strategy+business

Knowledge@Wharton

The Changing Face of Strategic Alliances in Latin America

09/11/2002

strategy+business (www.strategy-business.com) and Knowledge@Wharton (http://knowledge.wharton.upenn.edu) publish white papers on contemporary global business issues, featuring the latest research and ideas from partners at Booz Allen Hamilton and faculty from the University of Pennsylvania's Wharton School. strategy+business is a quarterly business thought-leadership magazine published by Booz Allen Hamilton. Knowledge@Wharton is an online resource for executives published bi-weekly by the Wharton School.

The Changing Face of Strategic Alliances in Latin America

Despite the challenging economic environment in Latin America, multinationals and local companies have huge opportunities. Strategic alliances, which have been popular over the last decade, will continue to be a key route to success.

Strategic alliances are more important than ever for Latin American companies that wish to grow and compete in a global marketplace. At the same time, multinational corporations from outside the region in search of their own growth opportunities continue to forge alliances and acquire companies to gain entry into Latin America and other parts of the world.

Latin America was a hotbed of alliance and merger & acquisition activity through the 1990s. Non-Latin multinational ownership in the top 500 Latin American companies grew from 25% of sales in 1991 to 38% in 1999, as global MNCs pursued alliances and aggressively acquired privately-held local companies and state-owned enterprises. Locally, the pressure continues to be intense on Latin American firms to consolidate and to seek the best possible alliance partners as an integral component of their growth strategies.

It is also true that alliances and acquisitions remain difficult to pull off; studies show that about half of such partnerships end in failure. In Latin America, cross-border and cultural factors make it even tougher to succeed. Putting many costly failures behind them, companies are now becoming more selective about why, where, and with whom they choose to partner.

In the last two years, the pace of foreign MNC M&A activity has slowed in line with the cooling of the stock market. But local activity, mostly domestic consolidations, is accelerating. For the next decade, alliances and acquisitions will continue to be a critical facet of competitive strategy for Latin America, making it imperative for companies to devote more time and talent to shepherding these relationships every step of the way so that they have every possible chance to succeed.

These conclusions are based on wide-ranging interviews with consultants at Booz Allen Hamilton, the McLean, Va.-based management consultancy, and faculty members at The University of Pennsylvania's Wharton School, as well as a review of studies by experts at Wharton and Booz Allen.

The Local View

"There have been so many acquisitions done by multinationals that the largest companies in Latin America have gone from being predominantly local to being multinational," says Alonso Martinez, a senior vice president of Booz Allen who is based in Coral Gables, Fla., and consults throughout Latin America. "At the beginning of the 1990s, maybe 25% of the largest companies in Latin America were multinational; now it's approaching 50%.

Many of these companies are

home-grown Latin American multinationals that have expanded through cross-border deals to achieve the size and scale to compete in the region with global players. "What has happened is most Latin American companies are facing bigger and more entrenched multinational competitors. That has put them at a disadvantage. For example, a confectionery company in Latin America might be sizeable for its home country, but it is competing with Nestle and Philip Morris, which in Latin America alone are multi-billion-dollar companies. So Latin American companies are under a lot more pressure to become at least regional multinationals," says Martinez.

Local companies are not just grabbing market share. They recognize specific strategic advantages in alliances and acquisitions. "The [local] clients that we talk to are worried about creating value. Latin American economies grew a lot throughout the 1990s, but little from 1998 on. Suddenly growth is not the way to create value. You create value today by synergies. The second thing they think about is whether an alliance will make their company more interesting for international investors and whether this will provide liquidity." Access to international markets for IPOs is increasingly expensive for companies focused on a single country, says Martinez. "A lot of Latin American stockholders would like to have international liquidity. One way to get that is to have your stock traded somewhere."

Thirdly, shareholders in Latin America are concerned about having all their eggs in one country basket, especially because of currency problems. "They'd rather have a collection of troubled countries than only one to hedge the risk," observes Martinez.

"In the last two years, the pace of foreign MNC activity has slowed in line with the cooling of the stock market. But consolidations of local players is accelerating."

Latin America is seeing more alliances among its own multinationals. In early summer 2002, it was announced that the Bemberg family, the controlling shareholder of Quilmes Industrial (Quinsa) S.A., known as Quilmes, a leading beer producer in Argentina, agreed to sell its stake to Cia de Bebidas das Americas, better known as AmBev, a leading brewery in Brazil.

"The idea is to create a leading company in the southern cone. It's an excellent example of a strategic alliance among emerging multinationals," says Jorge Forteza, senior vice president at Booz Allen and president of Booz Allen Argentina.

The deal ran into complications, however, when Heineken, the multinational Dutch brewer, announced that it wished to acquire a 37.5% stake in Quilmes and would match AmBev's offer. Heineken already owns a 15% stake in a joint venture with Quilmes International Bermuda Ltd., of which Quinsa owns 85%, and said it was waiting to expand its stake in Quilmes when AmBev announced its offer. According to the news agency AFX, the Quilmes deal with AmBev has been blocked until Sept. 15, 2002, pending a ruling by the Paris International Chamber of Commerce in a case brought by Heineken. If the court rules in favor of Heineken, the company said it remains interested in acquiring the stake.

The Promise and Pitfalls

In a 1994 article, "A Practical Guide to Alliances: Leapfrogging the Learning Curve," two former Booz Allen partners, John R. Harbison and Peter Pekar, Jr., defined a strategic alliance as a cooperative arrangement between two or more companies in which "a common strategy is developed in unison and a win-win attitude is adopted by all parties." What is more, the alliance is reciprocal, with each partner prepared to share specific strengths with the other, and the parties are willing to pool resources, investment and risks for mutual advantage. A strategic alliance, these authors wrote, "fills the middle ground between transactional arrangements and acquisitions."

Harbison, who joined Raytheon Company in February 2001 as president of Raytheon Commercial Ventures, Inc., and Pekar, currently a vice president at investment bank Houlihan Lokey Howard & Zukin, note that strategic alliances are not necessarily better or worse than sourcing relationships or acquisitions. But alliances often are the preferred way to go when acquisitions are not feasible due to constraints on cross-border controls or financial limitations or when relevant capabilities are inseparable from the parent.

But alliances are tricky because the forces that compel the parties to seek partners can be complex and change quickly, and firms may not be prepared to make the kinds of adjustments alliances require. Further, the partners' shared vision of what alliances could be are often very different from the reality they face once they begin to execute.

Wharton management professor Harbir Singh, who has written extensively on mergers and acquisitions, says that while strategic alliances and acquisitions can create value, most studies have determined that about half of them fail. The reasons for failure may include lack of strategic fit in terms of complementary resources; lack of organizational fit in terms of cultures, decision-making processes and systems; lack of trust; inappropriate choice of a governance structure, and inability to manage conflict.

Singh and two colleagues – Jeffrey H. Dyer, of the University of Michigan Business School, and Prashant Kale, of the Marriott School at Brigham Young University – have also studied how companies learn from experience and analyzed certain steps these companies can take to tilt the odds in favor of establishing a successful alliance.

In their paper titled "Alliance Capability, Stock Market Response and Long-Term Alliance Success: The Role of the Alliance Function," they argue that companies that have experience, and, even more important, have a dedicated alliance function ("with the intent of strategically coordinating alliance activity and capturing [and] disseminating alliance-related knowledge") achieve greater success with alliances.

> **"Local companies are expanding through cross-border deals to achieve the size and scale to compete in the region with global players."**

For example, companies such as Hewlett-Packard, Eli Lilly and Parke-Davis have appointed a "vice president" or "director" of strategic alliances with his or her own dedicated staff. These units are responsible for spreading alliance-management know-how throughout the organization. Singh and his co-authors found that firms that establish a dedicated alliance function achieve greater stock market gains than companies without such a function, with the firms reporting that 63% of alliances succeed. On the other hand, firms without a dedicated alliance function achieve much lower stock market gains and report a long-term success rate of only 50%.

Emerging Market Challenges

What factors enter into the picture when firms are considering alliances in emerging markets? Wharton management professor Gerald McDermott, who lives in Argentina and has conducted research on the impact of domestic financial and industrial institutions on foreign investment strategies in Latin America and East-Central Europe, says several variables must be taken into account.

First, are both parties to the alliance developing adequate capabilities to make the alliance work, and are they preparing for a more sophisticated relationship going forward? "In general, we're talking about the problem of asymmetry and control," McDermott says. "Fights can break out and companies can get into downward spirals. You have to make sure everyone is investing adequately in capabilities."

Second, it can be helpful to have a third party act as a mediator between the principals so that trust can be firmly established and the alliance can get off to a sound beginning. A local government can play this role by providing infrastructure development, training facilities, or tax incentives. "You have to keep an eye on how the institutional environment is developing. Can it provide an adequate framework in which your alliance is operating? Patents, contract law and property rights are important because they allow you to feel more or less secure as you transfer proprietary knowledge to your alliance partner. Also, how are the training facilities? The labor market? Alliances often depend on constant skill development."

Third, the parties must be prepared for shifts in the leverage that each of them possesses. "We always think of the big guy from the outside having leverage, but that's not always true, according to McDermott. "In Argentina, for example, you generally don't have restrictions on foreign ownership like you do in China. Local companies also have political contacts [that they can use to their advantage]. So you have to be aware of the changing bargaining power."

Companies also need to be mindful that economic and political climates can differ sharply from one country to another, making alliances more likely in some places than in others. This is especially true in Latin America.

Some companies, in Brazil for example, may feel less need for alliances because Brazil enjoys a huge internal market for products and services, and companies there still have good opportunities to achieve growth through domestic sales, according to Martinez.

Mexico, on the other hand, is different. "Mexican groups probably have made more alliances than other Latin American groups, largely because of NAFTA [the North American Free Trade Agreement], and they have searched hard for alliance partners," Martinez explains. "If you take out Brazil and Mexico, it's largely an issue of survival for the rest [of Latin America], trying to avoid specific country risk. Argentine companies and others, like those in Peru, are looking for a way to give some solidity to their businesses in a rocky economic environment."

"Studies show that about half of alliance partnerships fail. In Latin America, cross border and cultural factors make it even tougher to succeed."

Perspective of Global MNCs

MNCs seeking inroads into Latin America have a somewhat different perspective than that of local firms, according to Wharton management professor Mauro Guillen.

"In some countries, there has been more of a need for alliances because these are politically imposed on multinationals by governments," he says. Another important variable is the industry or activity. "With certain manufacturers there's no need to go with a local partner," says Guillen. "But in telecommunications, banking or other sectors that are strictly regulated and where politics plays a role, there's more of a need. Right now in Mexico, which has liberalized many of its rules and regulations and is part of NAFTA, the need for having a local partner has been greatly reduced over the years. I would put Chile in this category, too. In other countries, such as Peru, Colombia, Venezuela, Argentina, and Brazil, it's probably more useful to have a partner."

Forteza points to Chile as an interesting example of how MNCs are taking a closer look at where they want to establish alliances.

"Chile is the best Latin American country in terms of macroeconomic performance, but we see more multinationals reappraising whether they should stay in Chile," he says. "It's a small country and may not be worth management's time. If I'm a multinational and I don't see the possibility of building a business in Chile, what do I do? Maybe I combine Chile with a regional alliance that includes Brazil. Sometimes it works, sometimes not. But in that way you can manage to stay in Chile. If your analysis shows you won't benefit, the next thing you have to ask is, 'Do I exit the country completely?'"

Many MNCs, instead of seeking outright acquisitions, are opting for alliances on a selective basis. Forteza says this holds true in many different countries – those that are attractive but small, like Chile; those that are both small and are suffering economic turmoil, like Ecuador, and those that are large, attractive markets but are nonetheless troubled, like Argentina.

"Multinationals now say, 'Maybe we can do an alliance with a local player with complementary products and footprint.' This is happening in big countries like Brazil and Mexico, such as the alliance between ING and Seguros," notes Forteza.

In 2001, ING, the Amsterdam-based global financial services group, acquired Seguros Comercial America, the largest insurance company in Mexico. It controls 21% of the Mexican life and health insurance market and has a 33% share of the property and casualty insurance market. Following the acquisition, ING rebranded the company ING Comercial America.

This acquisition builds on ING's other banking and insurance joint venture and pension fund activities. ING announced on July 31, 2002 that it entered into an agreement with Grupo Financiero Bital for a 19.2% stake in Banco Bital, a leading retail bank in Mexico. The $200 million investment will enable ING to further enhance its banking and insurance strategy in Mexico. In 1998, ING entered into a joint venture with Bital to enable ING to distribute its insurance products through Bital's branches. ING said it owns 49% of that joint venture. The alliance between ING and Bital dates back to 1997, when both companies established Afore Bital, one of the largest pension funds in Mexico. In October 2000, ING acquired Bital's interests in Afore Bital.

> "Companies need to be mindful of political and economic differences that can make alliances more difficult in some countries than in others."

In a 1997 article in strategy+business, "Betting on Strategy and Growth: Strategic Alliances in Latin America," Wouter Rosingh and Artur Ribeiro Neto of Booz-Allen wrote that most strategic alliances in Latin America fall into three categories: "Multinationals supplying technology and know-how to local firms in exchange for market access; leading multinationals or regional firms joining together – often across borders – in regional ventures to increase the scale of their operations; or large capital providers joining forces with industry specialists to take advantage of major infrastructure opportunities."

Examples of successful alliances following these strategies, and cited by Martinez and Forteza include:

- An alliance that began in 1991 between U.S. retailing giant Wal-Mart and Cifra of Mexico. It was Wal-Mart's first experience in international expansion. Wal-Mart eventually became majority shareholder in Cifra, and in 2002 the name of the combined company, Mexico's biggest retailer, was changed to Wal-Mart de

Mexico. Wal-Mart has not fared as well, however, in other Latin countries, Forteza says.

- Unilever has entered into alliances with several companies in Peru and Ecuador. "Alliances in both countries ended up in acquisitions by Unilever," Martinez says. "Those worked well for all the companies involved. The local companies gave Unilever a good distribution system and Unilever gave the local companies access to its technologies."

- In 1999, Companhia Brasileira de Distribuição (CBD), Brazil's largest supermarket chain, announced it had entered into an alliance with the Casino Group, a large French chain. Under an agreement, Casino Group could have an interest of up to 40 percent of CBD's voting stock by 2004. As with the Unilever alliances, the French company is using the alliance to make inroads into Brazil, while CBD obtains access to capital and technology, says Martinez.

The Outlook

Forteza and Martinez argue that Latin American companies will increasingly look to alliances in years to come as an avenue for growth and that Latin America may see the emergence of more home-grown multinationals.

"From the local group's point of view, Latin American companies don't have an option," says Martinez. "The path to growth in Latin America will be rocky in the coming years. No one sees economic growth as a big avenue. Also, there's a huge amount of consolidation happening in every industry. You have to do alliances. If you don't, you're going to be erased."

It is also the case, he says, that few Latin American groups have the financial muscle on their own to grow with very aggressive international acquisition strategies. So the only option they have is alliances.

"Booz Allen sees some of today's emerging Latin American multinationals eventually becoming competitive outside the region."

But, Martinez adds, alliances within Latin America are not easy to establish and sustain, in many cases, because families control companies and are reluctant to divulge financial information and share power. "Even if they are publicly held companies, they are tightly controlled," he says. "Still, because the economic situation in Latin America is more complicated now, people are more open to alliances than they were before. Families that five or six years ago may never have thought about it today are doing alliances even if they lose control of their companies."

According to Martinez, there's a window of opportunity for Latin companies to forge alliances as MNCs retrench from their M&A spree of the last decade. "When the stock market was bullish, you could buy almost any company. Now that the market is not so bullish, acquisitions of companies in Latin America by large multinationals are slowing, and that provides opportunities for local companies to form alliances." According to Thompson Financial Data the number of M&A deals in Latin America has fallen from over 160 per year at the end of the 1990's to about 100 in the past twelve months, with the total value of these transactions falling from a peak of $55 billion in 2000 to $20 billion over the 12 month period from July 2001 to June 2002.

Jorge Forteza says a changing economic climate has forced the global MNCs to become more cautious in their regional expansion everywhere, and that is also slowing the pace of M&A activity by foreign companies in Latin America.

"Now that Latin America hasn't proved to be the goldmine that it looked like it would be during the heady days of policy reforms at the beginning of the 1990s, more multinationals are reappraising what it means to be global," Forteza explains. "You have to look at the world economy as a series of tiers. If you want to be global, you need to first make up your mind what you are trying to do in the developed [Group of Seven] economies [Canada, France, Germany, Italy, Japan, the United Kingdom and the United States]. Then there's a whole tier of large, secondary developing economies – Mexico, Brazil, Russia, India, China and Indonesia. They add up to 60% of the potential of emerging markets."

In the 1970s and 1980s, Forteza posits, multinationals had one goal – to have a presence everywhere. But circumstances have changed.

"The tide of globalization has reached its high level," Forteza says. "We've done an analysis of multinationals that shows the footprints of large multinationals are shrinking, not growing." In part, this is because of pressures on domestic markets. But it is also because MNCs have to come to terms with competition from countries like India and China, and are becoming much more selective about their global footprint. "We feel most multinationals want a footprint in the G-7 countries. All the rest is being reappraised."

The downward shift in financial markets has also had an impact on the plans of MNCs. "The decline in the stock market is forcing companies to become much more shrewd about cost-benefit calculations," says Forteza.

As global MNCs retrench, Forteza and Martinez of Booz Allen see some of the emerging Latin American MNCs eventually becoming competitive forces outside the region. "Over the next 10 years, we will see a new development," says Forteza. "For the local players the big question is, 'How do we become a multinational?'"

Booz Allen research suggests that, again, there will be a tiered strategy. Says Forteza, "Latin American players are starting to see whether there are niche structures for them. Brazil, for example, is putting a lot of emphasis on China and India. We have a vision [in the years ahead] of the emergence of Latin American multinationals.

strategy+business (www.strategy-business.com) and Knowledge@Wharton (http://knowledge.wharton.upenn.edu) publish white papers on contemporary global business issues, featuring the latest research and ideas from partners at Booz Allen Hamilton and faculty from the University of Pennsylvania's Wharton School. strategy+business is a quarterly business thought-leadership magazine published by Booz Allen Hamilton. Knowledge@Wharton is an online resource for executives published bi-weekly by the Wharton School.