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OPENING UP: The Promise and Pitfalls of Alliances

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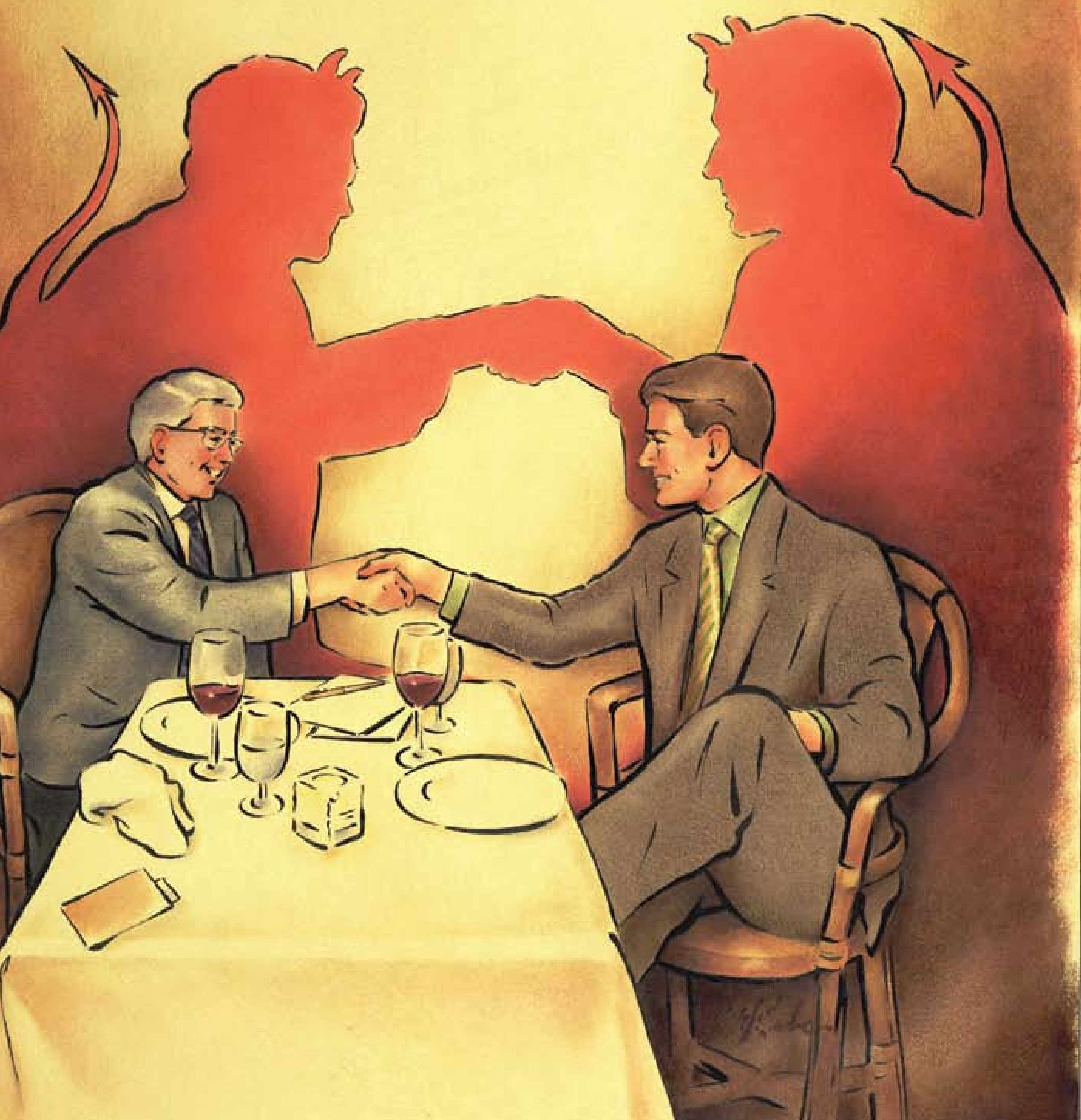

Distributed "open" network alliances are currently de rigueur across a host of sectors and industries, but without careful structuring of the actual networks, companies risk losing control of valuable knowledge flows, in turn compromising competitive advantage.

Open business models are all the rage, having found favor as an organizational strategy that can enable breakthrough innovation – no small matter where developed markets, technological complexity and a fast-paced global economy make such transformative change hard to come by. However, companies continue to scrap for the next big thing, but now with an increased fervor that goes beyond the four walls of the organization. That can lead to some crucial decisions – with big implications.

What does this mean for traditional, internal research and development? While R&D remains a dominant channel for generating market share, it is an increasingly expensive option, and one that tends to rely on companies accessing, on demand, the required specialist capabilities needed to continually drive growth. This specialization is difficult to develop and adapt to ever-changing, volatile marketplaces, especially when projects require capabilities that a company does not have. The alternative—a move toward an outside-in, "open" model—is extremely attractive on paper. It's easy to understand that collaborating companies can achieve more together than they would if they worked independently. Proponents argue that the model makes even more sense during periods of economic uncertainty when growth is stalled. Hence, the opportunity to connect with external parties to develop new ideas and take them to market quickly and efficiently is, at first glance, a compelling option.

It is no big surprise, then, that the number of high profile, open network alliances seems to be forever increasing across a wide range of sectors. Consider, for example, the recent push for convergence of digital technology into the world of commercial white goods and home products. The Continental Automated Buildings Association (CABA), a non-profit industry organization, hosts the Internet Home Alliance, a diverse co-development network alliance of large companies such as Whirlpool, Cisco, Intel and HP that works to increase the use of Internet-based services within the home.[1] Each of the companies involved has committed to an open policy of knowledge sharing in a drive toward achieving a common strategic business goal. As such, it represents an increasingly common example of the new willingness among large corporations to forgo the traditional "closed" model of business development and migrate toward a collective open platform.

However, the majority of such collaborative experiences tend to dangle in front of business leaders like carrots they'll never reach because the challenges in execution are often insurmountable.

GOING "OPEN": THE ROLE OF ALLIANCES

The number of corporate alliances continues to rise by as much as 25 percent every year and now accounts for nearly a third of many companies' revenues and value.[2] Open business models abound, and organizations, aware of the way growth engines sputter when confined by corporate walls, call upon co-development with other firms to spark innovation and generate value. However, a critical issue with embracing this open model is to understand exactly what is meant by the plethora of ambiguous terms used almost interchangeably to describe essentially the same phenomenon. It is no wonder that time-pressured executives are often left puzzled over labels such as open innovation/open business model/distributed innovation/decentralized innovation/co-creative alliances – the list goes on ad infinitum.

To better understand the logic of the open business model, it is therefore helpful to define what it is and what it is not. For instance, it is not just about outsourced R&D, technical innovation and straightforward supply chain partnerships*. Instead, open business models are grounded in strategic intellectual property management, strategic R&D addressing both technology and business innovation, and perhaps most importantly, the building of network alliances into organizational forms commonly known as "ecosystems". When all is said and done, at the core of the open model is the use of network alliances to facilitate the ecosystem and supercharge business model innovation. An effective open strategy hinges on how well a company can manage its network alliances.

Henry Chesbrough, a prominent thinker on the subject, has described the appeal of open models: "The use of partners in the research and/or development of a new product or service creates business model options that can significantly reduce R&D expense, expand innovation output, and open new markets that may otherwise have been inaccessible."[3] One needn't look further than industry giants like Procter & Gamble and IBM to see how playing well with others can have tangible benefits in the development of new products and services. Moreover, open business models, built on distributed network alliances, give companies access to resources and capabilities that wouldn't otherwise be available or cost-effective. But executing these models and actually harnessing value is a vexing task. And after decades of well-meaning mantras, surveys, and articles applying everything from game theory to behavioral science, achieving expected results through alliances sometimes seems grounded in little more than instinct. Few companies get it right consistently. In fact, a recent study suggests alliances fail 60–70 percent of the time.[4]

The failures of network alliances tend to come in two flavors: resource limitation and management of the alliance once it's off the ground. Generally speaking, many open pursuits lack specific routines, capabilities and structures, so company leaders are left to base their approaches on their previous one-off efforts. How can they get over this hurdle and use an open strategy to consistently spark sustainable growth?

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* *We use the terms "partnership", "partners" and "partner" to describe a range of business relationships or business parties, not as a reference to a specific business structure described by law.*

USING NETWORKS TO BUILD CAPABILITIES

To recap, many companies have good reasons for entering network alliances. At their most effective, alliances can increase access to otherwise scarce skills, resources, physical assets, technologies and markets. This can lead to more know-how being generated and leveraged to assimilate and learn from new knowledge flows between companies. This, in turn, can allow new alliance capabilities to be developed to exploit economies of scale, reduce operations costs, and disperse risk across the network membership.

Consider the example of IBM.[5]. At the end of 2003, the company was reevaluating its decision to invest heavily in its semiconductor business. In 2000, it had committed \$5 billion to chip R&D and manufacture, but by 2003 there were questions surrounding the expected return on that investment as it became clear that financial targets were not being met. Pressure to cut their losses and exit the business began to build, but IBM realized that to do so would be foolhardy. The advances they had made in developing leading-edge chip technology were seen as vital to retaining its competitive advantage in the bigger, more lucrative server market.

But clearly a rethink on strategy was required, which prompted their leadership to explore the idea of sharing its advanced semiconductor knowledge with a number of allies. Big Blue already had a handful of alliance networks aimed at improving manufacturing and chip design, but they believed these were somewhat limited in application and were not achieving the real innovative breakthroughs the company desired. Subsequently, in an effort to throw wide the doors of open collaboration, IBM invited a number of partners to form deeper relationships with the company's R&D staff. The objective was to explore ways of sharing knowledge across a network of alliances that would foster innovation and help each partner reach a specific strategic goal.

IBM has since gone on to develop what it calls a fully fledged "open ecosystem" of semiconductor chip R&D with nine partner companies. This network includes such diverse companies and organizations as Advanced Micro Devices and Albany Nanontech, a university research center. IBM attributes the success of this ecosystem to careful alignment around each partner's strategic goals, which has facilitated alliance relationships that are tightly specified in scope. Furthermore, in an effort to advance collaboration, the tech giant has created a positive sum environment allowing network partners to invest capital to grow IBM's facilities and gain access to the latest IBM semiconductor technology. Moreover, these network members contribute state-of-the-art knowledge by co-mingling with IBM's scientists and engineers, promoting even more knowledge sharing. The payback from this strategy has been immediate. IBM has effectively developed new semiconductor design and manufacturing capabilities, and has posted good results even in times of economic uncertainty. This turnaround from inward-to-outward facing is summed up best by CEO Sam Palmisano who now believes that IBM is "most innovative when we collaborate."

Similar to the semiconductor industry, few industries have been more profoundly influenced by alliances than pharmaceuticals. In this sector, alliances typically help generate value by facilitating advantageous positioning within a given industry or by increasing market share through innovation or better ser-

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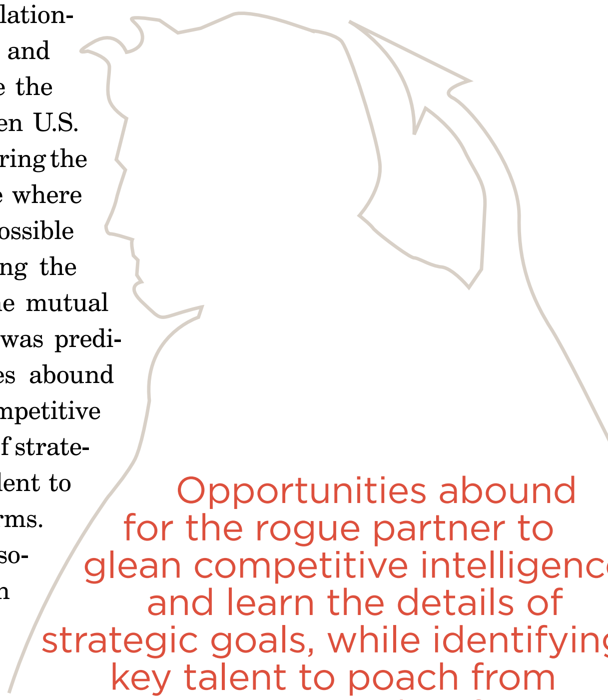
vice offerings. Acting on the looming transition of Zocor—a leading cholesterol drug – to the public domain, Merck & Co. formed an alliance with Schering-Plough to develop Zetia, which prevents the intestines from absorbing cholesterol, making Zocor and Lipitor more effective.[6] Other companies have entered alliances to gain competitive advantage from a *resource* perspective through evolved capabilities and offerings. Millennium Pharmaceuticals realized early on that they simply weren't big enough to take multiple new drugs through a 10+ year FDA wringer. Instead, they focused their attention on the early stages of drug development and partnered with larger firms like Pfizer and Merck to handle the rest. These partnerships gave them time to develop their capability to bring new drugs to market. As Millennium Pharmaceuticals gained its sea legs, it began to grow other areas of the business through co-development.[7] Improvements from both the resource and positioning perspectives demonstrate the power of network alliances in transforming and evolving companies and their capabilities.

Although competitive advantage can be there for the taking by those willing to collaborate, it would be misleading to think the process is risk-free.

THE BALANCING ACT BETWEEN RISK AND OPPORTUNITY

Indeed, the decision to collaborate with other companies, some of which may even be competitors, is often plagued with strategic uncertainty. Striking a balance between risk and opportunity seems easiest on paper, and despite enticing opportunities, the danger of entering restrictive, overly complex or unproductive relationships is foremost on the minds of company leaders. As obvious as it sounds, businesses should try to learn about each other before entering an alliance, but inevitably they must make decisions based on incomplete information. Mismatched capabilities, cultures, internal processes and a general lack of trust between partnering companies constitute the primary relational risks that hamper alliance development. Additionally, inappropriate governance systems and lack of flexible knowledge exchange also prevent well-meaning alliances from getting off the ground. Such shortcomings suggest the importance of structure and formation for network alliance success.

Moreover, the threat of opportunistic behavior often looms large in the formation of alliances, with companies trying to take more from a partnership than they're willing to give. Subtle shifts in objectives, from mutual goals to competitive advantages, add instability to relationships that are at once competitive and collaborative. Extreme cases, like the well-documented alliances between U.S. and Japanese automotive firms during the 1980s, can end in a learning race where each tries to learn as much as possible from the other before terminating the alliance, with little regard for the mutual goals on which the relationship was predicated.[8] Additionally, opportunities abound for the rogue partner to glean competitive intelligence and learn the details of strategic goals while identifying key talent to poach from competing member firms.



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These issues continue to resonate across network alliances in complex technology sectors such as telecommunications. But one company leading the way by recognizing the need to be collaborative and open, while retaining strong protection of knowledge assets, is Finnish wireless communications giant Nokia. The past few years have seen the company embrace the notion of the open business model by launching a number of high profile innovation and venturing initiatives designed to orchestrate networks of innovation partners around the world. This has led to Nokia investing substantially in developing what it calls a global ecosystem of new talent, ideas, markets and financial practices through its venturing funds BlueRun Ventures and Nokia Growth Partners. Both these funds are tasked with building network alliances in product and service areas Nokia views as key growth enablers.

To complement this strategy, Nokia has also implemented an open strategy within and across its primary R&D function, the Nokia Research Centers, located in six countries across Europe, North America and Asia. The Research Centers have a powerful outreach to research institutes and organizations, venture capitalists, and diverse technology-driven corporations. All are brought together in local and global network partnerships to form co-development alliances that lead to business model innovation in areas Nokia is looking to expand. Technological innovation is generally developed in parallel with these partners, with Nokia careful to protect its core intellectual property in areas where it may be most exposed to the threats of IP loss. Indeed, the company has long been revered as a leader in protecting and exploiting its proprietary technologies through astute management of its collaborative partnerships. This has often led to lucrative licensing deals being struck to capitalize on its open network development strategies.[9] It has also meant that Nokia has largely avoided the pitfall of inadvertently creating a competitor from alliances that involve the free exchange of knowledge between collaborators to accelerate the innovation effort. Positive sum agreements are generally sought, with IP often being traded to facilitate the knowledge sharing.

It is clear from examples such as Nokia that risk mitigation in this area rests on the assumption that the effectiveness of a network alliance begins or ends with the presence (or absence) of structure. Broadly speaking, formal partnerships usually involve equity-based relationships between companies. Such transactions are thought to be advantageous because equity tends to stabilize networks, tighten the relationships between partner firms, and thereby enhance exchanges of tacit knowledge and learning. On the flip side, more informal partnerships also have their proponents, who argue that a flexible, off-hand approach to collaboration can spark increased creativity that most companies using a formal alliance would find hard to emulate. Added to this are the perceived cost savings associated with more relaxed business relationships, compared to traditional transactional arrangements. Doubters, however, cite the implications of potential increases in coordination costs as informal networks become larger and more sophisticated leading to almost unmanageable complexity[10]. As with most things in life, the middle ground between the opposing schools of thought may turn out to be the most pragmatic route for companies embarking on an open strategy. The correct mix of formal and informal partnerships may well yield the biggest reward.

LEARNING AND PROTECTING: A DELICATE BALANCE

Once companies decide to ally with each other, those involved need to focus on forging new relationships on a more trust-based footing. Failure to do so can have a profoundly negative impact on alliances. Indeed, the likelihood of achieving desired results from alliances drops dramatically when eroding levels of trust between companies slow progress, thus requiring tighter governance systems.

Moreover, businesses looking to establish outside-in network alliances should have convergent strategic goals and divergent competitive goals. Even when inter-organization learning is an alliance goal, relationships often consist of both competitive and cooperative behavior. Therefore, partner firms with significant competitive overlap may want to limit the scope of the alliance to control knowledge-sharing while still reaching targeted goals.

Overcoming the risks of exposing proprietary knowledge requires balanced, open interactions. To effectively exchange knowledge, participating companies must have similar learning capacities to prevent imbalance in the flow of information. In addition, imbalances in absorptive capacity—the ability to take in new knowledge—can compromise the ways companies differentiate themselves from each other. Longstanding alliances can increase the risks of one party duplicating the products, processes or services of another. The *trying to learn, trying to protect dilemma* arises as a consequence of one party inevitably trying to absorb as much knowledge as possible from a partnership while protecting their own core capabilities from the probing eyes of an opportunistic partner.

For this reason, companies should establish the scope of a network alliance at its onset to avoid opportunism. In general, alliances with a narrow scope are less likely to be hampered by opportunism. Alliances with a broader scope require more protective governance and typically involve equity-based ventures to encourage a positive outcome and create a win-win scenario for all partners. Ultimately, companies entering alliance partnerships need to establish adequate trust to offset the risk of perfidious participants adopting the evolved capabilities of partner firms without absorbing the R&D costs to develop them. Moreover, building sufficiently deep ties between network players can reduce the threat of one exploiting another's vulnerabilities. This, in turn, should be considered in developing a well constructed intellectual property strategy tied directly to the product or service being developed. Knowing when and where to protect proprietary knowledge is crucial for network alliance members that walk the tightrope between learning and protecting.

A ROADMAP TO AN OPEN WORLD

Each of the issues described above emphasizes the importance of a company's ability to play well with others. Beyond that, however, ambiguity reigns with respect to an open business model, and much of the accepted learning about network alliances is vague on the topic. Nevertheless, there are several guiding principles that can amplify the opportunity and stifle the threats inherent to open business models.

Initially, the obvious vulnerabilities that come with alliance relationships involve member firms making decisions on partnering based on incomplete information. Companies bridge this divide by assessing the *relational quality* of a potential partner, which expands the notions of trust and compatibility on which alliances are constructed.[11] When evaluating an opportunity for entering an alliance or establishing a further alliance, companies need to consider the following with respect to the partner's behavior:

- Trustworthiness based on past experiences working and collaborating with a potential partner
- The negotiation process at the outset of an alliance, which can alter the comfort levels of a participating company. At this point, companies form opinions on the organizational and technical capabilities in addition to the ethical fortitude of the other partner firms
- A firm's behavior once the partnership is in place, which has profound influence on perceived trustworthiness as challenges arise
- A firm's behavior outside the context of the alliance. This should also be considered when assessing the prospective partner's business ethics and any perceived risk to reputation through association

Relational quality at these four junctures qualifies the trust (or lack thereof) that should be the basis for establishing an effective relationship. While trust is difficult to build and easy to destroy, it influences most alliances. Once partner firms establish trust, the scope of the partnership can expand to reveal further opportunities for value creation and conflict resolution that arise in the day-to-day working of a partnership.

Take for example the recent alliance between subscription-based movie and video game rental company Netflix and Korean *chaebol* LG Electronics.[12] Both companies entered a co-development partnership to develop a set-top box to allow Netflix to stream movies and video content directly into the home. The ability for each to reach new levels of scale is significant. LG Electronics could potentially reach millions of ready-to-go Netflix customers, and Netflix could gain a new media platform that could carry the company into multiple new business models that utilize digital distribution for its services.

Once firms establish a partnership, four principles generally govern the outcomes.

Align on strategy and scope

It should go without saying, but companies entering a network alliance strategy must be clear about the overall strategic goal behind a proposed collaboration. Aligning its strategic objectives with those of its semiconductor research alliance partners helped IBM minimize opportunism and lower the potential for competitive risks. Companies should, therefore, be aware of the motivations behind each party's participation in a network alliance. They should determine whether their objectives are to build market share, reduce operational costs, or accumulate new capabilities from partner firms. Companies should then base the scope of their alliances on these objectives. It's important to note that strategic goals should always converge, but competitive goals can differ. For example, organizations with significant competitive overlap in technology development may want to limit the alliance scope to control knowledge sharing.

Get the governance right

Partnerships hinge on firms' ability to operate and collaborate within the boundaries of their alliance objectives. Choosing the appropriate governance mechanism is critical to this process. Companies should be mindful that equity-based structures can stabilize a network partnership, resulting in more positive interaction between partner firms. The "mutual hostage" effect of shared equity alliances aligns the interests of partner firms and can ease concerns about opportunism. On the other hand, informal structures can be a powerful pathway to alliance effectiveness and can work well where high levels of trust are evident between the companies. Collaboration can often be enhanced and productivity boosted when partner firms have enough confidence in each other that formal governance structures are unnecessary.

Manage the learning dynamic

Network partnerships thrive on open knowledge exchange between partner firms. This frequently involves an imbalance in risk across the alliance when proprietary technological knowledge is potentially up for grabs. Nevertheless, it is crucial to maintain open, collaborative environments to achieve the desired results from an alliance, and companies can foster open collaboration by carefully considering the scope of an alliance. This can protect partner firms from opportunism and enable freer exchange of information. Indeed, when an alliance is broad in scope, equity-based alliances can be a good way to promote knowledge sharing and support proprietary knowledge protection. Furthermore, partner firms should have comparable learning capacities to avoid imbalances that can lead to opportunism. Finally, network hub firms should carefully balance open collaboration with controlled flows of knowledge to avoid valuable knowledge leaks.

Build trust and positive results will follow

Developing trust between network partners can offset the risk of opportunism, reduce operational costs, and foster effective alliance strategies. The objective should be to build social capital by developing deeper ties between network member firms. To this end, companies should consider the compatibility of their corporate cultures and decision-making styles, behavioral patterns within and outside the context of the alliance, and relational qualities based on previous experiences with a potential member firm. Collectively, these considerations foster confidence between companies, ease conflict resolution through the course of an alliance relationship, and allow collaborative scope to grow as alliance relationships mature.

GETTING IT RIGHT FROM OUTSIDE-IN

While open network alliances are ripe with possibility, getting them right and making them work is a tricky undertaking in the real world. Companies trying to grow their capabilities with open business models are well aware of the vulnerabilities that hamper progress. Effective implementation of these guidelines, which address some of the most common stumbling points, can eliminate structural uncertainties that hinder the formation and ongoing success of open network alliances.

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