Research on Partner Selection of Vertical Strategic Alliance

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Abstract: This paper analyzed the reason why enterprises want to take part in vertical strategic alliance and the common problems of vertical strategic alliance. After that, we brought an evaluation indicator system for partner selection which consists of five decision factors and 23 indicators.
Keyword: Vertical strategic alliance; Partner selection; Hidden aim; Cultural compatibility

1 Introduction

As the progress of science and technology becomes much quicker, enterprises that merely rely on batch production and scale operation face much more risks in the more and keener market competition and hardly to gain long term advantage. Establishing strategic alliance with other enterprises is an important way to control the operation risk and promote the competition advantage.

Strategic alliance can be categorized into horizontal strategic alliance and vertical strategic alliance. The horizontal strategic alliance consists of enterprises coming from the same industry, which are potential competitors, produce and sale same products and services. In the vertical strategic alliance, partners belong to different industry and they have direct or indirect input-output relationship.

Unlike horizontal strategic alliance, the partners of the vertical strategic alliance do not in competition relationship and hence the vertical strategic alliance is much more acceptable for enterprises. Vertical strategic alliance integrates the upstream and downstream enterprises of industry chain, manages several conterminal different production and operation stage in one alliance.

Vertical strategic alliance can help enterprises cooperate with other enterprises that have different and complementary role in industry chain to utilize more resources and form much more great power to participate in market competition. By the cooperation in vertical strategic alliance, enterprises can reduce or eliminate the disadvantage introduced by information asymmetry. The vertical strategic alliance is also an effective substitution of vertical integration because it can prevent the series problem of relevant resource dependence, eliminate the indeterminacy in the supply chain system and decrease the potential loss by the price fluctuation of input goods. Therefore, vertical strategic alliance is a particularly important strategic alliance form.

Although the strategic alliance offers the partners a chance to create win-win situation and many enterprises actively establish and participate strategic alliance, especially vertical strategic alliance, they usually can not realize their expected aim and cause to failure. Investigations revealed that the failure rate of strategic alliance is almost among 50% and 60%[1]. Since 1980's, McKensey carried out a tracking research on over 800 strategic alliances and recorded that only 40% strategic alliances can last over 4 years. And many strategic alliances are broken up in very short time[2]. There are many reasons for the failure of strategic alliances, but the unsuitability of partner is thought as one main reason by researchers and practicer[3]. An investigation on 750 American CEOs discovered that their most lacking and needed expertise is how to choose strategic alliance partners[4].

2 Why Enterprises Participating Vertical Strategic Alliance

Every enterprise has his particular reason to participate vertical strategic alliance since they have different resources and different expectation. To choose partners, enterprises must know why other enterprises want to take part in the vertical strategic alliance. The reason why enterprises participate vertical strategic alliance can be summarized as follows:

2.1 To stabilize the total sale

Many big enterprises build production lines with huge production capability to gain scale economy, and decrease the average cost of products and win more customer orders. But these huge capability production lines need much more high investment and have much more high idle cost. To fasten the capital recovery and avoid production line being idle, enterprises must acquire steady sales market. This phenomenon is much more important in high production batch industry, such as raw material industry and chemical industry. In this case, enterprises tend to establish strategic alliance with agents or end customers to gain steady customer order by offering preferential price. The vertical strategic alliance with downstream customers can not only stabilize the total sale and decrease the marketing risk, but also help enterprise to strengthen the customer relationship, understand customer demand much better, and improve the development of new product and marketing. For example, Baosteel is the most big steel-plate-for-auto supplier and hold a market share of almost half. At the same time, the downstream auto companies also have giant scale and demand and the market convergence tends to become higher. In this case, Baosteel's loss of one main customer means great sale decreasing. At the same time, auto industry undergoes a rapid and continuous technological progress, Baosteel must continuously develop new product according to the new demand of auto companies. Therefore, Baosteel established strategic alliance with china main auto company such as FAW, Dongfeng, Saicgroup. By the deep cooperation on steel sale, new product co-development and steel post-processing, the simple sale-purchasing relationship between downstream and upstream enterprises is expanded to close strategic partnership[5].

2.2 To stabilize raw material supply

High capacity production line needs huge raw material supply. The enterprise operation would face great risk if the raw material supply fluctuates, including supply stop, the increase of raw material price and the changing of raw material quality. These supply risks would be much higher for enterprises purchasing raw material for foreign country and having special technological requirements. By establishing strategic alliance with raw material supplier, enterprises can not only stabilize the raw material supply, but also decrease the purchasing cost. This is the reason why auto companies want to establish strategic alliance with Baosteel. At the same time, Baosteel also establish strategic alliance with his supplier CVRD[6].

2.3 To apportion the cost of investment

As the technological rapidly progressing, there are usually several technological solutions for one customer demand, which means high technological risk. The high cost of research and development and production line construction are a huge burden for any enterprise. By establishing vertical strategic alliance with upstream or downstream companies, the cost of investment can be apportioned and the technological solution can be optimized by partners.

2.4 To satisfy the control requirement of government

The industry policy of government may have character requirement on enterprises. For example, foreign auto companies who want to produce auto goods in china must have local partner. Government usually has multifarious control requirement, local partners know well how to satisfy these requirement and they also have much strong influence on governments. Therefore, many transnational enterprises establish strategic alliance with local partners when entering a new market.

3 Common Problems in Vertical Strategic Alliance Partner Selection

Although there are many reasons for the failure of strategic alliance, the inappropriate partner is noted by most researchers and practitioners. The lack of expertise on partner selection is thought as the main reason for the failure of strategic alliance [7]. An investigation revealed that only 30% strategic alliance had achieved their aim and other 70% led to failure. In the failing strategic alliance, 70% is caused by inappropriate partner (see Figure 1)[8].

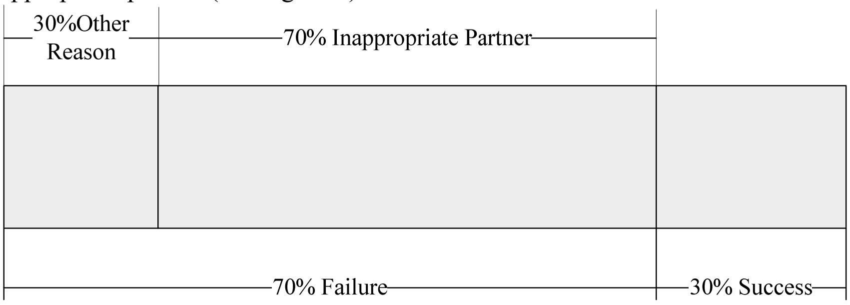

Figure 1 Partner Selection and Strategic Alliance Failure

The reason why so many enterprises still fail where other enterprises' fail is that there are some issues which are usually bypassed at the beginning of strategic alliance.

The first bypassed issue is hidden aim. At the beginning of vertical strategic alliance, partners usually reached a consensus on the aim of vertical strategic alliance and each other's right and obligation. However, besides open consensus, some partners may have hidden aim, such as knowing and obtaining downstream distribution channel in the help of partner. In some cases, the hidden aim may be the main aim for which enterprises participated the vertical strategic alliance. These enterprises would adopt opportunistic behavior to realize their hidden aim despite the vertical strategic alliance open aim and other partner's benefit, which cause the failure of strategic alliance in most cases. Another type of hidden aim is the manager's hidden aim of partner.

To avoid the hidden aim, enterprises should know each other's strategic intention very well before the establishing of strategic alliance to ensure the open aim is real and valid and the strategic alliance would benefit each other. Although the hidden aim can not be banished completely, the reality and validity of open aim can restrain most hidden aim. The key factor is to ensure every partner gain enough benefit according to their effort. If one partner does not get deserved benefit, it would raise hidden aim even if it dose not have at the beginning of vertical strategic alliance.

When establishing vertical strategic alliance, enterprises should consider the possible hidden aims and their potential damage to other partners. Enterprises should frankly discuss the hidden aim and add hidden-aim-restraining clauses in alliance agreement.

The second issue is the cultural compatibility. When choosing partners, enterprises usually emphasis the complementarities of competence and resources but neglect whether they can realize cooperation smoothly. If the cooperation can not realized this, the originally weak trust would be seriously shocked and the alliance is subject to dismissed. The barely operated alliance would face the increasing operation cost by the conflict and distrust. At the same time, the alliance aim can not be achieved or well achieved.

Enterprises culture shape the management behavior and the smooth cooperation among partners in alliance rely heavily on the compatibility of enterprises culture. But this does not mean partners should have similar culture. Every enterprises has its own particular culture, similar culture requirement would greatly reduce the potential candidate for partner. Especially for vertical strategic alliance, enterprises come from different industry and may have very different culture. The cultural compatibility means that every enterprise and its employee can easily understand another's culture, and can understand the reason and aim of its behavior. Based on this basis, partners can forecast other's behavior and prepare for it. In the case of cultural conflict, partners can make concessions and ensure the smooth cooperation.

The third issue is the balance. A well-made alliance should have a good balance, which means that partners shouldn’t have to have similar scale. Traditionally partner choosing emphasize similar scale balance while the most important thing is that partners should have similar contribution to the alliance. If one strategic alliance rely heavily on one member's contribution, the alliance is not necessary.

The fourth issue is the dynamics of market. The dynamic changing of market environment can make the alliance aim invalid or make partner's contribution tiny. If the aim of establish strategic alliance is to stabilize the sale and develop new market, enterprises should pay close attention to the prospects of downstream industry and specific enterprises. Especially when the product can be used in several downstream industries, the chosen partner should be in an industry with high product added value and rapidly expanding market capacity. This kind of alliance can help enterprises take up a good market position in rapidly developed downstream industry.

4 Indicator System

To choose the most appropriate partner, the key issue is not which method should be used to evaluate the potential partner, but which indicators should be used. Many researcher had made remarkable contributions on the partner selecting indicator system [9,10]. Based on the previous work and above analysis, this paper bring forward that the decision factors should be complementarities, desire, capacity and growth, compatibility, trust and cooperation. Corresponding indicators are stipulated in each decision factor see Table1.

Table 1 Indicator System for Partner Selecting in Vertical Strategic Alliance

<table>
<tr><th>Decision Factor</th><th>Indicators</th><th>Decision Factor</th><th>Indicators</th></tr>
<tr><td rowspan="4">Complementarities</td><td>Material resources</td><td rowspan="5">Capacity and growth</td><td>Management capacity</td></tr>
<tr><td>Human resources</td><td>Cooperation capacity</td></tr>
<tr><td>Knowledge and technology resources</td><td>Alliance experience</td></tr>
<tr><td>Marketing channel</td><td>Finance health</td></tr>
<tr><td rowspan="4">Desire</td><td>Strategy coherence</td><td>Growth</td></tr>
<tr><td>Positioning coherence</td><td rowspan="3">Compatibility</td><td>Scale</td></tr>
<tr><td>Benefit importance</td><td>Core business</td></tr>
<tr><td>Other goal</td><td>Culture tolerance</td></tr>
</table>

	Potential steal	Trust and cooperation	Familiarity
	Manager reputation		Honesty record
	Win-win consensus		Executives stability
			Executives relationship

The complementarities decision factor considers whether the candidate has different resources from other members. Consequently, the candidate's score in each indicator is not decided by its resources amount but scarcity. The paper identifies four indicators in complementarities decision factor, which are material resources, human resources, knowledge and technology resources, and marketing channel.

In the capacity and growth decision factor, there are also five indicators. Management capacities consider the candidate's inner management level, which mean the control degree of strategic level to operation level. The cooperation capacity stands for the enterprise's ability to cooperate with other enterprises and accomplish common tasks. Whether the candidate has rich past experience is also important to alliance. Finance health is a hysteretic indicator to enterprises' capacity. The prospect of candidates is reflected by the growth indicator.

Although the compatibility decision indicator only has three indicators, it is important. The huge size candidate would not get a high score in scale indicator because this indicator is designed to reflex the matching of enterprises. Hence, if the candidate has similar size with the core company, it would get a high score. Similarly, candidates have different core business would get a high score. The indicator culture tolerance requires that the candidate has a tolerate enterprise culture, which is easy to adjust the operation pattern to realize cooperation with others.

The familiarity indicator in trust and cooperation decision factor reflex whether the candidate is familiar to the core company, which can help the smooth cooperation. The honesty record also help the trust building in alliance, while the private relationship between is doing the same thing. Another factor that hampers alliance performance heavily is the personnel changes of partner. It may change the desire of the partner and cause the slowly carrying of former agreements and even abandon. Therefore, the indicator executive’s stability is brought forward.

The most important factor to decide the candidate's contribution to the alliance is its desire. So this paper brought forward seven indicator to detail investigate the desire decision factor. The strategy coherence indicator evaluate whether the candidate's strategy has coherence with core companies. The position coherence indicator evaluate whether the candidate holds same positioning to alliance with core companies. The benefit importance is also a significance indicator because if the alliance's benefit to one partner is not important, the partner would have no incentive to make contributions. The win-win consensus indicator reflex whether the candidate is willing to realize win-win. The left three indicators are to detect the hidden aim. If the candidate has other goal or may have potential steal behavior, the alliance is threatened. Similarly, if the manager has personnel hidden aim, the alliance also can not achieve its origin aim.

5 Conclusion

The most difficult problem in partner selection is choosing proper evaluation indicator. Based on the previous work and analysis on the incentives and common problems of vertical strategic alliance, this paper brought an indicator system which consists of five decision factors and 23 indicators.

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