

# Preparation for a Strategic Alliance



CORPORATE FINANCE ASSOCIATES

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As the complexity of developing new healthcare products has increased, and the marketplace, including the regulatory environment, more difficult and competitive, many companies have come to the conclusion that they need capabilities beyond their own company. This realization has fueled the interest in strategic alliances in recent years. Strategic alliances can offer the proverbial (and elusive) “win/win” possibility by careful matching of the partner’s objectives. In this paper we will start by examining some of the logic behind strategic alliances, typical objectives, and potential risks. The primary focus will be on how to prepare for such an alliance. With adequate preparation, the objectives will more likely be met, risks will be reduced, and the strategic alliance can be successful. Entering into a strategic alliance is one of the most critical negotiations in the life of a company, and requires as much management attention on creating an alliance as they would on any other critical capital investment decision.

The decision to investigate the possibility of entering into a strategic alliance may come at any time in the corporate life cycle, but typically comes when a new product or market thrust is being considered. It could come early in a company’s life, when the first product is being developed for market, or it could come when a mature company has adopted a strategy of entering into a new marketplace. In any case, the motivation will come as management examines the need for resources to implement the strategy they have chosen. We have found that corporate management most often focuses on the need for cash, and usually will look to an outside financial investor or a financial lender such as a bank. We have found the Growth Resources Model (Figure 1) to be useful in drawing management’s attention to other sources and types of resources.

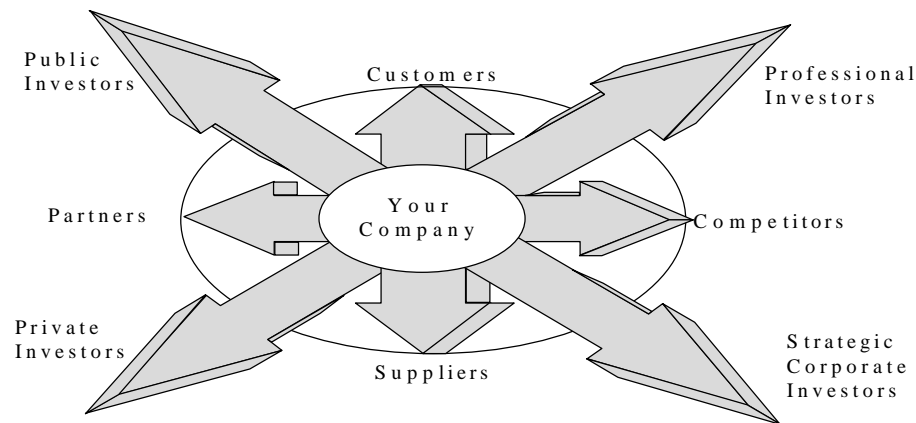


Figure 1

It serves as a framework for making strategic financial decisions. The “inner world” of a company - customers, suppliers, competitors and current partners- not only already know the company, but can offer many types of resources beyond cash. The “outer world” of primarily financial investors may not know the company

yet, but can provide cash and other valuable resources. We will focus on potential agreements with the “inner world” as well as potential strategic corporate investors from the “outside world”.

There are several types of strategic alliances, which can be categorized either by the objectives

of the alliance or by the structure of the alliance. We will focus on the objectives of strategic alliances, and minimize the discussion of possible structures, such as traditional and non-traditional contracts, joint ventures, equity investments, etc. This is an important topic, as it effects the motivations of companies. Obviously a company will be much more committed to the success of their joint activity, say manufacturing, if they are an equity owner in the total activity as opposed to being strictly an “arms length” contract manufacturer. Structuring issues do need to be part of the planning and negotiation of any joint activity.

**Objectives of a Strategic Alliance**

Strategic alliances provide flexibility in trading off time, capital and control in return for needed resources. There may be many objectives, but they cannot all be obtained simultaneously, or without giving up something in return. The first set of alliance objectives revolves around obtaining the resources and skills needed to implement a corporate strategy. Typical categories are given in Table 1.

For some companies, a strategic alliance may speed their path to the marketplace. This could be because they can cut research time by obtaining a major portion of the technology they need from a partner, could avoid capital construction for a manufacturing facility, or could tap into a marketing and sales force which is already familiar with their target market. In today’s competitive marketplace, reduced time to market equates directly to increased market share and profits. As an example, the medical device life cycle is so short that a marketplace delay of 9-12 months can cost 50% of the eventual revenue for a new competitive product.

Another objective of strategic alliances may be to spread the technical and financial risk of an undertaking. This was the rationale behind the formation of the Micro Computer-Technology

Corporation (MCC) which was formed in the ‘80s to share the development costs of technology which was commercially unattractive to the individual members such as General Electric and 3M. Alliances can also help companies with widely varied skills, such as research, manufacturing and marketing, share the risk of opening a new market.

Quite often a smaller company will be motivated to seek a strategic alliance in order to enhance their credibility in the industry by associating with a more established and respected company. For conservative customers, who have been raised with the motto “nobody ever got fired for buying (*fill in the name of an established market leader*)”, sales will depend on reputation as much as performance.

**Risks**

As might be expected, the case for strategic alliances is not one sided. There are risks involved, but careful preparation can reduce them. The most obvious risk is that of losing control of your company’s destiny. For any partner, large or small, there is a danger that another party to the agreement cannot carry out their assigned portion of the responsibilities. This can never be totally eliminated, but in depth due diligence will reduce the risk. A small company may also feel a loss of independence, which depends greatly on the management and objectives of the larger partner. If a company is approached by another company to participate as a partner in a cooperative activity, the potential partner should insure that it will not defocus its own activities by its participation.

No company enters into an agreement without expecting to gain from it. The total return from a well engineered alliance will be greater than some of what the members could have achieved without the alliance, but this may be at the cost of some potential gains for one of the partners.

<u>Resources and Skills</u>
Technology
Distribution Channels
Sales Force
Access to customers and markets
Market reputation
Regulatory Expertise
Manufacturing Capabilities
Business Skills
Capital

Table 1

Another risk, which can only be addressed by thorough knowledge of your core competencies and corporate strategy, is that you may depend on a partner for skills which you need to develop to implement your long-term strategy. This may make you a hostage to your partner.

As always, corporate management must make the final determination as to whether the reward is worth the risks incurred. This is just another reason to maintain senior management involvement in any strategic venture, including the planning, as opposed to the common tendency to hand off responsibility for the alliance to middle management.

### ***The importance of preparation***

There are several straightforward reasons for spending time in the transaction preparation phase. Without detailed preparation it is not possible to know what skills and capabilities are needed to meet company objectives. This can lead to giving up too much for a partner's contributions which are not really essential. Even with a good definition of what is needed, without preparation it is easy to waste time approaching partners who don't have what is needed. You may want to approach Company X because you know they have excess manufacturing capabilities, but, have you checked to see if they are familiar with your processes or packaging needs? Some companies also have personalities (or cultures) which will never mesh in a team effort, and others will not be compatible with specific companies. Time spent in preparation can help identify these incompatible potential partners before wasting time with them, or worse yet, negotiating a deal with them. On a positive note, careful preparation, identifying skills and operational compatibility, will help negotiate an agreement which can be successfully managed after the deal.

### ***What should be done during preparation?***

The foundation for any transaction, strategic or financial, is a clear understanding of corporate goals, objectives and expectations. In a smaller company these may be synonymous with those of the company owners or founders. While

considering the near term tactical situation, which may relate to some new business opportunity, it is important to consider the long term strategic goals, such as the eventual ownership structure of the company. If a company has a long term objective of being a publicly traded company, this needs to be considered early, to avoid teaming arrangements and equity deals which will complicate the public offering. On the other hand, if that company enters a strategic alliance with a publicly held company, it may be possible to avoid some of the complexity of "going public" by merging with the partner. If the owner's objective is to maintain a majority control, this forecloses some strategic options. Several studies of poorly performing strategic deals have found that a common thread has been unclear or conflicting expectations from the alliance players. A company's search for an alliance should start with an understanding of the company's strategic plans and internal agreement as to expectations for the alliance. These points will also need to be reexamined periodically during the definition, search and negotiation process. They will, in fact, form the basis for evaluating the fit of any partner or deal.

With this foundation laid, it is time to develop an in depth definition of what is needed to accomplish the plans (e.g. expanded products or markets). This should start by examining the business opportunity or situation driving the consideration of partnering. The management team needs to carefully examine the total set of capabilities needed to be successful, including funding, technology, manufacturing, sales, marketing and other less visible parts of offering a total package to customers, such as product support. Any given company will currently be strong in some of these capabilities, but probably not in all of them. At this stage, it is important for management to do a candid assessment of their own company's strengths and weaknesses. Considering the potential for being taken hostage by a partner who is responsible for a capability which should be one of their core competencies, management may determine that the only prudent approach is developing capabilities where they are now weak. Unless, however, this is the case, a company should at least consider alternate sources for non-core capabilities.

At this point, corporate management should do a Strategic Risk Analysis. There are essentially three major categories of risk to consider; Performance Risk, Financial Risk, and Market Risk. Understanding these will help determine the risk of various tradeoff scenarios which will be analyzed during the alliance process.

Performance Risk means the risks involved in producing the product and getting it to the marketplace. Examine the process in detail, and note where the major uncertainties lie. Also consider how much control you feel you need to maintain over these steps in the process.

Another major risk is obviously the Financial Risk. Consider not only if you have the resources to initiate the project, but if you have the funding to successfully implement the project. This should include funding to buy (sub-contract) services needed.

The third major risk, which is often overlooked, is the Market Risk. This risk includes the time factor - can you get your proposed product to the market in time to satisfy the customers and beat your competition? You also need to examine whether you have adequate knowledge of the market to design a successful marketing campaign, and if you have the right sales force to execute your marketing and sales strategy.

***What is negotiable and what is not?***

At this point, it is time to sit down and ask three basic questions, followed by some in-depth tradeoff studies. The questions are:

1. What must be retained internally for strategic purposes?
2. What cannot be done internally?
3. What could be done externally?

For each of these questions, examine the costs and time required.

When this is done, a company will be at the point of doing tradeoffs for those tasks and activities which could be done outside your company. The primary variables in these tradeoffs will be time to complete the project (such as a new product introduction), the amount of control retained over the project, and, of course, the capital needed. When looking externally, there are at least three options, each with advantages and disadvantages. It is possible to acquire the capability permanently by buying a company with the skills. Another option is to execute conventional arms length contractual arrangements to obtain the capabilities temporarily, or a company can enter into a cooperative arrangement which will closely tie two or more companies with one another.

The general trends of these trades are summarized in Table 2:

	<b>Time</b>	<b>Control</b>	<b>Capital</b>
<b>Acquire</b>	-	+	-
<b>Contract</b>	+	+/-	-
<b>Team</b>	+	-	+/-

Table 2 Trade-off Trends

Buying a capability will require at least some capital, and will probably lose time but will gain control. Buying a capability temporarily, through a contractual arrangement, will cost capital, may

buy time, and could either increase or decrease control of the resource. Teaming with another company will probably gain time, may actually gain capital, and will probably lose control.

There is no obvious “right” answer, and the acquisition of each capability must be done in the context of the company’s total strategic plan.

### ***Profiling an Ideal Partner***

Few companies ever find their “ideal partner”, but it is still important to spend some time determining the profile of that elusive ideal. This leads naturally to a set of criteria which will help evaluate candidate companies, and which will serve as a guide in seeking information during the due diligence process. Although there are many ways to describe this ideal partner, we have found that the following areas are nearly always on the list for any deal:

#### **Industry and markets**

Does the partner have the knowledge of the market needed to accomplish the tasks you expect? If you don’t know the market, and are expecting the partner to lead marketing, they should have extensive, specific market experience. If they are to be visible to your customers, the partner should be known and respected in the marketplace. If you expect them to provide some specific product technology, market knowledge may not be as important.

For teaming in any marketplace, knowledge of the regulatory environment is essential. This is especially true for the healthcare industry because of the significant influence of the FDA, EPA, OSHA, etc. on market approval process. In some cases, you may consider an alliance with a partner specifically because of their knowledge and expertise in the regulatory domain.

#### **Products**

Your partner needs the technology to carry out their role. They may be providing technology which you must integrate into the product, or they may need to integrate your technology in their processes. Even if they will be primarily marketing and selling products, they need to be comfortable with the technology being used.

If you need manufacturing or packaging capability for your product, this becomes an important characteristic to determine. What kinds of products do they currently manufacture, what facilities may be planned, and how is that capability being used? Be sure that it will be

available for your needs over the life of your project, or that you have alternate manufacturing sources.

#### **Culture**

Any alliance will eventually be implemented between individuals within companies. This means that there are at least two cultures which must be identified and consciously considered during the alliance process. The first of these is the national or regional culture, while the second is the internal business culture of the prospective partner.

The national culture will influence both the individual and the corporation. Some cultures place much more emphasis on the formal position held by an alliance leader than the American culture does. There are also noticeable differences in how consensus is gained for decision making. These cultural backgrounds will influence the management structure of each partner, as well as the structure put in place to manage the alliance.

Even companies within the same national culture can vary greatly in their internal culture. Early in the alliance process the internal culture will be difficult to determine, but company representatives should continually be observing the decision making process and management structure of any partner. The partner should be able to make decisions quickly, but they need to use processes which are compatible with your own. There should be some basic commonality of management and business philosophies. There will be chemistry between partners at the individual and corporate level which can only be developed over time; however, it is useful to determine at an early stage what kind of company culture is likely to fit with yours.

A company which has been successful in previous strategic alliances likely has the culture and management team to be successful again. Unless you have a previous successful history of operating strategic alliances, you should look for a partner which does have such a history.

#### **Financial Position**

One of the most common reasons for strategic alliances is to obtain capital from a partner. If a

capital contribution will be essential to an alliance, then the financial strength of any partner is vital. If the need is for cash, then their cash position will be important. A desirable partner will have the financial strength to support the project throughout its planned life. This means looking for a partner with a strong financial position, as evidenced by the standard financial ratios such as debt/equity and liquidity ratios.

If you are willing to contribute cash to an alliance, the cash position of the partners may not be as significant, but they still need to be fundamentally financially sound.

### **Selecting Candidate Partners**

At this point in the alliance process company management will know where they want to go with their company, know what resources they need, and will have determined what could be done externally. They will have done enough analysis to determine what might best be accomplished with a strategic partner, and have generally profiled the characteristics of a "good" partner. Now it is time to find them. Many companies overlook the fact that they already have an "inner world" of contacts, as already discussed, which will often contain candidates for an alliance. Companies often overlook this inner circle of business contacts as potential alliance partners. It is important not to restrict the process at this time, and companies should "cast a wide net" in considering candidate partners. Trade associations, and those associated with a desired marketplace, can be a rich source of candidate companies. With the flood of electronically available data there is less of a problem with finding data than with evaluating it. It is at this stage of the process that many companies find they need outside support, both to identify potential alliance partners, and to begin the evaluation process. It can be difficult to be objective in considering a competitor as a potential teammate, or in considering a customer as an investor in the company. Input from outside advisors, or a Board of Directors can be very useful in gathering and evaluating potential partners.

If not already done, now is an appropriate time to select an alliance manager, and to involve the

individuals who will have the responsibility for carrying out the alliance. Managers who have been successful internally may not have the skills needed in an alliance, where the emphasis will be on gaining cooperation without having direct reporting authority over all the resources. If a company has limited experience in managing strategic alliances, they may need to have assistance in selection and training of alliance managers. By selecting them early, and getting them involved in the initial alliance negotiations, they will be able to start building a base of knowledge concerning the alliance partner, and will have more ownership of the final alliance structure.

At this point the knowledge of potential partners which has been gathered can be matched against the criteria developed earlier. There is much to be gained at this point by not ruling out potential partners unless there is an obvious mismatch in some characteristic. A simple categorization into an "A" and "B" list, or something equivalent may be appropriate, allowing for somewhat differing approaches to these companies. A tailored approach should be constructed for the "A" list, which will focus on the strategic fit between the partners. The "B" list can be made aware of your interest in partnering, and given a rough idea of your expectations so that they may have an opportunity to "self nominate". As much homework as you have done by this stage, you still will not be aware of yesterday's board room discussions and strategy changes within your long list of potential partners. A higher than expected percentage of deals will in fact come from the "B" list of candidates.

### **Approaching Candidate Partners**

The strategic partnering process changes character significantly at this point. Until now a company will have been working internally, possibly with an outside consultant who has their interests in mind. Now they will be reaching out to other companies who will be looking at any potential deal from their own perspective - what do they gain, and how does it fit in their strategy? It is absolutely essential that management of the initiating company be sensitive to this, and that they attempt to look at the deal from the perspective of their potential

partner before contacting them. This is the time to try and estimate how the activities of the alliance, and the capabilities of all companies involved, will contribute to their strategic plans. This focus on strategic fit is the single most important concept to master in the contact phase. It is also prudent to initiate contact already having an idea of what the other party's objectives will be. Initial written and face-to-face contacts should emphasize the potential partner's strategic fit in the alliance. Continually seek to confirm previous estimates of their objectives throughout the rest of the process, and revisit internal corporate expectations as the companies get to know each other better.

The initial pre-negotiation contacts with potential partners should be two way streets, no matter what their relative sizes or apparent leverage positions in the deal. Insist on continuing due diligence investigations, seeking additional information from the other company, and cooperating with them in providing information. This will be the first experience of the companies in working together, and can give insight into how they may function in a cooperative environment. Use this time to validate the assumptions made in earlier assessment of the potential partner. It is also the time to find any skeletons in the closet - better now than after all parties have spent significant time in negotiations or even have a signed deal.

### **Entering Negotiations**

One of the last bits of preparation for negotiations is also one of the most important. Companies should determine, before starting negotiations, when they will "push back" from the table. Part of this preparation involves having a solid grasp of the value of the alliance, as measured by assessing the company's value, both now and after the proposed deal. Do analysis under the assumption of no alliance, and also under some representative assumptions of deal scenarios which are likely to arise in the negotiations. A company should never allow themselves to believe they "have to make the deal" if the analysis does not support the deal. Additional reasons for "walking" include any misrepresentation by the other company, a lack of chemistry between counterparts from the

companies, and any evidence of a poor operational fit. Although the logic may seem reversed, there is a much better chance of negotiating and implementing a successful strategic alliance if the parties enter negotiations with a firm picture of what they will not accept.

### **Summary**

Alliances are potentially a life-giving or sustaining strategy for a company if they do not internally possess all the skills needed to successfully reach their corporate objectives. Companies need a team which is as good as they are in their core skill areas. If they are willing to trade off capital, control and time, they can often create an alliance which reduces their risk and increases the return on their invested resources. It is essential for a company to build a firm foundation by understanding their own objectives and expectations from an alliance. They need to have a clear view of their options, and to take the time to determine alternate paths to create those options. Potential partners should be evaluated in terms of how they can satisfy the needs of the alliance and how the proposed alliance fits into their strategy. Continue to gather information on the potential partner through the process and be prepared to shut off negotiations if the deal being proposed does not meet the needs of the business opportunity. By thorough preparation it is possible to increase the probability of becoming one of those companies which have found strategic alliances to be a key to success.

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