



GETTING FIT

Exercise Your Alliances to Trim Inefficiencies, Boost Value, and Get Them in the Zone of Functional Inefficiency

By David S. Thompson, CA-AM

Benjamin Franklin had it right when he said a penny saved is a penny earned. This adage is especially relevant in the context of alliances, given that partnered activities are seldom more efficient than a “go it alone” strategy of acquisition or in-house development. It should come as no surprise, then, that astute alliance managers can save their companies much more than Franklin’s singular penny.

A key alliance concept is to push for thoughtful savings. In other words, we try to reduce inefficiencies without disturbing the effectiveness of an alliance. While it is typically more efficient to build or buy an asset, the process is usually far more expensive and risky. Effective and efficient alliances exist in a zone that balances alliance risk with some level of expected inefficiency. We call this zone the functional inefficiency territory, or FIT.

Two important questions for alliance managers as they seek to reduce inefficiencies are:

- How does one know where to spend time to reduce inefficiencies?
- How does one know when an alliance has entered the functional inefficiency territory (FIT)?

In order to answer these questions, it is important to understand three key alliance concepts: risk, inefficiency, and value inflection.

Relationship between inefficiency and risk

When an alliance is created, some of the risk held by each party prior to signing an agreement is converted into three basic (and manageable) categories: human risk, business risk, and legal uncertainty. Reducing or increasing alliance inefficiency changes the risk profile of an alliance.

To illustrate the point, here is an example: It is possible to reduce legal uncertainties by creating layers of process within the alliance. Extensive educational programs, testing, checklists, and management approvals can be implemented at each level and in every part of an alliance. While these processes would certainly reduce risk, they would unnecessarily increase alliance inefficiencies. On the other extreme, one could hire smart employees and provide absolutely no training or guidelines, thus producing a highly efficient but extremely risky alliance environment. As in the story of

Goldilocks and the Three Bears, the key is to find a ratio of risk to inefficiency that is “just right.”

In many cases, value is squandered by allowing alliances to become more inefficient than they need to be. Working with someone else is always less efficient than working alone; however, working with someone else can be much more effective. The key to keeping an alliance in a value-producing state is to optimize risk and inefficiency at the places that produce the most value for an alliance. The graphic above depicts the FIT zone that represents an optimal balance of risk and inefficiency in an alliance.

The best alliance managers locate inefficiencies by studying the categories of human risk, business risk, and legal uncertainties associated with the contract. They focus their constrained resources on the areas that have the potential to produce—or destroy—the most value.



Common alliance inefficiencies include:

- Duplication of effort across the alliance value chain
- Time wasted on trivial disputes that do not increase alliance value
- Time spent on “over-perfecting” alliance communications
- Product or service timeline slippage due to ineffective communication

Alliance adjacencies deserve attention

In addition to the examples above, an additional type of inefficiency—an alliance adjacency inefficiency—deserves a more in-depth look. (And for even more depth, see “Look Out Ahead: How Ignoring Alliance Adjacencies Can Constrain Value,” Q1 2015 *Strategic Alliance Magazine*.) An alliance adjacency inefficiency is one that “spills” out of one alliance into other alliances or wholly owned assets within a single company. The wise alliance manager will be aware of how his or her alliance interacts directly or indirectly with other alliances and other products or services. Alliance adjacency issues are almost always value inflection points and are worthy of attention.

Adjacency can be defined as the state of being near or contiguous to something. In the context of a formal partnership, alliance adjacencies represent the requirements and contingencies at the boundaries of an agreement. It is important to examine how these limitations can affect the use and potential benefits of a company’s own products and services as well as those it might offer as part of another alliance.



In large part, alliances are created because each partner expects to gain something of value. That value might take the form of a new way of grouping products or services, a supply chain that lowers costs or offers customers a seamless solution, access to a new technology or talented people, or a means of reducing the risk of developing an expensive product or service. With these benefits always come expectations of what can and cannot be done by each partner over the course of an alliance, usually codified in a contract. These contractually defined limitations create alliance adjacencies.



Looking across a company's alliance portfolio, adjacencies take a variety of forms—large and small, malignant and benign—with each business deal containing multiple sets of unique commitments. While no contractual arrangement is necessarily created to interact with another, they sometimes do interact, often in unforeseen and strange ways.

To better understand alliance adjacencies, it might be helpful to consider what happens in a typical contracting cycle. The deal teams from each company—negotiators, lawyers, and key stakeholders—are tasked with ensuring that the contract accurately captures what was agreed upon during negotiations. The contract has to describe under what conditions value is exchanged and the rights each party has under the agreement.

In addition, almost all contracts define the alliance's duration, how to handle mutually generated intellectual property, conditions that would trigger the end of the alliance, how post-termination alliance assets would be allocated, and how disputes are to be handled. These rights and value statements, along with all other guidance given in the contract, define the boundaries within which the alliance will operate.

If not addressed effectively, these contractual boundaries can become the source of countless alliance inefficiencies and other forms of organizational friction, which can become major problems for current and future partners. These inefficiencies might be called an opportunity cost by an economist; however, it has been

our experience that simple opportunity costs are usually discussed as part of an individual deal and are fairly and adequately valued and accounted for in the contracting process. What an economist's theoretical treatment of these costs lacks is the ability to quantify weaker restrictions that a contract may impose on the parties, as well as the ability to predict the addition of future partners.

When the extra work only impinges upon a single alliance member with no effect on the others, the inefficiency is isolated and easier to manage. But when the extra work spills over to impact other adjacent alliance members, it becomes significantly more complex. The work that is created by an adjacent alliance usually takes on three forms: process redesign; extra work created by the loss of operational degrees of freedom; and increased coordinating activities.

Three common alliance adjacencies and sources of alliance inefficiency

THE THREE-LEGGED RACE: Within an alliance, more time and effort is needed to coordinate activities such as press releases, key decision making, budgeting, and spending. This increased effort is a bit like the childhood game of running a three-legged race. Those who can best coordinate their movements win, while those who cannot usually fall down. The race is entertaining to watch, but it can be expensive and time consuming if run metaphorically in an alliance setting.

THE ONION: Some alliances require companies to protect and separate their intellectual property. There are legal names for some of these protective systems: firewall, clean lists, washout periods, and so on. This process is reminiscent of how an onion is treated if it is stored in the refrigerator with other foods. The onion needs to be contained so that its properties don't spill over into the other foods kept in close proximity. There is an additional cost to containing an onion. It is a cost measured in time and money, and in alliances it represents an additional source of inefficiency.

GULLIVER'S TRAVELS: Many companies are engaged in multiple alliances, with each governed by a contract that circumscribes the activities and boundaries of each

participant. For example, it is not uncommon for a contract to dictate that partners cannot develop products that compete with the allied product for the duration of the alliance and for some specified period afterward. Individually, these restrictions may seem logical and manageable. Taken together, however, these restrictions can, like the Lilliputians of Gulliver's travels, tie down a giant a single thread at a time until the giant can no longer move. Similar to the predicament encountered by Gulliver, an alliance's strength can be sapped by limitations on activities multiplied by the total number of a company's alliances.

Value inflection points

Value inflection points are instances in the alliance process where more value can be added or destroyed than at other times or in other areas. The greater the degree of inflection, either positive or negative, the more important the value inflection point. For example, a bit of sand and some rare earth metals that are worth at most a few cents are processed into a computer chip worth hundreds or even thousands of dollars. The steps that transform the sand and metals into a chip add value to the product, but each step in the process does not necessarily add the same value. Said another way, value creation and destruction in an alliance is not linear, as some steps have the potential to create or destroy more value than others.

Every alliance value inflection point is permeated with the three types of alliance risk (business risk, human risk, and legal uncertainties) and is subject to all types of alliance inefficiencies, including alliance adjacencies. **Any alliance process or activity that is a "triple threat"—that is, one that has high alliance risk, high inefficiency, and is a major value inflection point—is by definition the core work of an alliance manager.**

In summary, a skillful alliance manager can bring great value to an alliance by:

1. Prioritizing efforts where they matter most—around key alliance value inflection points
2. Managing the three basic risk categories associated with alliances, specifically prioritizing efforts around key alliance value inflection points
3. Reducing alliance inefficiencies to an acceptable level by managing alliance inefficiencies, inefficiencies created by ordinary alliance processes, or by alliance adjacencies issues. ■

David S. Thompson, CA-AM, is chief alliance officer at Lilly and is a member of the ASAP board of directors.

