

# Compensation Measures for Alliance Formation: A Real Options Analysis\*

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**Abstract.** The objective of this paper is to present a real options model of alliance formation between two firms in a new market, and to analyze how different compensation measures affect the alliance timing and the option values. We examine two feasible compensation measures to promote alliance formation: share adjustment (flow compensation) in the new market and subsidy (lump-sum compensation) provided by one firm to the other. We find that although subsidy induces earlier alliance than share adjustment, the latter is socially optimal, because the joint option value under share adjustment is larger than that under subsidy.

**Keywords:** Real options; Alliance; Flow payment; Lump-sum payment

**JEL classification:** D74; L24

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