company a competitive advantage. The Darwinian process may, however, take place in populations of companies (Hannan and Freeman 1989), as those with the best environmental fit survive in markets requiring companies with certain characteristics, and those without them go bankrupt.

When the term 'evolution' is applied to cooperative arrangements like strategic alliances, it is not normally used with much scientific rigor. Here the definition offered by the Oxford English Dictionary is probably most appropriate, namely, 'any process of gradual change occurring in something, especially from a simpler to a more complicated or advanced state'. In this sense, the evolution of alliances may be taken to mean merely that they develop in scale, scope, or form over time. Since this development takes place in relation both to the partners and to the environment of their cooperative operations, evolution is a dynamic rather than simply an additive process. The most effective alliances seem to be those that show evolution over time, rather than merely a competent pursuit of their objectives agreed at set-up.

### 18.2.1 Evolution phases

Achrol et al. (1990) describe the four stages of alliance development in their schema as entrepreneurship, collectivity, and formalization, leading to domain elaboration. Thus alliances are typically fluid and creative at the outset. This stage is followed by one of the integration of alliance personnel to its purpose, where a defined sense of collective mission is developed. The formalization stage involves the development of systems and procedures; ultimately the domain-elaboration stage is one of self-renewal, where the alliance's flexibility is renewed, its scope redefined, and a new and expanded quest embarked upon.

Lorange and Roos (1992), who distinguish three main phases in the development of alliances—formation, implementation, and evolution—stress that evolution is far more important to an alliance than control by its partners. Moreover, 'we see a need to change the control emphasis of a strategic alliance as it evolves from the hands-on physical control mode to a more decentralized financial control form. It goes without saying that the executives involved in the management of the strategic alliance from the two parents' sides must be sensitive to how they should shift their emphasis on control over time' (Lorange and Roos 1992: 121).

Evolution will vary in the form it takes, and this is dependent on, *inter alia*, the initial alliance form adopted. A JV is set up in the form of a hierarchical company and, with the support of its founding parents, may evolve like any other company. Lorange and Roos describe the generic evolution of a successful JV as commencing with responsibilities firmly in both partners' hands, developing into a situation in which the venture claims more responsibilities for itself. At this stage, one partner may become the more dominant. The third stage will be achieved as the venture becomes a free-standing entity with its own independent management. The JV may, like Unilever, ultimately come to dwarf its parents in power and commercial strength. It may acquire new shareholders, extend its role, recruit staff unconnected with the parents and in fact do anything within its articles of association. The same applies to a consortium that is given a separate corporate existence. Airbus Industrie, having been formed in 1970 as a Groupement d'Intérêt Économique under EU regulations with profits and losses accruing to the four partner companies rather than to the consortium itself, has been reformed into a limited company.

Lyles and Reger's (1993) study of how a JV developed illustrates a number of these points: different phases in alliance evolution, the conditions affecting its degree of autonomy vis-à-vis parent companies, and eventual absorption by one of the parents. The outlines of this case are given in Box 18.1. The case also exemplifies the most common end-point of JV evolution—namely, an outright purchase by one of the partners.

Collaborations are different in that, lacking a corporate structure, issues of autonomy are unlikely to arise in the way that they are liable to do with JVs and subsidiaries. Collaborations are destined to remain just that or to evolve into another form. They may, of course, as did the Royal Bank of Scotland and the Banco Santander, also create both consortia and JVs as part of their overall collaboration. Since the relationships are directly between the partners rather than via a third, jointly created organization, they can be very complex and require a level of intimacy not present in most JVs. The 'gatekeepers' for each partner are likely to play an important role in shaping the evolution of the collaboration. The effectiveness with which they perform that role will depend on the standing they enjoy within their respective companies and the quality of their personal relationships, as well as their personal ability and vision.

### Box 18.1 Evolution of the ACE consortium

This joint venture was established in 1946 and evolved over a period of thirty-two years. It was formed, to produce speciality industrial machine tools, by seven firms, two from the USA and the others from five different European countries. One of the American firms, ACE, wanted to enter the European market with its existing speciality industrial machine tools, while the other firms were interested primarily in finding a reliable supplier of machine tools produced locally in Europe under licence from the second American partner.

The alliance passed through three main phases. The first lasted ten years and was one of slow and rather unfocused development under a senior management supplied by three of the partners. The second phase lasted a further twelve years under an entrepreneurial CEO supplied by one of the American partners. This period saw the redesign of the American partner's products for the European market, and an expansion of both supporting functional activities and new plant locations. During this phase, the joint venture was highly profitable and expanded successfully. Indeed, it developed a superior product to ACE's own which brought the joint venture into conflict with that parent. The joint-venture CEO was able during this period to increase the joint venture's autonomy through several sources of upward influence: his successful entrepreneurial leadership, the seeking of support from the parent company's customers, differentiation of the joint venture's product, and informal relationships with parent-company managers. Four years into this second phase of evolution, ACE increased its equity position to 75 per cent. This appears to reflect its desire to strengthen overall control, as well as to invest further into success.

The CEO's retirement led into a third phase of evolution. The replacement CEO was less entrepreneurial. During this phase, the joint venture's product line was reduced and it now reported directly into the relevant product division within the dominant parent company. Ten years on, the joint venture was completely acquired by the majority parent company.

*Source*: Lyles and Reger (1993).

More loosely structured cooperative arrangements are less likely to evolve very far. Ad hoc pools reflect collaborative arrangements that require no more than a bare minimum of resourcing, usually for a limited period of time. They are normally based purely on contractual agreements and do not return any surplus funds into the alliance itself. Therefore, the prospects of an ad hoc pool evolving are small. A successful ad hoc pool may, however, provide the basis for more intensive arrangements in the future, in the form of a consortium. Evolution is more likely to take place in a consortium, as the partners' interests and capabilities synchronize, and they learn as a result. However, the evolution in this case is frequently limited to the re-creation of complementary roles in a new follow-up consortium rather than developing into more sophisticated forms of cooperation (De Rond and Faulkner 1997).

As Bleeke and Ernst (1995) point out, the various alliance forms are frequently likely to end up as a sale of one partner to the other, or of one partner's JV holding to the other, in the dissolution of the alliance, or in the agreement of the partners to extend or contract

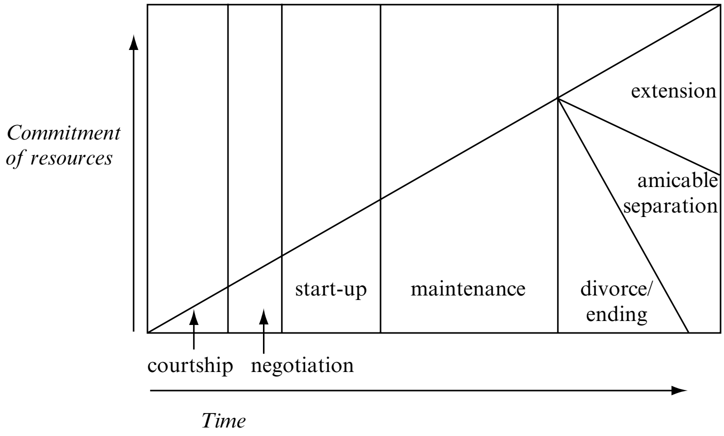


**Figure 18.1** A life-cycle model of alliance evolution.
*Source*: Murray and Mahon (1993).

the range of activities they carry out together. There is ample evidence for all these possible outcomes, and no one particular outcome is inevitable. Outcomes depend crucially upon the ongoing relationships between the partners and the partners' changing strategic imperatives. Murray and Mahon (1993) depict alliances as exhibiting a life cycle as illustrated in Figure 18.1.

The two axes of the figure indicate time and commitment of resources by the alliance partners. Alliances begin with a courtship stage, as does any relationship. If this goes well, detailed negotiations follow to develop an agreement. Then follows stage three, the start-up phase, in which joint activity begins, and substantial resources are committed. Murray and Mahon describe the next stage as the maintenance phase, which involves the routinization of operations and reporting relationships, as the organizations continue to work together on an operational basis. This is, of course, the phase when the ultimate success of the alliance will be tested, as it gains in responsibilities, continues in steady mode, or declines in importance and becomes marginalized by the partners. The fifth stage of the life cycle is described as the ending, which can take a number of forms:

1. the end of the specific relationship with extensions into other areas of mutual interest;
2. an amicable separation with no immediate further joint activity;
3. a hostile parting, inhibiting the likelihood of any future joint activity.

The time line for the fourth stage may, of course, be short or extended to an infinite length, depending on circumstances.

Schacht (1995) takes issue with Murray and Mahon's view that the options for the ending phase of an alliance are limited to extension, separation, or divorce. Continuing at reduced levels, for instance, is a real possibility. Schacht argues that neat classifications of alliance evolution are oversimplified. Instead, he seeks a more complex and contingent prognosis of alliance evolution, tying it more closely to organizational learning. 'A more comprehensive international strategic alliance life cycle model . . . would have to recognize that, when new projects are initiated within ISAs, prior progress along the various learning curves need not be lost. Subsequent projects could start at higher levels of organizational knowledge about technologies, opportunities and systems/procedures' (Schacht 1995: 62). Schacht emphasizes the need for an active stance towards managing the life cycle of an alliance and relating it to the possibilities for organizational learning, if a required pattern of alliance evolution is to be achieved. He also stresses the role of organizational politics in influencing the evolution of organizational learning. The existence of the 'not-invented here' syndrome, for example, may have a strong impact on reducing the achievement of organizational learning, and thus inhibit the evolution of the alliances.

Ring and Van de Ven (1994) view the evolution of alliances, or, as they call them, Cooperative Inter-Organizational Relationships (IORs), 'as consisting of a repetitive sequence of negotiation, commitment, and execution stages, each of which is assessed in terms of efficiency and equity . . . the duration of each stage varies according to the uncertainty of issues involved, the reliance on trust among the parties to a cooperative IOR, and the role relationships of the parties' (Ring and Van de Ven 1994: 97). They also emphasize that the formal aspect of each stage must be matched by informal understanding and acceptance. The evolutionary cycle they posit is shown in Figure 18.2.

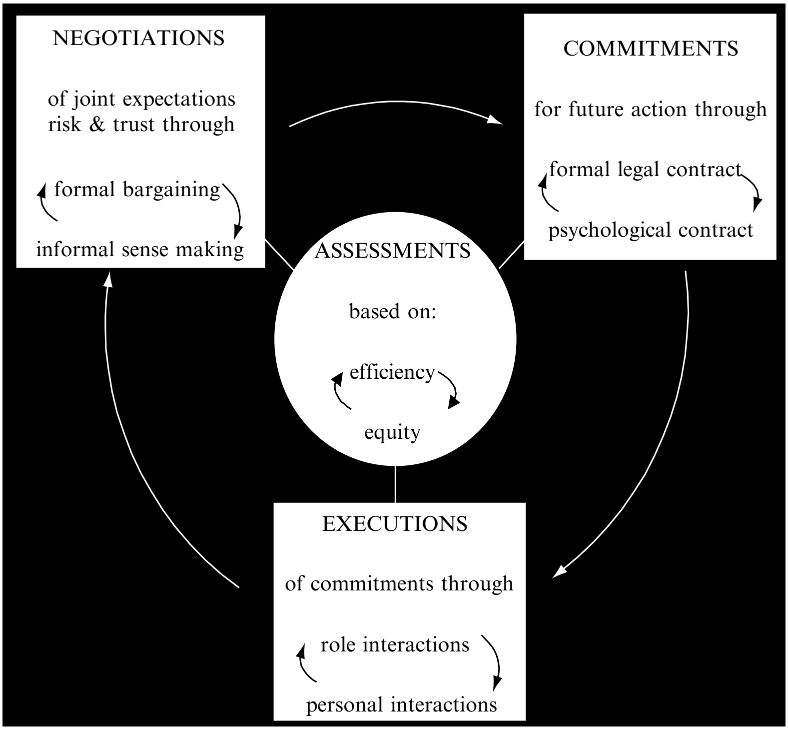


**Figure 18.2** Development of inter-partner cooperation.

In the negotiation stage, the intended partners develop joint expectations and make sense of the mission they are to embark upon. Through formal negotiations and informal sense-making they assess the various uncertainties associated with the deal, and form views on trust, commitment, respective roles, equity, and efficiency. In the commitment stage, the terms and governance structures of the alliance are established. The degree of legal formality with which this stage is endowed varies with the nature and culture of the partners. In the execution stage, the commitments and rules of action are put into effect and business actions are initiated, such as the purchasing of materials, the production of goods, and the administration of the agreement towards an agreed set of objectives.

Although the first cycle of the IOR's activity will no doubt be the most involved and protracted, owing to the high level of uncertainties involved in partners who have not worked together before, further proposed projects that cause the alliance to take on further responsibilities and hence evolve will, in Ring and Van de Ven's view, go through the same three-stage process. This process was very clearly visible in the 'five trades' described by Roland Bertodo that characterized the successive projects of the Rover–Honda collaboration (see Box 18.2).

Evolution in alliances also depends upon the development of personal relationships between those involved in the cooperation. In its absence, role behavior predominates and the alliance is unlikely to evolve. As Ring and Van de Ven (1994: 103) put it:

> Through repeated interactions over time . . . these formal role relationships and expectations become socially embedded in an incremental and escalating progression of socialization, accommodation, and normative expectations that mutually arise among cooperative IOR parties. Qua persona behavior substitutes for role behavior as personal relationships build and psychological contracts deepen.

**Box 18.2 The evolution of the Rover–Honda alliance**

The evolution of the Rover–Honda alliance took the following path. At the commencement there was a limited licensing arrangement for Rover to manufacture the Triumph Acclaim from Honda 'knocked-down' kits. The next phase was the development of the Rover 200, which was a Japanese-designed car with Rover fenders, wheels, bumpers, and interior. There was also an agreement at this time for Rover to make cars for Honda. Rover provided the missing European values in terms of styling that Honda needed. In 1986 the alliance evolved further with the launch of the Rover 800 and the Honda Legend. This involved the two companies working together in joint design and manufacturing teams. In 1989 the next project—the Rover 200/400 with its twin the Honda Concerto—was embarked upon. This involved further development of the alliance, as it was the product of joint development and co-production plus cross-sourcing of components. In 1990 the two companies embarked on further integrated production and development and carried out a 20 per cent share exchange. The alliance had evolved from a simple arm's-length licensing agreement in 1979 to a situation in 1990 with joint design teams working on new models, joint production of each other's cars, joint sourcing of components, and shared R&D, yet the companies retained their separate identities.

*Source*: Faulkner (1995*b*).

Whereas some commentators ascribe the evolution or dissolution of alliances over time to the degree of matching they are able to achieve with the exogenous factors prevailing in the external environment, Ring and Van de Ven concentrate on the internal behavioral factors and governance structures that develop between the executives of the alliance partners. They conclude (1994: 113), 'As the uncertainty, complexity, and duration of economic transactions within and between firms increase, it becomes increasingly important for scholars and managers to understand developmental processes of how equity, trust, conflict resolution procedures, and internal governance structures emerge, evolve and dissolve over time.'

### 18.2.2 Outcomes of evolution

Bleeke and Ernst (1995) conclude from their experience with over 200 alliances, mainly those in which a separate entity like a JV is created, that the way alliances evolve is crucially dependent on the relative bargaining power of the partners. This, in turn, relates to the initial strengths and weaknesses of the partners, how these strengths and weaknesses change over time, and the potential for competitive conflict between the partners. In the light of these factors, these authors identify six patterns of alliance evolution (1995: 103):

1. *Collisions between partners*. These alliances are inherently unstable. They involve the core businesses of two strong direct competitors. Owing to competitive tensions, these alliances tend to be of short duration and fail to achieve their strategic and financial goals. Most 'collisions between competitors' end in dissolution, acquisition by one partner, or merger. An example was the alliance between General Electric and Rolls-Royce which broke up in 1986 with accusations that Rolls-Royce had introduced a directly competitive aero engine. The motives for establishing such alliances can include an exploitation of market power, or a period of trial marriage prior to a merger.
2. *Alliances of complementary equals*. These alliances are, by contrast, potentially stable and long-lasting. They involve two strong and complementary partners that remain strong during the course of the alliance. Because they are building on each other's strengths rather than trying to plug gaps, the partners obtain mutual benefit from their cooperation, which is likely to last much longer than the five-to-seven years' average lifespan for alliances. The alliance between Rover and Honda exemplifies this kind of alliance, as well as its potential to broaden and deepen over the course of time. This potential means that the partners should concentrate on assessing ways in which the alliance should evolve so as to enhance the value of their stake in it.
3. *Alliances of the weak*. This is the case where two or more weak companies join forces in the expectation that this will improve their market power. It was clearly an important motive for the formation of Airbus Industrie. Bleeke and Ernst argue that in such alliances the weak usually grow weaker, the alliance then fails, followed quickly by dissolution or acquisition by a third party. Airbus Industrie shows that this is certainly not an inevitable prognosis, though clearly, if a partner to this kind

of alliance sees it simply as a refuge from competition, it will very soon become a lame duck which pulls down the whole cooperative enterprise.

4. *Bootstrap alliances*. This is the case where a weak company tries to use an alliance with a stronger one to improve its capabilities. This strategy can be successful in a minority of cases, resulting in the strengthening of the weaker partner. The partnership then develops into an alliance of equals, or alternatively the partners separate after the weak partner has achieved a capacity to compete on its own. The weaker partner must have a clear intention and plan to learn, and the stronger partner must be willing to provide such help, if this strategy is to succeed. Bootstrapping is often the hope of partners from developing countries, who view alliances with stronger foreign companies as an opportunity to acquire technological and other expertise that they need to become internationally competitive. The trend, as noted in Chapter 16, is, however, for the stronger foreign partners to acquire increasing control over the weaker ones and eventually to buy them out. Bleeke and Ernst themselves conclude that this is the usual outcome of alliances falling into this category.
5. *Disguised sales*. In these alliances, a weak company becomes the partner of a strong company, often one with which it is, or will become, in direct competition. The weaker partner remains weak and is eventually acquired by the stronger one. Disguised sales rarely last more than five years. The problem is that alliances are often pursued as a second-best strategy when their management is unwilling to sell a weak company.
6. *Evolution to a sale*. In this case, the alliance starts with two strong and compatible partners. However, competitive tensions develop and/or bargaining power shifts, and one of the partners ultimately sells out to the other. Nevertheless, because of the complementarity between the partners, these alliances often succeed in meeting their initial objectives and provide value to the partners. For this reason, they may well survive beyond the average life span for alliances.

Bleeke and Ernst argue that it is dangerous for companies to ignore the high probability that any alliance will end up in a sale by one of the partners to the other(s). If managers do not appreciate that an alliance will probably end up in a sale, they run the risk of ending up with an unplanned sale that fails to secure maximum shareholder value. Their point is that managers should always bear in mind that alliances quite often turn out to be transitory arrangements that, nevertheless, serve an important strategic purpose. The implication is that an alliance can be a good vehicle for acquisition, divestiture, or other goals, so long as its evolution is planned. In order to be in a position to plan for a particular path of alliance evolution, an initial evaluation is critical:

> Such evaluation can help companies avoid disastrous partnerships and unanticipated sales of important businesses. It can help managers choose corporate partners that will advance their organization's long-term strategic plan. And it can help reveal opportunities in which an alliance may be used as a low-risk, low-cost option on a future acquisition. (Bleeke and Ernst 1995: 97)

Bleeke and Ernst conclude that categories 1 and 3 in their typology—collisions between partners and alliances of the weak—almost always fail and should be avoided. This requires some qualification. If competing partners decide to merge, following a trial period, then the merger may well be more effectively planned and managed because it was preceded by a period of cooperation. Alliances of the weak can succeed if a productive division of labor is worked out between the partners, and if as a result the deployment of scarce resources (such as technical staff and R&D facilities) can be optimized and economies of scale realized. They also assert that type 5 alliances, disguised sales, are based on shaky grounds.

Child and Rodrigues (1996) also identify four different paths in the evolution of international alliances, with particular reference to knowledge transfer between the partners. They suggest that alliance evolution depends both on the balance of power between the partners and on the distance between their respective social (cultural) identities. Their analysis has the merit of bringing to attention the part that cultural distance (versus fit) may play in determining whether alliances evolve towards a more intensive, mutual form of cooperation or not. There are several conditions that enhance this positive evolution of alliances.

## 18.3 Necessary conditions

Alliances are normally set up for specific purposes. They may be focused on the synergies available from the fusion of key competencies from the partners directed towards a specific target, or the interaction may be more complex. Over time, the partners may allocate new projects and responsibilities to a successful alliance. If its initial purpose or scope remains the only one, the alliance is unlikely to evolve dynamically. Lorange and Probst (1987) emphasize that many alliance failures are due to the fact that they have not had sufficient adaptive properties built into them to cope with evolutionary pressures. Some redundant resources must, they believe, be committed to the alliances to achieve sufficient flexibility for development, a point also emphasized by Nonaka (1988). The combating of entropy is seen by Thorelli (1986) as the key reason for pursuing the path of evolution, and a feeling that where there is no longer growth the onset of decay may not be far away.

Dynamic alliances like ICL–Fujitsu show a flow of new projects, additional areas of cooperation, and flexible adjustment to change. What started as a technical support alliance between ICL and Fujitsu in 1981 has since led to a far-ranging technology, product, and marketing alliance. It culminated in Fujitsu's acquisition of ICL and its incorporation into the Fujitsu 'family'. Fujitsu has, however, maintained ICL's identity and stressed its continuing role as a partner rather than as a subsidiary.

Less successful alliances may also go through substantial developments, but exhibit major limitations. Courtaulds and Nippon Paint, after a period in which the alliance ceased to evolve having achieved its initial objectives, then pursued the new-projects trail with a coil-coating JV into Continental Europe, and closer R&D cooperation. However, mutual understanding between these partners required substantial reinforcement following a difficult period and the realization by Courtaulds that Nippon was becoming a world-class player and a potentially serious competitor.

In other cases, an inability to evolve the alliance has led to alliance failure, often to the potential disadvantage of both partners. The Disney–Pixar alliance, for instance, was created at a time when Pixar had a unique technology and vision, but no capital, no brand name in motion pictures, and no distribution. Disney was able to provide these critical assets, plus experience in developing animated features and access to various ancillary outlets for characters, such as television, theme parks, and licensing skills. As Pixar developed its own reputation through the huge successes of the first two collaborative projects, Disney proved willing to offer a more balanced division of revenues. However, yet more hits led Pixar to demand intellectual property rights as well as a larger cut of the revenues, even as the Pixar name became recognized for quality computer animation. When Disney was unwilling to accept even further evolution of the alliance in favor of Pixar, this money machine broke up, leaving Disney short of skills for animation of any kind, but making Pixar the target of every production studio.

### 18.3.1 Flexible adjustment

Flexibility in the relationship between partners is obviously an important success factor, since it implies that, when circumstances change, the alliance is allowed to reflect this in a sensitive way. Dynamic alliances tend to show considerable flexibility during their life. The Rover–Honda alliance moved through different levels of activity, each of them placing different requirements and levels of strain on the people involved in the relationship. They coped well owing to a willingness and ability on both sides to adapt to changing circumstances. Initially, contractual safeguards played an important part in providing a basis for trust to develop between Honda and Rover. One safeguard for both partners was provided by an agreement that Honda was not to sell its Ballade model in European Community markets. This gave Rover an opportunity to establish a footing for the Triumph Acclaim in key European markets, while at the same time it reduced the risk of questions that might be asked about the quality of Ballades made by Rover and, by extension, about the quality of Honda's cars in general. Later on when the alliance had evolved to a greater level of complexity with joint development work, reliance on formal contracts was no longer sufficient. Instead, the partners had to develop sufficient mutual tolerance and flexibility to be able to sort out unexpected problems, including higher than expected development costs, durability problems with Honda's new V6 engine, and Rover's quality control problems.

### 18.3.2 Balanced development

The idea of balanced development or 'symmetry' suggests that an important condition for the success of an alliance is that one partner does not move strongly ahead of the other in its strategic and other benefits. As Makhija and Ganesh (1997) point out, if one partner learns faster than the other, or if its capabilities come to exceed those of the other, this alters the bargaining power between them. When the relative bargaining power of the partners becomes increasingly skewed, this creates a growing tension that may well lead to failure of the alliance.

On the other hand, we might suppose that so long as one partner feels itself to be doing well from the alliance, it will not be too concerned if the other partner has done even better. Such matters are, at all events, difficult to judge objectively, and are highly dependent upon perception. The ICL–Fujitsu alliance, for example, was very dynamic, even though ICL was very dependent on Fujitsu for its future. Yet ICL executives continued to profess themselves happy with the alliance, even when Fujitsu had moved to a position of owning 80 percent of their company. Nevertheless, although a partner may be prepared to accept some loss of bargaining power if the alliance continues to meet its strategic objectives, there will be a limit to its tolerance.

Recriminations over the balance of benefits to partners are more likely in less successful alliances, and indeed may contribute to failure. ICI, for example, reported unbalanced benefits to the partners in its alliance with Sumitomo, presumably reflecting its view that Sumitomo struck a deal at the outset that was clearly more profitable to the Japanese company than to ICI. The failed alliance between AT&T and Olivetti suggests that when things are going wrong, an imbalance of benefits accruing to the partners can become a source of contention.

De Rond and Faulkner (1997) point to another aspect of balanced development. This stems from evidence that firms are vulnerable to dissolution either if a partner shuts down or if partners form a collaborative relationship with a new partner (Singh and Mitchell 1996). Consequently, companies are advised to identify potential new partners, even while cooperating with their current partners, and to develop and retain some proprietary skills. This may, of course, offend current partners and threaten to undermine their trust in the alliance, if it is not pursued wisely. Nevertheless, a careful balance between maintaining independent strength and cooperating with others appears unavoidable, especially in industries experiencing high levels of technological change.

### 18.3.3 Trust and bonding

Chapter 4 indicated how mutual trust between the partners can, as it develops through various stages, nurture the further evolution of their cooperation. The process of establishing trust between the partners can be provided with an initial foundation if they arrive at a clear specification of their mutual contributions and obligations, and assess the strength of the inducements or threats that remove or offset advantages to the other partner in reneging on the agreement. These conditions permit a calculation to be made of the advantages of cooperation and of developing the cooperative relationship.

Inkpen and Currall (2004) agree that the presence of clearly defined collaborative objectives will foster the initial development of trust between JV partners. The greater the initial level of trust between partners, the more they can then go forward to rely increasingly on informal social control and the lower will be the initial costs of monitoring and controlling the JV. If a heavy reliance on formal controls can be avoided, this in turn is likely to foster the development of trust. As we note in the next section, once a JV has been formed and initial conditions support continued collaboration, then the learning process becomes central to the way the alliance and the quality of trust within it evolve.

If initial difficulties can be avoided or overcome, and if the alliance proves to be an economic success, it is likely to mature into an organization with an increasing sense of its own identity and culture. Unless the alliance is established for a one-off or temporary purpose only, or as a stepping-stone for one partner to absorb the other, the partners may well not place any time limit upon its potential life. The very success of an alliance will tend to encourage the partner/parent companies to grant it an increasing measure of autonomy, and also provide the management of the alliance with the legitimacy to take its own decisions (Lyles and Reger 1993). This evolutionary process permits stable, ongoing relationships to develop, relationships both between people in the partner organizations who have a responsibility for (or interest in) the alliance and between people working on an everyday basis in the alliance's own organization. They are in a position to accumulate knowledge about each other, and this tends to reinforce the relationship. Moreover, the success of the alliance in meeting partner interests also preserves the initial and fundamental basis for their relationship that lies in calculation.

As relationships develop over time within the context of a successful collaboration, so there is a natural tendency for those concerned to identify increasingly with one another's interests as well as for emotional ties to grow. In this way, 'bonding' can form between partners, which Faulkner (1995*a*) has identified as being, in turn, a significant requirement for alliance success. Thus a virtuous cycle may be established, which reinforces both trust and the cooperation that it nurtures. This cycle can, of course, be broken and reversed.

Bonding may occur if the trust and cooperation between partners reaches a stage at which it is underpinned by a strong mutual identification based on shared norms and even a degree of affection. Thorelli (1986) has argued that entropic forces affect alliances that do not consciously evolve and create bonding mechanisms, so that they gradually cease to be important or even move towards dissolution. Three possible bonding mechanisms have been identified as means whereby alliances may achieve effective bonding. Clearly all three do not need to be present in all alliances, and there may be other mechanisms. However, if no bonding mechanisms are present, the prognosis for the alliance may be poor, as the partners may be regarding it more as a specific resource or skill substitution mechanism, rather than as an interactive collaboration.

Important bonding mechanisms are:

1. successfully going through an external challenge together;
2. exchanging personnel at a number of levels on a regular basis;
3. developing a culture that is a combination of the partners' cultures (see Chapter 15).

Clearly bonding will be easier to achieve in a JV company, where the staff are all working together, than in a collaboration, where typically they are not. Personnel exchange may be in the form of secondment to the JV, which has a very different impact on the individual to personnel exchange between the partner companies in collaborations.

Bonding is a more difficult task within collaborations, since the companies relate at an overall corporate level, but still only a part of the partner's personnel have close exposure to the personnel of the other partner company. Thus Rover manufacturing, design, and technology staff had close relationships with Honda personnel, but sales and marketing personnel did not. In these circumstances, bonding strength varied considerably. It was high, and deliberately so, in Rover–Honda and ICL–Fujitsu, who claimed to have surmounted an external challenge successfully together, to exchange personnel regularly and to be in the process of developing a combined culture.

Bonding appears, therefore, to be significant for successful alliance development, presenting different challenges for JVs and non-JVs. For JVs, bonding within the venture seems relatively straightforward, but the relationship between the partner companies themselves, and between the partner companies and the JV, is more complex and difficult. In collaborations, the challenge is to develop a mutually effective culture that spreads outwards even to personnel not directly involved with alliance matters. In the absence of this, the cultural interface merely moves from that between the partner companies back into the partner companies themselves, where different cultures develop between those who are and those who are not actively involved in the alliances.

We emphasized the fact that, while the success of cooperation between organizations requires the presence of clear net benefits to each of them, the quality of that cooperation and its ability to evolve constructively depends in turn to a considerable extent upon the relatively few individuals who are the active links between the organizations. The ability to achieve bonding is very much in the hands of those primary actors. As well as gatekeepers and the other staff from each partner who are regularly working together, top partner managers must also be included in this category. Chapter 10 noted how top-management commitment to alliances has emerged as a major factor in their success, partly because bonding at that level strongly encourages cooperation lower down.

Sometimes the process of bonding begins remarkably soon and actually assists the clarification of economic possibilities and the partner's willingness to commit the investment of time and money to realize these. For example, a medium-size British company producing advanced electronic equipment acquired a relatively small American company that possessed technology that would enable it to enter a new and potentially significant product domain. The American company had, as one of its customers, a very large fast-moving consumer-goods manufacturer, based in the USA but with a global scope. It was a very minor supplier to this consumer-goods giant, but the British acquirer appreciated the possibility of developing an important bridge via the customer into a large potential market. According to our informants in the British company, its senior management consciously cultivated the vice-president in charge of procurement for the consumer-goods corporation to establish a personal relationship between him and its own CEO. Within eighteen months, a genuine friendship grew between them to the extent that their two families were spending their holidays together. This bonding between the two executives has been instrumental in enabling the two companies to collaborate, with a minimum of legal formalities, in developing suitable applications of the new technology. As they continued to collaborate, both parties increasingly appreciated the economic benefits that could derive from the successful application of the new technology and which will doubtless build the 'hard' foundation for their future partnership.

## 18.4 Organizational learning

As described in Chapter 13, organizational learning is an important key to the successful evolution of alliances. The example just cited could be regarded as one in which the willingness of partners to learn was initially assisted by personal bonding and where the learning then led to a deepening appreciation of the economic potential of further collaboration. Alliances in which partners actively learn from each other are likely to appreciate the value of the alliance more strongly than others. This is particularly likely in relation to the skills in which they felt deficient when seeking a partner, but it also extends to other unexpected spin-off learning.

If an alliance in which learning has been achieved should suddenly terminate, the partners will be able to count the benefits in terms of the development of their competencies. For those alliances where partners merely engage in mutual skill substitution rather than corporate learning, the loss of a partner is inevitably more damaging. Nothing may have been learnt and there is a sudden gap in the provision of the functions carried out by the former partner. As Chapter 13 noted, alliance partners bent on evolution through learning should ensure that this learning is disseminated throughout their organization and not just to the personnel directly interfacing with the alliance partner. They should also set up a system for regularly reviewing what they have learnt as a result of the alliance, and set targets for the next phase of learning.

### 18.4.1 Initial conditions and learning

Doz (1996) concluded from a close study of three international strategic alliances that a combination of initial conditions and subsequent learning produced an evolutionary process leading to success or failure of cooperation. The initial conditions he identified include the partners' understanding of the environment in which the alliance is to operate, their understanding of how alliance tasks are to be organized, the mechanisms the partners establish for mutual interaction and learning, the complementarity of their skills and capabilities, and the care with which the goals of the alliance are expressed.

The successful alliance between General Electric and SNECMA to develop and manufacture civilian jet engines illustrates the benefits for subsequent alliance evolution of favorable initial conditions. As Doz elaborates, the two partners identified a clear and common strategic rationale for their collaboration, since both were searching how to enter the civilian aircraft engine market. So there was little conflict between their expectations. Their overlapping experience and skill base enabled them to work well together and to develop mutual trust. At the same time, coming into a new market, they were not encumbered by a legacy of procedures and perspectives, and this made it easier for them to develop a common set of new appropriate organizational processes. The two partners also created a JV program management team that brought their respective staff into a very close working relationship that provided a strong interface. Some managers occupied dual positions within the JV and their parent company, which was a way of enhancing the perceived significance of the venture and further strengthening ties between the parent companies.

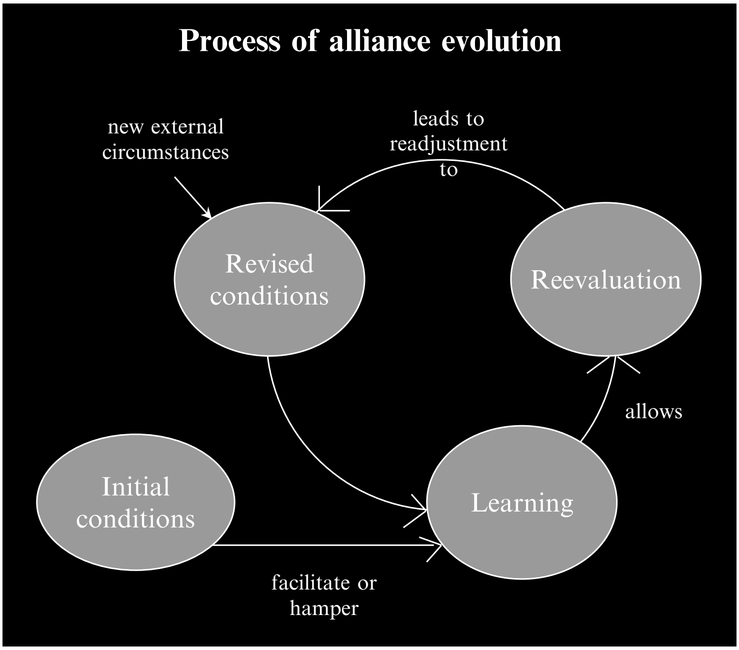


**Figure 18.3** The process of alliance evolution.
*Source*: Adapted from Doz (1996: 64).

Initial conditions can facilitate or alternatively hamper the process of subsequent learning by the alliance partners, a learning process that in turn allows for reevaluation of how the alliance is progressing and the revision of initial conditions, if required. This evolutionary cycle is portrayed in Figure 18.3.

From a comparison of his case studies, Doz concluded that successful alliances were highly evolutionary and went through the iterative cycles of learning, reevaluation, and readjustment depicted in Figure 18.3. These cycles were 'typically characterized by greater and greater trust and adaptive flexibility, as well as by the willingness to make larger and larger, as well as increasingly specific and irreversible, commitments' (Doz 1996: 74). By contrast, failing alliances or cooperative projects were characterized by a high level of inertia. They achieved little learning, or the learning that went on was divergent between cognitive understanding and actual behavior.

Ariňo and de la Torre (1998) draw upon a case study of a failed IJV to develop a model of the collaborative process in alliances that extends the work of Ring and Van de Ven (1994) and Doz (1996). They conclude that positive feedback loops are critical in the evolutionary process, that the quality of the partner relationship is both an outcome and a mediating variable, and that initial conditions have a major impact on the evolution of collaborative agreements. The partners can build a reserve of mutual goodwill that can withstand the occasional setback in their relationship, and this is supported by the existence of procedures for resolving conflicts. The establishment of such procedures, the authors conclude, is a particularly important initial condition. Central to their model is the on-going assessment by partners of the efficiency and equity conditions prevalent in their alliance at any point in time, mediated by the quality of their relationship. Efficiency and equity assessments are triggered by external changes either in the environment or in the strategic context within which the alliance is operating.

## 18.5 Evolution and coevolution

An important new perspective on organizational evolution is that of coevolution (Koza and Lewin 1998). Coevolution states that organizational forms evolve within evolving environments. To some extent, this is true of biological evolution, as changing environments change the standard for fitness to survive, and driving evolutionary changes in the organisms within the environment. In populations of organizations, much of the relevant environment consists of other organizations, which both respond to exogenous change and drive change by their responses to the rest of the population, creating endogenous forces for selection. This model proposes that organizational evolution is the outcome of the coevolution of the competitive environment, firm strategy, and institutional pressures under conditions of uncertainty (Lewin et al. 1998).

Applied to alliances, coevolutionary processes will drive firms to view their alliance strategies as responses to changing strategic needs as well as changing institutional environments (Koza and Lewin 1998). This is consistent with the assumption in Doz's analysis that successful alliance evolution depends on the ability of the partners to revise initial conditions not just in the light of changed environmental conditions but also as a result of their own learning experience and changing competencies. This is a much more dynamic and open-ended model than the standard approach that focuses on the evolution of firms through adaptation of the strongest to a static environment. For different combinations of alliance strategies and learning capabilities will result in different patterns of alliance evolution.

## 18.6 Summary

1. This chapter takes note of a number of life cycle evolutionary schemas that have been proposed by commentators, and suggests that such cycles may be conditioned to move from one evolutionary stage to the next predominantly by internal factors that emerge within the alliance.
2. Important among these factors are, the development of personal relationships between executives in the partner companies such that they enhance the trust, bonding, and commitment which provide the cement for all relationships; balanced development, and flexible adjustment.
3. Emphasis has been placed on the close relationship of alliance evolution, as exemplified by new projects and new responsibilities accruing to the alliance, to the achievement by both partners of clearly identifiable organizational learning.

4. A synthesis of points and themes from the chapter suggests that the following are necessary conditions for successful alliance evolution:
   - A clear understanding of, and agreement on, alliance goals and tasks, and how to go about achieving them;
   - A willingness by the partners to adjust the operation of their alliance as and when changing circumstances require;
   - Balanced development: one partner should not move strongly ahead of the other especially if this is seen to threaten the latter's interests;
   - Mechanisms that help promote mutual trust by resolving conflicts and promoting bonding;
   - Attaching importance to organizational learning, and monitoring the extent to which it is put into practice by making adjustments to behavior and procedures that are required for alliance success.

## 18.7 Questions for discussion

1. Why is the evolution of an alliance so crucial to its success?
2. What is the role of trust in alliance evolution?
3. What are the contributions of initial conditions and subsequent learning to alliance evolution?
4. Is it sufficient for alliances to meet their initial objectives?
5. Can alliances be successfully renegotiated without damage to relationships?

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# PART V

# CONCLUSION

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# 19 Closing reflections

## 19.1 The future

This book has been motivated by the belief that there are important benefits from bringing cooperation further into the mainstream of management thinking. There are two directions in which progress needs to be made.

The first requirement is to give more attention to the process of managing cooperation and how it can be developed to a mature condition. This need arises from the fact that, so far, more attention has been given to the antecedent conditions and desired outcomes of cooperation rather than to the process of making it work and fostering its development. Consideration of the managerial process should reveal how the full potential of cooperation between firms can be realized. We have endeavored to make a start along this road by devoting Parts III and IV to managing cooperation and maturing the relationship.

The second requirement looks to the changes that are being experienced in the business environment and the positive role that cooperative strategies can play in that context. The need here is to explore more fully the contribution that cooperation can make as a mode of business organization under conditions of increasing complexity. We now consider these two avenues for development in turn.

## 19.2 The maturing of cooperation

Discussion of cooperation between firms has so far been dominated by a static, short-term, and instrumental perspective. This has focused primarily on the calculus involved in establishing alliances and other forms of cooperation, including their anticipated economic outcomes. We have noted its evidence in work on the motives to form alliances, in applications of transaction-costs analysis to the choice of cooperative form, and in analyses of strategic fit. At issue here are the conditions bearing upon the decision of whether and in what form to cooperate. These conditions and the calculus arising from them are undoubtedly critical for the underlying viability of any cooperation. Nevertheless, they constitute the platform for cooperation rather than the process itself. The subsequent management and evolution of cooperation therefore presents a further important strategic and operational challenge. It offers the opportunity to realize the full benefits of cooperation. These benefits may indeed lead the partners to modify their initial evaluations of the cooperation in the light of the experience and learning it brings.

Considered arguments have, of course, been advanced in favor of a short-term and purely calculative approach to cooperation between firms. These are grounded on the assumption that competition is the natural order of business. One example is the view taken by writers such as Hamel and Prahalad that cooperation is an inherently unstable arrangement in an essentially competitive world of global business. This implies that most companies entering into partnerships should reckon on them having a short life, and that they should plan to disengage from the cooperation once it has met the specific objectives that they attach to it. Chapter 18 noted the argument of McKinsey consultants Bleeke and Ernst that, if the great majority of JVs end up in a sale after five years or so, the partners should plan for this right from the start and enter it into their initial calculus.

It is also pointed out that cooperation is often used as a limited-duration device to acquire key competencies from competitors. In which case, companies had better beware of overcooperation with actual or potential competitors. Otherwise they may find that cooperation has given their competitors access to their proprietary technology or core tacit knowledge. This view, then, justifies a focus on the entry and exit conditions for alliances. It tends to confine any attention that is given to the cooperative process between entry and exit to the need to safeguard against reneging or exploitation by one partner at another's expense. It adopts a cautionary, and essentially negative, attitude towards cooperation. Cooperation, according to this opinion, can be dangerous to a firm's health.

These cautions can be substantiated by experience, but taken by themselves they project a slanted and limited light on interfirm cooperation. When companies have entered alliances on naïve or false pretences, this indicates that cooperation was inappropriate to the circumstances, or that inadequate safeguards were built into the relationship. It does not follow that cooperation per se is unproductive. Indeed, we noted in earlier chapters that, for productive cooperation to develop, the partners should be assured that they will not be betrayed by the other party. In particular, the trust between partners that is intrinsic to genuine cooperation, and the creation of conditions for mutual learning by the partners, both rely upon an adequate specification of terms and conditions for the cooperation at the outset.

The factors that promote and enhance cooperation remain insufficiently explored, as do the ways whereby cooperation can be managed effectively. The 'soft' and processual side of cooperation management requires more attention. Nevertheless, we can already identify the main ingredients for effective business cooperation:

1. A realistically worked-out basis for a relationship. This should assure the partners that the mutual benefit they expect to obtain from cooperating will outweigh the investments they have to make, the risks of the partner's failure to deliver on its obligations, and the opportunity costs arising from alternative policies such as simple market trading. The extent to which reliance can be placed on formal contractual conditions is a very relevant contextual condition here.
2. Selection of a cooperative form that suits the contingencies relevant to the cooperation. These might include partner motives, whether an alliance is of a scale

or a link nature and the capital requirements associated with this, the extent and nature of resourcing by partners, the balance of global and local needs to be met by the alliance, and the legal and political conditions in its environment.

3. A conscious policy of open communication and effective flows of nonsensitive information between the partners and their cooperative unit (if one has been established). This build-up of information will help to promote each partner's understanding of the other. The interpretation of information, as well as propagation of the merits of cooperation, can be facilitated by the appointment of alliance managers from the senior echelons of each partner who are given sufficient time and resource to carry out this role.
4. Evident public commitment to the cooperation on the part of top executives from each partner. This should include regular personal visits to each other. The senior personnel from each partner, and the alliance managers or coordinators, are in a position to activate another requirement for continuing business cooperation—namely, that thought must always be given to how that cooperation can fruitfully progress beyond its initial objectives. In other words, some redundant resources need to be committed to evolving the alliance.
5. The creation of trust between the partners. This should be based on the honoring of agreements and the development of close ties between the personnel from each partner firm who work together within the cooperation.

This list of ingredients for effective cooperation points to the ties that have to be sustained and developed in the process. Ebers and Grandori (1997: 270) identify three kinds of ties that exist between cooperating organizations, each of which require active management during the course of the cooperation:

1. Flows of resources and activity links. Agreement on the broad outline of resource flows and activity links may well be reached at the outset of an alliance or other form of interfirm cooperation. They generate an interdependence between the partners. It is, however, impossible to plan the details of these flows and links a priori, and the organic development of the cooperation will modify them over time. They therefore have to be managed and coordinated actively.
2. Information flows. These must be kept open not only to achieve an effective management of joint activities, but also to encourage the growth of mutual confidence and trust between the partners.
3. Flows of mutual expectations and evaluations. These flows among the partner members influence their perceptions of the opportunities and risks of the cooperation, and hence help to shape their evaluations of the partnership and its future. It is important that arrangements are in place to permit the partners to compare and discuss their expectations and evaluations of the cooperation on a regular basis.

The importance of providing for adequate ties between partners and their cooperative unit cannot be overstated, and it is often neglected in practice. For example, the case study by Lyles and Reger (1993), summarized in Chapter 18, illustrates the significance of keeping policy-makers aware of the benefits arising from cooperation and of the JV's CEO maintaining close informal relationships with parent company managers. If partner companies are receiving feedback which demonstrates the positive value to them arising from the cooperation, they are likely to encourage its further development through providing appropriate resourcing and/or granting it the autonomy to secure its own support. Learning is likely to be another important feedback loop, and to have two types of content. The first is evidence of substantive learning, such as ways in which the other partner is providing access to new techniques. The second is evidence that there has been learning how to cooperate, such that problems are being successfully ironed out. This second type of positive feedback will in turn help to promote trust between the partners.

The combination of experiments with repeated two-partner games and insights from the study of trust is beginning to indicate how the quality of cooperation can be enhanced over time. It appears to be critical to ensure that each partner believes it worthwhile at the outset to give cooperation a chance. This belief might be facilitated by (*a*) a sustained period of initial negotiation, conduct of feasibility studies, and other joint 'work'; (*b*) a recognition that, once transactions have commenced between the partners, it will be difficult to withdraw from them and that therefore one partner will have to live with the consequences of any cheating by the other partner; and (*c*) safeguards against the risk of reneging. These safeguards may be local to the cooperation in terms of hostages given up by the partners, such as the investments they have sunk into the joint operation. They can also be institutional: either in the form of effective laws to protect contracts and property rights, or in the 'softer' form of effective social norms about honesty and the obligation to carry out commitments.

Once the process of cooperation is under way, it can be reinforced through positive feedback, as just indicated. Additionally, cooperation is a social process in which members from each partner will work together, at least from time to time. As Chapter 4 indicated, it is likely that the process of joint working will reinforce trust, especially if it meets with success, as the people concerned come to know each other better and perhaps eventually form some personal friendships. There is, of course, no guarantee that this accumulation of resources for trust will progress smoothly, and trust will always remain a fragile, readily disabused, phenomenon. Nevertheless, an understanding of the bases on which trust can be promoted provides valuable guidance to managers of cooperative business relations on how they can nurture such a delicate plant, yet one so essential to successful cooperation.

The key message from this book on the process of cooperation is that it can often be nurtured, very fruitfully, beyond its initial condition. It could therefore be extremely limiting to judge cooperation between firms solely in terms of that initial situation. Managed with some determination to make it succeed, the partners' evaluation of their cooperative strategy might well change in the light of their experience. They may come to attach greater value to cooperation, through this experience, than they did initially, and they may place it within a longer time perspective than was originally the case.

## 19.3 Cooperative strategy in the global economy

Reference in this book to new forms of cooperation and the new emerging economies indicates a need to understand better the benefits of cooperation under conditions of increasing complexity. This issue is of natural concern to large global multinational corporations, for it is linked to the question of whether they can sustain their dominant role in world business essentially through their present forms, adapting these at the periphery rather than transforming them substantially. Many MNCs appear to regard cooperation as a transitory expedient in circumstances, such as entry to a new market or operational location where an initial knowledge deficiency or absence of local political connections renders it necessary to work at first with a partner. At the back of their corporate minds is the assumption that, after a while, they should either reduce their dependence on the partner or absorb it. From this perspective, cooperation is not regarded as an enduring or fundamental condition for success in the modern world, despite the rapidly increasing number of alliances since the mid-1980s.

There are, however, good reasons to suppose that cooperation between organizations is increasingly appropriate for coping with the emergent conditions of the global competitive economy. The world economy is becoming increasingly integrated so that changes in one region impact rapidly elsewhere. The rate of change is increasing, one example being the steady reduction of product development-to-market lead times. There is increasing technological crossover from one sector to another, as well as between countries. This conjunction of increasing interdependence and unpredictable combinations between players is creating complex adaptive systems that are inherently dynamic and coevolutionary rather than static.

It is no longer sufficient to describe the relevant context for firms as one of globalization. Globalization in itself just creates a simple form of additive complexity, equivalent to Gell-Mann's notion of 'crude complexity' (see Chapter 16). In other words, globalization adds extra elements into reasonably well-understood equations, such as those governing optimal logistics. Rather, the business environment is taking on characteristics of Gell-Mann's 'effective complexity' in which the relationships between components of the system are becoming less predictable and more subject to nonlinear transformations. The equations and their interactions are no longer so easy to model or understand.

This is particularly illustrated by the emerging post-September 11, 2001 world. The sudden impact of transnational terrorism, and the responses of existing nation-states, on world commerce and politics is as shocking, and longer lasting, as the impact of the jetliners on the World Trade Center towers. The outcome, though, is much less certain or apparent. We already see shifting political alliances followed closely by tentative steps to a realigned system of world trade and investment. Which nations will be allies in twenty years? Will the old East–West divide become a North–South barrier, or will the EU, NAFTA, and an emergent East Asian free trade zone grow, solidify, and separate? There are many such questions today, and new ones arising every day. What looked a few years ago like a triumphal capitalist global consensus is changing dramatically, but in no certain direction. For MNCs, though, risk and uncertainty are certainly high and rising, and alliances and cooperative strategies are apparent answers to this environment.

The new environment is no longer one that can be adequately characterized as a system of a 'punctuated equilibrium'. This is a system in which periods of relative stability are interrupted by stormy episodes of restructuring. The 'disturbances' in this type of system are reasonably predictable, and there are macroeconomic tools for mitigating them. By contrast, what we are now coming to experience is a state of affairs in which equilibrium cannot be taken as the norm (if, indeed, it ever could). The term 'dynamic disequilibrium' appropriately conveys the character of this system.

Indeed, in the newly recognized knowledge-based increasing-returns industries, economists (Arthur 1989) now recognize that there are no inevitable equilibria. Being an early mover, operating in a dense ecology of alliance, path dependence, and lock-in of trained consumers seem to ensure a far surer route to success than the traditional one of producing something cheaper and better. In these industries the optimal product is not bound to triumph, and chance plays a major role. As Bettis and Hitt (1995) put it, strategic-response capability becomes the key to survival as it does in biology, and a network of alliances helps develop such a capability.

The challenge for the researcher is to find conceptual frameworks that can function in a dynamic or turbulent environment. Traditional models of market power, transaction cost efficiencies, or resources tend to be static, or at best can comprehend stable, predictable change. We have described these constructs, but have also discussed some newer approaches to cooperation that may be more useful in a world where history is reborn. Coevolutionary models propose that firm strategies evolve together with the environment that they face (Lewin and Volberda 1999). Today's environment may require a model of evolution more akin to that facing the biological world after an asteroid impact, but the key message—that strategic change is always chasing environmental change is critical. Network models appear to be ever more relevant as network industries, networks of firms, and network firms are identified. Cooperative relationships that build and stabilize multilevel networks as they compete (and cooperate) with each other make for a highly complex solution to the highly complex and rapidly varying environment. Finally, real options theory, which considers alliances as providing 'real call options' on strategic commitments, seems ever more relevant as these networks are constructed and reconstructed in an unpredictable world. The old models still have value, but emerging dynamic models such as these are, perhaps, the evolving answer to a world of uncertainty.

The challenge for firms in such a system is to optimize along more than one front simultaneously, rather than sequentially in the way they are used to doing. They have to retain the competitive and strategic strengths they have developed through sunk costs, yet at the same time be prepared to follow alternative avenues should these suddenly turn up. They must try to maintain competitive advantage while also adapting continuously. Even large multinational corporations are unlikely to possess all the competencies required for this, and their very own scale and internal complexity can cause their adaptability to be severely handicapped. As a result, firms will have to find new forms of organizing to suit the emergent business environment. These will need to be 'new organizational forms that help avert complexity catastrophes . . . or practices that promote a rich fund of ideas' (Beinhocker 1997: 38). This is where the necessity for cooperative strategies becomes evident.

Firms can choose to deal with this phenomenon of complex adaptive systems through one of two general approaches. The first is to attempt to reduce the impact of external complexity through using their own resources and negotiating positions to create conditions that will preserve value for their specific competencies and practices. The application of massive resources to R&D may enable a firm to generate a steady stream of advanced products that have high appeal to the market, including appeal to latent consumer needs. This may enable the firm to dominate its sector sufficiently to offset, at least for some years, the threat of competition to its profits. One sees examples in pharmaceuticals, such as Glaxo, and consumer electronics, such as Sony. However, as Beinhocker (1997: 35) also notes, evidence suggests that in the new environment firms are finding it difficult to maintain higher performance levels than their competitors for more than about five years at a time. A 'go-it-alone' strategy is becoming increasingly difficult to sustain even for the largest, best-resourced firms. Most, of course, are not in that category in the first place.

Another facet of this 'reduction-of-complexity' policy can be seen in attempts by MNCs in emerging economies to use their international reputation and the financial resources they can offer for commercial and social investments. This 'clout' enables them to open up their own direct channels to the host government and its agencies without the use of local partners as intermediaries. They can then attempt to reduce environmental uncertainties by using these channels to negotiate their own preferred accommodations to the environment, backed by governmental intervention.

Cooperation between firms is not necessary to this approach. If it is used, this is likely to be for relatively short-term benefit, to plug resource gaps or to overcome barriers. If there are such gaps or barriers, acquisition rather than cooperation is the preferred solution. The firm attempts to ride through complexity relying on its own strength in order to preserve its cultural and structural integrity. This approach is, however, flexible only at the periphery and retains the rigidities of the corporate core. In a turbulent environment, it is subject to the dangers that La Fontaine correctly discerned 300 years ago in his fable of the oak and the reed.

Cooperation is, by contrast, integral to the alternative policy, which can be described as one of attempting to absorb the uncertainties of an effectively complex environment. Here the aim is to absorb the uncertainty generated by complex adaptive systems by means of working closely with one or more partners. In this approach, a firm relies on partners to enhance its capacity to adapt by providing competencies and resources that are complementary to, and that extend, its own. It also endeavors to engage the active support of its partners in formulating policies that address the environment. The idea is to achieve a synergy not only of resource but also of thinking, which can help to generate more flexible strategies. Cooperation can, and does, extend to networks of alliances or collaborations. These, as noted in Chapter 8, permit a flexible adjustment to changing market and technological conditions by permitting different combinations between the partners to suit particular projects as well as by facilitating an ongoing exchange of information within the network.

If, as seems the case, success within the new business environment lies in having relevant information, an ability to learn, and the capacity to access and combine key competencies including technologies, then the potential value of a cooperative approach is indisputable. These requirements can, of course, be provided within a single organization, but with increasing difficulty. Firms are finding it more and more problematic to bear the cost and risk of technological development alone. Moreover, a single organizational culture can easily suppress the stimulus to learning and adjustment that comes from divergent thinking, especially at lower levels of the organization. It is also difficult to encompass an adequate understanding of different environments within the staff of a single company.

Many MNCs are today attempting to organize in ways that cope with their inherent paradoxes, trying to reconcile hierarchy with heterarchy; control with adaptation and learning; globalization with localization. To achieve this, they will have to learn how to establish federated enterprises, or internal alliances. This may well prove inherently more difficult for them than the alternative of adopting a cooperative strategy. Doubtless MNCs will continue to prosper in areas of advantage where, for example, global products or services have great appeal, but it is likely that they will increasingly have to secure the advantages of flexibility and accelerated learning which cooperation with other organizations can offer.

Multinational firms are therefore more and more described as network organizations that specialize in the collection, arbitrage, and application of knowledge. Particularly in information- or knowledge-intensive sectors, the strategic distinction between wholly-owned but dispersed subsidiaries with responsibilities for developing and providing products for the world market (as opposed to local sales and marketing objectives) and allied firms with similar roles is becoming blurred. As subsidiaries are permitted greater freedom in their strategic leader roles (Bartlett and Ghoshal 1998), they also demand greater organizational independence, and parent companies must take the same care in dealing with them as with allies. The 'command and control' aspect of internal hierarchies must give way to a 'coach and communicate' role if subsidiary firms are expected to provide innovation, take risks, and generally succeed in the kind of market turbulence that is unnavigable for the centrally directed leviathan that is the traditional MNC. Cooperative strategies will be essential as MNCs expand into new markets and seek new strategic assets in previously unexpected locations, but these strategies may be organized as collaborations, JVs, or even wholly-owned but not wholly-controlled subsidiaries. The considerations presented in this volume will be relevant to all of these.

There is no denying the problems and pitfalls that can beset the new strategy. This book identifies many of them. At the same time, it argues that a cooperative strategy is relevant to the business environment of the twenty-first century, and that the means are available to manage it successfully.

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