THE COMPOUNDED RISK TRAP

Excerpts from Business Alliances, the Hidden Competitive Weapon

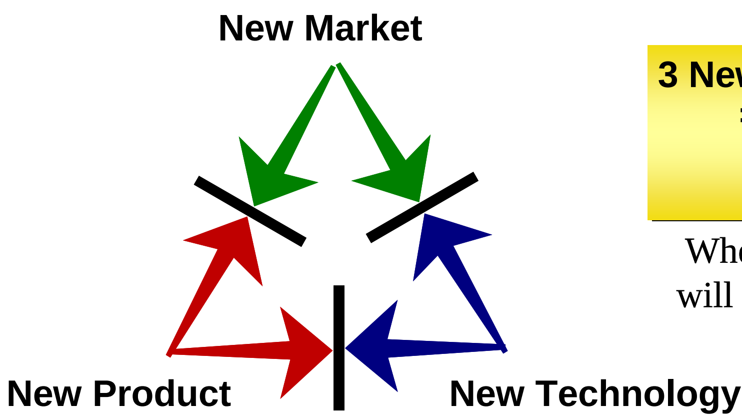
by Robert Porter Lynch

The higher the future ambiguity, the higher the probability of failure. Alliances are the step-children of uncertain risks and opportunities. Uncertainty breeds ambiguity, and ambiguity is the seed of business failures. (Note: High Ambiguity/Uncertainty REQUIRES High Trust)

Many inexperienced alliance creators fall into the trap of inadvertently compounding risks. In particular, beware of entering new markets with new products using new technological processes with new partners. Here four new factors are compounded. Rather than the risks adding arithmetically, they compound by the square of the number of new factors! It is far safer to enter a known marketplace with a tried and true product with a new partner. This is a very frequent occurrence in joint ventures which create a new, start-up corporation. Typically none of those forming the start-up joint venture have ever experienced the entrepreneurial agony and ecstacy of a start-up. As figure 1 in chapter 17 humorously indicates, perhaps they should reconsider the risks.

Law of Compounding Risks

*Complexity Increases by Double the number of New Interfaces**



3 New Elements
= 3 Interfaces
= 6 Interface Points

Where will Breakdowns will most Likely Occur??

*Formula
(N)(N-1)=Number of Interface Points to Manage

An excellent example of this compounded risk trap was a joint venture by an American exhaust component manufacturer in Brazil who secured an order from a European auto manufacturer with a car assembly plant in Brazil. The American's new partner was in the metal fabrication business, and did not know the automotive marketplace. When the American firm decided to set up their factory with a very new and technologically advanced production process that had been used for only a limited time in the U.S., the seeds of failure were sown.

Then the decision was made to fabricate with stainless steel, which is a very difficult material. No one in Brazil had experience with this metal for these purposes, and the procurement of the material was improperly handled when specifications were not accurately spelled out in the bid spec. The order for stainless steel was placed with a new Italian supplier who had underbid the competition and did not recognize the problems that would occur. Timing of production was critical, because an entire Brazilian automobile assembly line needed the exhaust components as their line of cars.

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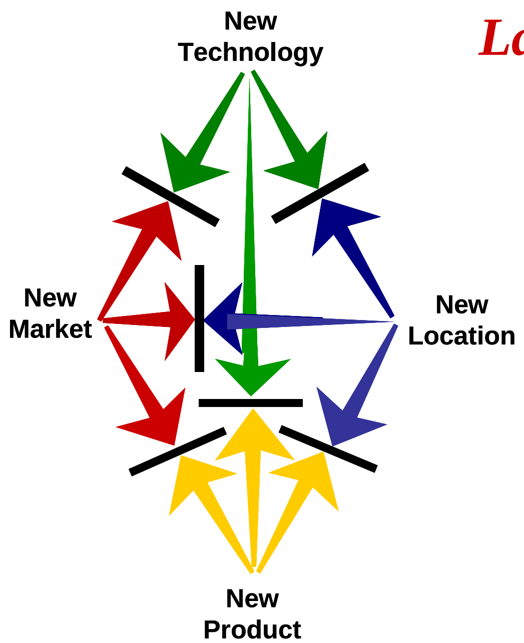

4 New Elements
= 4 Interfaces
= 12 Interface Points

Let's now introduce a NEW Location.

With Four NEW ELEMENTS there are now 12 different Interface Points to integrate, manage, and synchronize.

Each one presents a point of a potential Breakdown, which can trigger more breakdowns.

Using "Big Bang" Rollouts increases the chance of a total systems collapse.

The Options are:

- Predict the Breakdown Points in advance
- Use tried and true People who are experienced at handling these breakdowns with tested Processes and Protocols
- Sequence the Rollout to enable corrections to occur before the next phase
- Use Pilot Projects at a small scale to test the system.
- Commit to turning Breakdowns into Learning to trigger Breakthroughs

The exhaust component factory was completed, and ready to go. The stainless steel arrived, but when it was placed on the bending machines, it cracked. There was no proper steel anywhere in Brazil, and shipments from Europe or America would take weeks. Attempts to get around the cracking problem failed. Clearly the product could not be delivered on time.

As a consequence, the auto assembly line had to be shut down for nearly a week, at a horrible expense to the car manufacturer. Heavy penalties were in place for late delivery, which cost the Americans dearly. And the problem was solved by the American firm having to go to one of their friendly competitors and ask the competitor to supply the parts -- at an obvious profit.

The alliance manager's job was to maintain a win/win condition, which was made impossible by building the alliance like a house of cards. The architecture was flawed. Had the joint venture limited the introduction of the number of new risks into the alliance, the result would have been far different. Start with the fewest number of risks, achieve success, then incrementally add new risks.