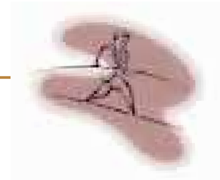


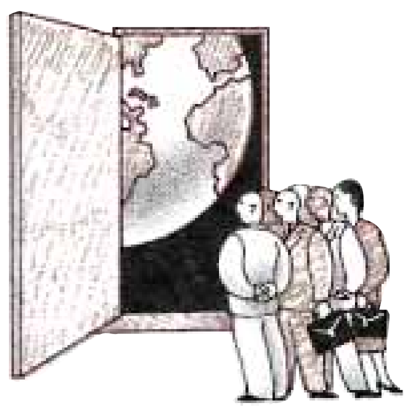
THE TRILLION-DOLLAR ENTERPRI$E

Huge global networks and alliances will soon create organizations of awesome capabilities.

BY CYRUS F. FREIDHEIM JR.

"VIRTUALLY EVERY INDUSTRY is consolidating," said Paul H. O'Neill, chairman of the Aluminum Company of America, as we stood on the veranda of Skibo Castle in the highlands of Scotland. "While there will always be room for small, highly creative firms, there will be giants that rule the earth," he continued as he sipped his Glenmorangie. "We haven't begun to understand their potential size and scope. They will be built by the same mix of vision and genius and risk-taking that made Andrew Carnegie [in whose castle we were standing] the greatest tycoon of his age."

The giants he was talking about will be the product of acquisitions, joint ventures, alliances of all kinds. They will not be the conglomerates of the 1970's and 1980's that attempted to gain stability by diversifying risk,



spreading their investments over separate businesses. Rather, these new enterprises will focus all their resources on dominating one, or a few, fields. They will restructure whole industries, change their economics and turn the basis of competition upside down. They will, collectively, have all the capabilities necessary to win in a tough, competitive, global marketplace.

In preceding decades, mergers and acquisitions have been the primary vehicles for this kind of consolidation. Today and into the next century, alliances will play a major role in the consolidation of industries, in part because of the shortcomings of the global corporation.

Consolidation on a global scale is very expensive, and often the global corporation must make major compromises in the selection of acquisition partners because of cost or national restrictions (e.g., on making purchases in the airline, military and oil industries). Hence, many of the best prizes are simply unavailable. The relationship enterprise slides by these limitations and goes directly to the best in any country with an offer to form an alliance with its crown jewel; no size problems, no national restrictions, no anti-trust problems, no

Cyrus F. Freidheim Jr., vice chairman of Booz-Allen & Hamilton and a member of the Council on Foreign Relations, the America-China Society and the U.S.-Japan Business Council, has more than 30 years of experience consulting for multinational corporations in 15 countries.

Illustrations by Margaret Hathaway

funding limitations, just a strong relationship with the the best company.

The relationship enterprise is a network of such alliances that operates as a single company in selected key areas. It is consolidation without huge investment, battles over ownership, postmerger headaches and regrets. The investment dollars can go into building market positions, new products, capacity and capabilities for the enterprise rather than for shares of an acquired company. The relationship enterprise is a natural evolution, a consequence of the political and economic forces of our times.

As consolidation through these networks of alliances occurs and the networks increase in focus and size, we will see the new Tyrannosaurus rex of the economic world, the trillion-dollar enterprise. It will be huge and powerful; it will move economies and technology ahead dramatically; it will serve customers everywhere; it will dominate its industries globally; it will help some nations and threaten others.

This evolution is a natural product of industrial globalization and political polarization. It stems from the need to capture the economies of scale and the scope of consolidation without the baggage and limitations of acquisitions and mergers. It stems from the historic drive of corporate leaders to overcome whatever obstacles lay in the way of their growth and progress.

Do not be lulled into complacency, however. Although the concept of the relationship enterprise is powerful and many companies are moving in this direction, the management challenges are considerable.

RELATIONSHIP ENTERPRISE

The term relationship enterprise simply captures what is happening today. The relationship enterprise is a network of alliances that operate as a single entity in key areas. Four characteristics distinguish the relationship enterprise and its grown-up version, the trillion-dollar enterprise:

Size and global reach: Relationship enterprises will be very big — some eventually growing into trillion-dollar enterprises. They will be well suited to operate globally with partners in major markets and regions across the world.

Network of independent companies: They will comprise independent companies, large and small, based in several countries, each with capabilities that are desired by the network.

Common mission: They will be bonded by a common mission with a broad strategic agenda and a recognition that they will be more successful jointly than independently.

Act as a single company: On issues related to their common mission, the member companies will develop and execute a common strategy and will act as a single company.

We have already seen an overwhelming endorsement of alliances. Growth and acceptance of alliances has been extraordinary in the 1990's. Companies are forming multiple alliances and alliances closer to the strategic core of their businesses. Networks are also forming in a few industries, such as commercial aviation and telecommunications.

THREE STAGES

I see the relationship enterprise developing in three stages: single-purpose alliances, network of partners and multiple partners acting in concert. These stages will at first evolve gradually, as partners recognize the value of their alliances and the potential for deeper involvement. Later, they will accelerate, even in convulsive upheavals, as when industry restructuring forces bold action. We are already well into the first stage, with single-purpose alliances forming across a range of activities.

Stage One: single-purpose alliances

Finding that they cannot continue to go it alone, companies are building more and more linkages with other companies to bridge traditional geographic and value-added boundaries. There has been a shift in corporate thinking on alliances. The old model was linear. If you wanted to expand internationally, the first choice was to do it yourself. If that was not possible, you would consider making an acquisition. Only as a last resort would an alliance be considered.

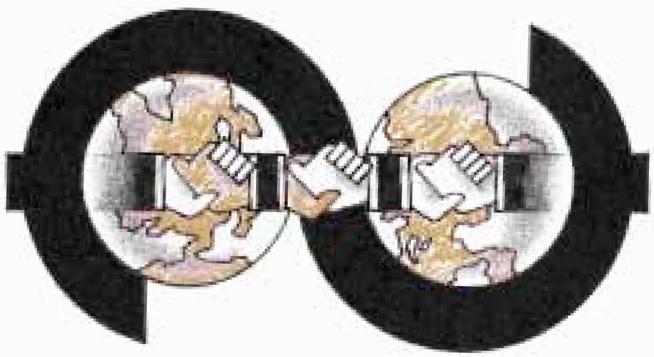
The new model is different. It recognizes alliances as being on the same footing as either going it alone or making acquisitions. The decision tree has changed. You determine what capabilities are required and pick the best way to get them. Take, for example, Corning Inc. at the time it considered expansion into the Asian market for television sets. Corning invented the all-glass television tube many years ago and was a major supplier in the worldwide industry, but had little presence in Asia. The Samsung Company was a large Korean manufacturer of consumer electronics, including television sets and tubes. Samsung wanted to expand its television manufacturing, which fit well with Corning's interest in access to the high-growth market in Asia. The alliance combined Corning's technology and Samsung's low-cost manufacturing and marketing reach in Asia. The alliance has been very successful, with sales now in excess of $500 million and a major share of a dynamic market.

Organizations across the world and in almost every industry are in Stage One because it is in their self-interest. They are responding to economic and political forces and are creating a new competitive dynamic.

Stage Two: network of partners

The second stage of evolution is just beginning: Networks are forming, bonds are strengthening. Communicating and doing business together becomes easier, trust builds and the common agenda evolves.

This stage is also a natural evolution. As companies add new capabilities or enter new markets through alliances, they begin to recognize the opportunities that broader and deeper involvement with their partners might offer. A good example is the global evolution of the telecommunications industry.



Telecommunications companies began forming alliances in the 1970's to extend their services across regions. These early alliances were bilateral and specific in their objectives and aspirations. As major companies became more comfortable working together, they expanded their relationships to include technology sharing, cross marketing and even common investments. Alliances shifted from bilateral to multiple companies. Today, several global networks are forming, each with the objective of serving all their customers' needs across the globe. Two networks centered on British Telecommunications P.L.C. and France Telecom/Deutsche Telekom are clearly in the second stage, forming a network of partners.

Although relatively few industries have evolved into the second stage, we can predict the characteristics that such enterprises (and the companies they comprise) will have.

If several companies are to operate as a single enterprise, they must be able to communicate easily. The optimum would be a common set of systems, common technology standards and a common language (or at least a common understanding of terms). The easier it is to do business together, the more likely it is that companies will expand their relationships.

The development of the Boeing 777 provides a good example of how common systems work for an alliance. The Boeing Company formed an alliance with a number of companies to design and build the new jet. Boeing and its five Japanese partners created a trans-Pacific telecommunications system, based on a common workstation, to link their design operations. The partnership's 500 workstations ran the same computer-aided-design, engineering and manufacturing software. At any point in the process, Boeing knew exactly where everyone was without having to use complex reporting systems. According to United Airlines, one of the alliance partners, the development of the 777 was the fastest and most efficient construction of a new commercial aircraft ever. Also according to United, the design itself was out-

continued on page 7

Aviation Alliances

Like several other industries, commercial aviation has had a history of consolidation principally through merger and acquisition. Many of the great names of United States aviation — such as Capital, Pan Am, Eastern, National, Southern, Republic and Piedmont — are gone, merged into more successful companies. In the airline industry, many carriers have gone bankrupt but somehow keep flying. Deregulation in Europe is just beginning to take hold. We should expect fewer mergers there than in the United States because most countries wish to retain their national airlines. Belgium appears to be the exception. Rather, we should expect a scramble (already under way) of cross-equity and other alliance arrangements designed partly to achieve better economics but principally to survive. Who can imagine France, Britain, Germany, Italy and the Netherlands without Air France, British Airways, Lufthansa, Alitalia and KLM? Certainly not the French, British, Germans, Italians or Dutch!

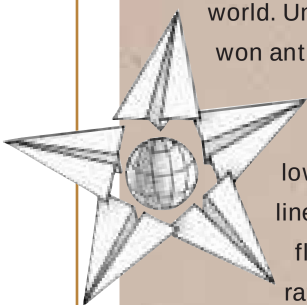
The primary force for consolidation now and into the 21st century is globalization. Although mergers will continue within countries, the only solution available for global consolidation is the alliance. Every country on earth reserves the right to approve or disapprove the sale of its airlines, and most say no. The United States has a law prohibiting foreign ownership of more than 25 percent. Can you imagine buying Japan Airlines?

In our research at Booz-Allen & Hamilton, we were able to find few airlines that flew beyond their own borders that did not have alliances with carriers of other countries. The average number of alliances is about five and many have more than 10.

The requirement for alliances is clear. The big question is the end game. Will the industry continue to evolve into a bowl of spaghetti, with each carrier setting up many bilateral alliances resulting in a scramble of relationships, or will alliances be rationalized around a few relationship enterprises? I believe that the power of global coordination will move airlines toward relationship enterprises, and that we are in the second stage of a three-stage evolution that will result in the world's airways being dominated by relatively few such enterprises.

In the late 1980's and early 1990's, code-sharing alliances swept the industry as airlines sought to offer seamless travel anywhere in the world. A passenger could board United Airlines in San Francisco, fly to Frankfurt and change to a Lufthansa flight to Athens, all on a United flight number. Baggage was automatically checked through. The passengers might not even be aware of the need to switch carriers — at least not until they looked for their United flight to Athens in the Frankfurt airport. These alliances also involved frequent-flyer miles (our Chicago-Frankfurt-Athens passenger received United Mileage Plus credit for the whole trip, even the Lufthansa leg). Marketing programs by both companies added flights across their combined network. For example, Lufthansa advertised flights from Munich to virtually any city in the United States (unsaid: by connecting with a United flight in the United States).

The second stage of the evolution increased the support between partners. Examples include KLM and Northwest, US Airways and British Airways (since broken up by British Airways in favor of an alliance with American Airlines), Delta, Singapore and Swissair. Further nonequity, cross-border alliances were forged by virtually every major airline in the world. United and Lufthansa won antitrust immunity in the United States and Germany, allowing the two airlines to schedule flights and collaborate on pricing. Joint marketing agreements were established in which one airline markets for both airlines in its home country (or continent). This allows the partners to close ticket offices and reservation centers and to rely on partner services in the airport, such as baggage handling, check-in counters and passenger services. One result of these alliances has been that few, if any, Lufthansa employees work in the United States and few United employees are in Europe.



The second stage witnessed a giant leap in the number of alliances, but the spaghetti-bowl approach to alliances has resulted in limited attention and investment in making the network of alliances successful, and it will take a lot of untangling to reap the benefits of the third stage. A few networks are already evolving and are poised to move to the third stage, potentially leaving those in the spaghetti bowl behind.

The third stage will see the spaghetti bowl sort out into a few networks of carriers that will operate as single companies — as relationship enterprises. The enterprises will have central scheduling for national and international flights to insure effective, customer-friendly connections and a common marketing strategy. They will organize selling, reservations, customer service and airport functions to eliminate duplication and operate at the lowest possible cost. Fleet plans and interior designs will be coordinated. Maintenance will be planned centrally and delivered in the most economical fashion globally. Finally, international flight crews will be planned and scheduled centrally. We should see United States crews on Japan Airlines planes.

The two largest relationship enterprises are already taking shape. One, called Star, will include United, Lufthansa, S.A.S. (Scandinavia), Varig (Brazil), Air Canada, Thai Airways and eventually several others. The second enterprise will include American, British Airways, Japan Airlines, Qantas, Aerolineas Argentinas and four or five others to be selected. Other groups will form to compete globally, but will lack the power and customer base to play in the top echelon.

These two behemoths will compete head-to-head for dominance of international air travel. They will use their leverage to attract the best new partners in important markets; to raise capital at low cost; to have the best distribution economics (even power over travel agents), and to gain the preferential treatment of a local airline in countries of their partners.

Just imagine if you were Korean Air or Aer Lingus how important it would be to be a part of one of the winning groups. I even envision a consolidation of United States airlines through a combination of mergers and alliances, melding several of the biggest United States carriers into two relationship enterprises. We have seen the first shots over that bow with the pending alliances in 1998 between American and US Airways, United and Delta, and Continental and Northwest.

The winning enterprise will be the group that is best able to operate as a single airline and that best leverages the inherent advantages of the relationship enterprise.

continued from page 4

standing. Virtually all United's requirements were built in at every stage of the development.

It is essential to the success of any alliance for the goals of the parents to be consistent and shared by the managers of the alliance. In Stage Two, the partners go beyond the goals of the alliance and share goals for their companies. In the telecommunications industry, each of the partners wants to provide global service to its customers. The alliances enable them to deliver on that promise. Each wants to serve customers across the globe; each wants to offer telecommunications capabilities to its customers that match or beat any competitor's offering; each wants its cost to be at the lowest level in its industry. Without the alliances, such goals would be merely dreams. No single company in the telecommunications industry could possibly afford to own or develop the phone companies, satellites, transoceanic cables, switching equipment and new technologies that total, global service to the BP Amoco P.L.C., the General Motors Corporation or the Mitsubishi Corporation implies, not to mention overcoming the legal and regulatory roadblocks to ownership that exist.

Britain and the United States are very close allies. The bonds extend to a common heritage, but have been forged with mutual support for the past 150 years (after the United States got over the burning of the White House and Congress in 1812). With few exceptions, the closest relationship between the United States President and another head of state has been that with the British Prime Minister. This alignment of values and this kind of trust are necessary in the alliances that make up a relationship enterprise.

The relationship between the Intel Corporation and the Microsoft Corporation is a good corporate example of this kind of trust. They share their closest secrets and the alliance is documented by a handshake.

Stage Three: multiple partners acting in concert

Once the values, goals and systems are aligned and the members of the alliance are embarked on a direction for which their combined energies, resources and capabilities are required, they are ready for the third and final stage: the partners recognize their potential power and begin to act together as a single company.

A relationship enterprise will actually operate more like a political federation than a business alliance. Each participating company will have its own agenda and objectives, which it will pursue independently. Each will have shareholders and other stakeholders who must be satisfied. However, each will lend its full power to the enterprise. For an analogy, think of how the United States engaged in World War II. It honored its alliance with Britain and other European countries by devoting its considerable wealth, production capability and military might to the common mission of freeing Europe. Nevertheless, the United States remained an independent nation, as did Britain, France, the Netherlands and Belgium. Clearly, the power of the alliance far exceeded the power of any one member operating independently.

SOWING THE SEEDS

Two megatrends — globalization and nationalism — create the fertile soil for the relationship enterprise. The explosion of alliances and their changing character provide the seed to grow relationship enterprises. The harvest will come as the networks of alliances being created today work closer together and establish the bonds of common goals, common systems and trust. The result will be a network of independent companies acting as a single company with a common mission. The result will be giant enterprises, operating globally, with enormous size and power, as relationship enterprises grow into trillion-dollar enterprises.

Individually, the two forces — globalization of business and nationalism — are understandable and predictable. Every chief executive officer knows that competition can come from anywhere in the world and understands that the market for a company's products and services knows no national boundaries. Robert W. Galvin, chairman of the executive committee of the board of directors of Motorola Inc., believes corporations need to think of their geographic markets in terms of consumers (i.e., population) rather than gross national product. On that basis, the United States is only 5 percent of the world market. Motorola is heeding that advice: More than 70 percent of its sales are outside its home country, compared with 25 percent a decade ago.

Throughout history, business owners and managers have figured out how to survive and prosper in their own worlds. Over the past two centuries, businesses have been challenged to deal with extraordinary change in the rules of combat, in the means of combat, in the places of combat. Imagine yourself as the head of a business in 1865 just after the Civil War in the United States. Much of the land has been devastated, the stagecoach is being replaced by the railroad, the economic conditions are horrible, most production is suited for armaments, many of the young men businesses rely on are dead or maimed. Who would have known that the United States was on the edge of the greatest industrial revolution in history?

This century has seen massive swings in economic fortunes. At the end of World War II, the productive capacities of Germany and Japan were annihilated; a million young men were dead; the United States was exhausted from the Depression and the war, and no one had any money. The technological revolution that followed in massive waves raised the standards of living in the industrialized world beyond anything even the most optimistic seers had prophesied.

At each moment in history, business leaders have had to understand the forces that were shaping their world and to work those forces to their advantage through profound and fundamental changes. Why should we think that the year 2000 is any different from 1865, or 1900, or 1945? To the contrary, the seas of economic and political change through which businesses must maneuver are clear on the horizon. This is why the emergence of new forms of business enterprises is inevitable.

Neither globalization nor nationalism can be ignored. Both are real and very important to business in the coming decades. These are two of the most important forces that will define the economic playing fields of the 21st century.

An international strategy that relies exclusively on exports, setting up shop in other countries and acquiring local companies is seriously flawed. Countries are carefully erecting barriers to protect their self-interests. Businesses cannot grow as they have in the past.

Remember that business is concerned with the productive use of capabilities and assets (people, capital, natural resources) to grow and make money. Politics and national aspirations can get in the way. Politics is concerned with creating environments conducive to social stability and raising the welfare of citizens. Business, although essential, can get in the way.

The companies that will play best in the coming decades will craft strategies that recognize these conflicting trends and take advantage of them. The business must be global in outlook, in markets, in sourcing, in technology, in culture and in people. But the business also must be at home in many countries — an advantage in places where governments are protecting local industry — and tap into local talent, resources and funding.

Economic forces are compelling corporations to expand and compete globally at exactly the same time that the tides of nationalism are rising worldwide. To deal with these contradictory forces, companies that have battled fiercely with one another are coming together. They have no choice. These are the conditions that make the 21st century the age of collaboration and the breeding ground for the trillion-dollar enterprise.

Reprint No. 99106