The "Frenemy" Effect: When Strategic Alliances Go South

How to fuel – and cool – competitive wars.

Nobody wins a price war, yet there is always one being waged somewhere. Sometimes a firm will conduct a surgical-like strike in a single market; sometimes war will spread like wildfire across many markets or a whole industry. When this happens, the damage can be staggering. When major American airlines entered a series of staunch price wars in 1992, their combined losses erased all profits the industry had made **since its inception**, according to some estimates.

A lot of the research done on competitive wars frames them in a dyadic manner: What happens when Firm A attacks Firm B. In new research, **Tieying Yu**, **Wei Guo**, **Yu Zhang** and I examined the case of "frenemies". When competitors forge a strategic alliance, does the risk of competitive war fade? And by competitive war, we don't mean run-of-the-mill optimisation of a firm's position in the market, but aggressive moves meant to challenge the entrenched status hierarchy within the market.

As we show in our **paper** published in the *Academy of Management Journal*, strategic alliances between competitors can indeed go a long way towards preventing a price war. However, once a war breaks out in a sub-market, all bets are off. The very glue that bonded competitors together can turn into gasoline fueling the fire and spreading the war to other markets.

We also took a step back and included the bystanders in the picture. What influence can third parties yield when war looms? Looking at two particular types of bystanders – the institutional investors and the stock analysts that competitors sometimes have in common – we found that, just like strategic alliances, their presence reduces the odds of a competitive war starting in the first place. But should one erupt nonetheless, their influencing and sanctioning powers actually contribute to slowing the spread of the conflict across markets.

The paradoxical effect of direct linkages between competitors

The airline industry is the ideal arena to study the world of competition, because airlines compete across many markets, with well-defined products ("routes") in a heavily regulated environment. For these reasons and more, airlines are the fruit flies of competitive strategy research.

We examined a dataset of 4,086 competitive wars across 2,066 geographic markets – defined as pairs of cities – over 20 years. We used the **Airline Origin & Destination Survey** to identify markets and calculate prices for each. A market was considered to be at war when prices were more than 20 percent lower than expected prices, taking into account seasonal fare changes. To obtain information on strategic alliances, we examined more than 37,000 articles in ***Aviation Daily*** during the same timeframe (1991 to 2010).

First, we found that a market with a high level of strategic alliances was 14 percent less likely to experience a competitive war than a market with a low level of strategic alliances.

However, *once incumbents were already at war in a given market*, a high level of strategic alliances meant a 72 percent *higher* risk of war spreading to other markets. That risk was only 43 percent higher when the level of strategic alliances was low. In sum, once aggression had occurred, strategic alliances went from deterring war to amplifying it.

Why do alliances act as fuel once a war has started? They force the parties to build trust as well as to share resources and knowledge, heightening their interdependence but also their vulnerability. This works as long as both parties behave, but once trust is breached, retaliation tends to be strong and swift.

Think of it as geopolitics. A country's worst enemy is often its very neighbour, because of their high interdependence. Proximity and repeated interactions often build a capital of trust over time (though admittedly, not always). Violation of that trust – even if it is merely perceived – can trigger the most brutal type of rivalry, the kind that gets the **animal spirits** involved. A parallel with personal relationships is also clear. Arguments with one's spouse can often take the ugliest turn. When this happens, common friends can act as mediators, preventing the relationship from spiralling out of control.

Common ownership

Common institutional investors have the power to sanction undesirable competitive behaviours because they hold critical resources on which firms rely. Competitive actions that could trigger a competitive war in the market are problematic for institutional investors – such as a fund – that own stakes in multiple competing airlines. For these investors, maximising the aggregated value of their portfolio is much more important than a single firm triumphing over the others in a war. The objectives of these investors, and their suggestions, are often taken seriously by management.

In our study, markets with a high level of common ownership were 27 percent less likely to experience a war than a market with a low level of common ownership. This cooling effect persisted after the instigation of war.

Our findings are consistent with previous economics and finance research that showed that common ownership tends to reduce the intensity of competition between firms. In the airline industry in particular, some past findings point to price levels increasing when competitors are owned by the same investors.

Common financial analysts

Meanwhile, firms in the same industry often share the same financial analysts. Although it may not be as obvious as in the case of investors, financial analysts also have a good reason to yield influence on warring parties. The high degree of uncertainty created by competitive wars increases analysts' forecasting errors, harming their status. In addition, analysts are incentivised to provide optimistic recommendations because their **personal income** is tied to trading commissions. So, a war hampers their ability to make accurate and optimistic recommendations that sell shares.

How can analysts influence firms? They can produce reports exploring the consequences of a war, have conversations with management, ask questions during conference calls and argue their point of view during media interviews. Of course, they can also decide to downgrade a stock or abandon its coverage, both of which have detrimental effects on a firm. While one financial analyst may have limited influence, analysts tend to follow each other's opinions, leading to a **herd effect**. In our data, a high level of common analyst ties – able to influence potential warring parties – reduced the risk of war by 14 percent.

Implications

Our paper adds to the discussion of whether there should be regulation about the concentration of investors. Banking, supermarket chains and ride-sharing platforms are just a few of the sectors that tend to share the same institutional investors. Just think of Softbank, which has major stakes in Uber, China's Didi Chuxing, India's Ola and Southeast Asia's Grab. While competitive wars hurt the protagonists, they ultimately benefit the consumer. In our sample, the majority (77 percent) of wars ended with prices lower than the prewar level. On average, prices dropped by 10 percent.

Beyond airlines, many other industries are marked by alliances between competitors. For instance, tech firms, pharmaceutical companies, telecoms and automakers often strike strategic alliances even as they compete. While cooperative relationships of this sort can breed more cooperation in the future, it can be a double-edged sword: The eruption of a competitive war in a single market can be a catalyst for outsized aggression among competitors.

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