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Global strategic alliances: Short-term effects on shareholders' wealth

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GLOBAL STRATEGIC ALLIANCES: SHORT-TERM EFFECTS ON SHAREHOLDERS' WEALTH

By

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ABSTRACT

This study defines Global Strategic Alliances (GSAs) in the context of current management and international business literature, and proceeds to investigate, in relation to shareholders of the participating firms, possible valuation effects that arise from the formation of such alliances. A GSA is defined as a cooperative arrangement between two or more global firms that can affect the competitive positioning of either participant in the market segment in which they set out to compete. This definition distinguishes GSAs from spot transaction activities and from any tactical arrangements in which a firm may engage, while accommodating the variety of strategic motives and organizational forms that accompany global partnerships.

The main thesis of this study is that GSAs are value creating activities for the shareholders of all participating firms; and in addition, the pattern of wealth gains is independent of the participating firms' countries of origin. To further investigate valuation effects, three previously untested hypotheses are included here: i. the extent of wealth gains of firms entering GSAs is positively related to the size of the business segment the alliance will affect, ii. wealth gains are higher on average for firms that have control over the alliance, and iii. in a GSA designated to be equally supported by the partners, the dollar values of their wealth gains are approximately equal.

The *event study* methodology is employed here as follows: the event day is the day of the initial public announcement of the GSA formation. The time frame for this study is from January 1st, 1985 to December 31st, 1992. The

sampling procedure yielded 135 GSAs between 252 firms from nine countries whose stock is traded in nine international stock exchanges. Daily returns from both the individual stocks and the indices of the corresponding stock exchanges are used to compute abnormal returns, based on the market model, and *z*-statistics are obtained, based on the Patell Standardized Residual Test .

The main hypothesis, which has been proven is that all firms in general exhibit positive wealth gains; furthermore, no country effect is observed in the distribution of these gains. Larger wealth gains are found to be associated with firms whose GSA affected a large business segment, while positive wealth gains are associated with equal control GSAs, with larger gains for minority partners and no effect for majority firms. A country effect is observed in the distribution of dollar gains among equal partners: the gains of non-US firms tripled those of the US partner firms.

The managerial implications of these findings are that the marketplace responds favorably to cooperative activity and favors a 50-50 arrangement over other alternatives. Since it appears that US firms are not gaining as much as their foreign-based partners, US firms should reconsider their objectives and competence before entering into an alliance. The implications for the researcher emanate from the fact that this is the first study, to date, to examine valuation effects of international events using data from several world exchanges, and, therefore, the findings are unprecedented and deserve further investigation, in particular, the finding of a possible value transfer among equal partners that is presented here.

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Adam Smith

I. INTRODUCTION

1.1. OVERVIEW

As we move toward an increasingly global business environment, the need to create organizational structures and relationships to survive and compete in the ever-changing marketplace, whether it is confined within the traditional measures of geography or not, becomes even more imperative. Cooperative strategies have evolved as a method of business arrangements with repercussions on organizational structure, and have been widely accepted and practiced at an increasing rate. The academic community has been monitoring the developments in the business world and has responded with the expected lag required for the collection, accumulation and interpretation of data. Subsequently, the number of studies researching different aspects of the cooperative venture activity has grown significantly in recent years.

Until the 1980's the study of international business management was typically attached to the multinational firm, which was generally considered as a self-contained unitary entity, with internal systems for planning, implementing and control (Caves, 1971). This is basically the first post-war

model of multinational development, in which the firm strives to internalize all the possible expertise and know-how that it possesses for expanding its operations outside its home country borders (Buckley and Casson, 1976). A very common case, including government-mandated partnerships, has been the expanding multinational company (MNC) attempting to enter new markets in cooperation with a smaller *local* company, that acted as the navigator for the larger *foreign* partner in the host nation's waters. This was the prelude to establishing a wholly owned subsidiary to operate in the new national market.

Interfirm cooperation is certainly not a new invention; the traditional approach viewed cooperative activities as *second best* solutions, whereas the firm's preference was clearly to undertake the task alone. While joint ventures are, perhaps, the most profound type of cooperation, there are many other types of *hybrid* arrangements in substance and form. At this point it is necessary to make one important distinction: a cooperative activity, even as a part of the corporate strategy, is not necessarily a strategic one, if it does not promote the overall competitive position of the firm vis-a-vis a market or a product[1].

It appears that many researchers even recently failed to recognize this difference, which goes beyond semantics; the motivation to cooperate can vary widely between the tactical and the strategic needs and as Powell (1990:313) suggested "*there is no clear cut relationship between the legal form of cooperative relationships and the purpose they are intended to achieve. The form of the*

relationship appears to be individually tailored to the needs of the respective parties". Furthermore, the organizational and other corporate resources involved in a cooperative venture are determined by the motivation of the firm, as well as the possible valuation repercussions on the corporate stock.

Today's global business practices call for companies of similar, rather than unequal, size to cooperate regularly by sharing technology, financial resources, human resources, markets and control and often to transcend national borders. Adam Smith's warning has been effectively used for decades by both anticapitalists and perfect competition advocates alike, and by anti trust regulators in the government ranks, to block any major non-market cooperative agreement among firms. In light of the global marketplace, one has to recognize that attempting an international conspiracy is nearly impossible, especially in the high technology industries where, very often, yesterday's front runners are today's laggards.

The dynamics of global competition are such that Prahalad and Doz (1987:48) suggest

> "*a first order of business for the strategist is to arm himself with a <u>strategic infrastructure</u> that allows him to wage the war of global competition. The strategic infrastructure comprises: 1. A portfolio of manufacturing locations to leverage factor cost advantages and the ability to integrate them into a global network and to cope with*

exchange fluctuations, 2. Constant attention to manufacturing technology and productivity improvements, 3. A multimarket presence to leverage competitive asymmetries and exploit the resulting price differentials, 4. A global brand and distribution presence, 5. A product family that allows cross-subsidization opportunities across products in a given national market . . . The need for strategic infrastructure . . . to remain globally competitive is becoming obvious to many diversified multinational companies (DMNCs). As a result, DMNCs that do not possess the strategic infrastructure are attempting to build one through a series of "strategic partnerships" with other firms that find themselves in a similar predicament."

The establishment of such partnerships or alliances in some industries is so prevalent that some believe it is a permanent phenomenon[2], while others suggest that it may only be a transitory stage to bridge the gap between competitive needs and internal corporate capabilities or a way of "buying time" before the firms develop their own capabilities (Prahalad & Doz, 1987:50)[3]. The point, though, is that, at the time of the partnership's creation, since none of the partners can undertake the agreed tasks alone, the new alliance itself possesses a specific competitive advantage over the individual partners and through the alliance, the partners share this advantage, creating value that all partners will share in the final analysis.

Perhaps the simplest form of interfirm cooperation is the basic capital budgeting situation, in which one firm acquires goods and services from another firm in a spot transaction (McConnell & Nantell, 1985: 520). At the other end of the spectrum there is the merger of the two firms, which decide to pool their resources totally. In between the two extremes there can be a number of different arrangements; Contractor and Lorange (1988:5-7) ranked these arrangements in order of increasing organizational interdependence (Table 1).

Each type is distinctively different from the others, both in form and in substance: for example, a technical training and a start-up assistance agreement are usually short-term with the duration and compensation specified in the hiring contract; typically, after the termination of the contract, the company supplying the technology has limited, if any, links with the other party, unless stipulated by subsequent agreements. Patent licensing is a one-time transaction but the compensation, in the form of running royalty, can be extended into several time periods. Contract manufacturing, management contracts and know-how licensing involve a greater degree of interdependence among the partners both in terms of organizational levels involved and the duration in time and compensation methods can be mixed, depending on the particular case.

The term joint venture, very broad itself, is commonly used as a separate legal entity which was created by the partners according to their cooperative agreement. This is the top of the hierarchy in terms of degree of organizational

interdependence and linkages among partners. It is, perhaps, the most studied mode of cooperative activity that has developed its own typology.

TABLE 1

TYPES OF COOPERATIVE ARRANGEMENTS

	TYPICAL COMPENSATION METHODS	EXTENT OF ORGANIZATIONAL INTERDEPENDENCE
Technical training/ start-up assistance agreements	L	Negligible
Production / assembly / buyback agreements	m	
Patent licensing	r	Low
Franchising	r; m	
Know how licensing	L;r	
Management / marketing service agreement	L;r	
Non-equity cooperative agreements in: Exploration Research partnership Development/coproduction	 $\rho_i=f(C_V,R_V)$ $\rho_i=f(C_V,R_i)$ $\rho_i=f(C_i,R_j)$	Moderate
Equity joint venture	α	High

α = fraction of shares/dividends

r = royalty as a percentage of turnover

L = lump-sum fee

m = markup on components sold or

ρ_i = profit of firm i in non-equity joint venture

C_V ,R_V = costs and revenues of the venture

Ci,R_i= costs and revenues of the firm i

R_j = revenues of the dominant partner

Source: F. Contractor (1986)

Table 1 differentiates between equity and non-equity joint ventures to indicate that a complex arrangement, such as this, does not necessitate the creation of a separate corporation, as long as the rules and regulations of the cooperative agreement are clear and all parties abide by them. This is the norm in extractive industries, oil and gas in particular, where multipartner consortia are formed for R&D purposes.

Why do firms cooperate[1]? This simple question evokes a complex answer. Any type of cooperative arrangement which a firm may elect to pursue is expected to satisfy one or more overlapping objectives. Following is a listing of the major potential benefits as typified by Contractor (1986) (Table 2). Benefits from cooperative activity are viewed as positive contributions to the value chain, as suggested by Porter; the combined efforts of all partners must add up to a value chain that can produce a more competitive end result that neither partner alone could have achieved. Therefore, it is important that the partners have complementary strengths and that their strategies be compatible. There are cases, however, where the partners instead of making complementary contributions, provide similar inputs to the venture.

The first item on Table 2 is very often cited as a primary motivator for cooperative activity. Risk reduction through such ventures can be achieved by (1) spreading the risk of a large project over more than one firm, (2) enabling diversification, in a product portfolio sense, (3) enabling faster entry and payback, and (4) cost subadditivity. Classical examples are the development of projects such as airplanes, defense projects and oil exploration. Iin industries with a high degree of technological obsolescence and increasing new generation

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1

Among the reasons is "follow the competition": this is exactly what AT&T did, as its CEO said: "in January 1993, we announced an agreement to acquire a 20 percent equity interest in Unitel Communications, Inc., a Canadian long distance company, for cash and advanced telecommunications equipment valued at approximately $120 million. We negotiated this alliance, which will include joint projects and marketing efforts, as a competitive response to an alliance between MCI Communications, Inc. and a consortium of Canadian telephone companies called Stentor".(Source: Worldscope).

development costs, such as computers, risk reduction is of primary importance.

What a difference a decade made. In late 1970's Friedman, Berg and Duncan (1979) in an empirical survey found negative correlation between R&D intensity and propensity to form joint ventures[4]. Apparently this reflected the prevalent model of multinational development. Today, we see IBM codeveloping with Apple a new generation of computers and at the same time both companies competing in the same consumer market with comparable products.

With the exception of the wholly owned subsidiary, all other entry modes into a foreign market (licensing, franchising, subcontracting and joint venture) involve a cooperative strategy, which entails varying degrees of resource commitments and organizational preparedness. In addition to Dunning's eclectic paradigm, government mandated restrictions beyond the control of the firm, may necessitate a cooperative strategy. In international business, market entry strategy is, perhaps, the most common cause for the creation of new ventures.

Vertical quasi-integration refers to ventures so designed that partners' inputs are complementary, not similar, with each partner contributing one or more different elements in the production and distribution chain. The bibliography on vertical integration is extensive; suffice it to say at this point that firms that elect this mode of transacting essentially elect to take a middle position between the two extremes of total vertical integration and complete

contractual relationships or outsourcing.

TABLE 2

STRATEGIC CONTRIBUTIONS OF ALLIANCES

RISK REDUCTION Product portfolio diversification Dispersion / reduction of fixed cost Lower total capital investment Faster entry and payback	**MARKET ENTRY STRATEGY** Overcoming government mandated restrictions Benefit from local partners' knowledge of market
ECONOMIES OF SCALE Lower average cost from larger volume Lower cost by using partners' comparative advantage	**VERTICAL QUASI INTEGRATION** Access to materials Access to technology Access to labor Access to capital
COMPLEMENTARYTECHNOLOGIES Technological synergy Exchange of patents and territories	Drawing on existing fixed marketing establishment Regulatory permits Access to distribution channels
COLLUSIVE BEHAVIOR Defensive moves to reduce competition Offensive moves to capture market share	Benefits from brand recognition Establishing links with major buyers

Adapted from F. Contractor (1986)

A major research subject in the 1960's was the collusive behavior that certain firms within particular industries (steel, aluminum, oil etc.) were suspected of exhibiting through regular cooperative programs. Hence, the antitrust considerations of interfirm cooperation, which was viewed with suspicion by government regulators[5]. However, as a motivator it can be powerful. Note that when Caterpillar linked up with Mitsubishi in Japan, they did so to exert pressure on Komatsu's profits and market share on its home front that allegedly generated 80% of its total cash flow (Hout, Porter & Rudden 1982:102).

The newly coined term of Global Strategic Alliance (GSA) generally refers

to any type of cooperative strategy with the following qualifiers: international in scope, mixed motive (competitive / cooperative) in nature and, most importantly, strategically significant to the partners as described above. These properties distinguish GSAs from single-transaction market relationships, unrelated diversification, or other tactical arrangements, while accommodating the variety of strategic motives and organizational forms that accompany global partnerships.

The finance literature has clearly established that individual investors benefit from international diversification. In addition, from the late 1960's until now there has been a large number of studies of MNC development and expansion and the impact of various strategies on stockholders' wealth. Initial studies found that MNC expansion was associated with higher value for the stockholders, and this international diversification was interpreted as the benefit which the MNC provides the investor, who otherwise would have not been able to realize. This was a very plausible explanation, if not true, at that time. However, several studies on the subject provide mixed and conflicting conclusions.

Another group of studies sought to document a possible source of wealth gains in the synergy effect that occurs from the partial combination of resources of independent firms. This view essentially followed a parallel route to the mergers and acquisitions studies and, in fact, quite openly, sought the

similarities between the partial and the total interfirm combinations. This seemingly logical connection produced studies with conflicting results.

Lastly, a different approach from the international business literature proposed by Kogut (1983:38) places the source of MNC value in the "positive-multinational-network": "the primary advantage of the multinational firm ... lies in the flexibility to transfer resources across borders through a globally maximizing network." As Doukas and Travlos (1988) argue, such network provides the firm with a number of valuable options that, on most occasions, cannot be traded or acquired by investors outside of the MNC, and, consequently, every corporate move that enhances or increases these options should be reflected in a corresponding increase in stock value. Only a few studies looked into this issue and it appears that this explanation holds.

Even if we take the most simplistic position of all, that of the classical investment decision for a given series of projects, a rational corporate management conceivably would only select those that at least have positive NPV. Therefore, by virtue of undertaking a non-negative NPV project we should expect either zero or positive valuation effects to the corporate stock. In reality though, a cooperative agreement is not always as simple as an export arrangement. The tremendous complications that arise in strategic alliances make it extremely difficult to forecast the value of this strategy in terms of project NPV. Hence the disparity of findings in empirical studies.