

STRATEGIC ALLIANCE DUE DILIGENCE? IT'S TIME IS HERE!



by Peter M. Palermo
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Venture Capital Professionals (VCs) have been extremely successful in their role of providing lifeblood to startups, being a lifesaver to troubled ships, and providing a powerful engine to accelerate growth in legacy companies. VCs provide capital, management expertise, and motivation. In the course of their risk assessment, they insist upon talented, credible leadership with a powerful vision, solid business model and an unwavering bias for action. End of story? Not necessarily. While all of the traditional steps in the due diligence process (legal, financial, technology, economic and management leadership) have served the investor community well in the past, there's a new and equally essential assessment tool that needs to be added to the VC's risk assessment "toolbox".

Strategic alliances, strategic partnerships, and other "business arrangements" are certainly not new. "Partnering" in today's world, however, has changed dramatically as a result of two major driving forces: globalization and technology. Companies of all sizes in all industries have come to realize that their ability to compete, to win, and in some cases, to even survive in the New World Economy depends on their ability to access an extensive range of inputs that they neither possess nor could develop alone in a timely, cost effective manner.

Startups and legacy companies alike see a world economy where new and old technologies simultaneously clash, converge, and seemingly morph to form new technology platforms destined to accelerate even shorter product life cycles, escalate R&D costs and further heighten global competition.

Just What Are Strategic Alliances?

While today's definition of strategic alliances is not dissimilar to the first academic work addressing the alliance issue (Sun Tzu's Art of War, 450BC), the spirit, practice and complexity of initiating, structuring and managing alliances has taken on totally new dimensions. Gone are the days of the simple bilateral or trilateral agreements. The New World Economy has ushered in mega-alliance networks and "alliance constellations" with literally hundreds of alliance relationships that have now given birth to group vs. group competition. Not only are the rules of the game changing, but more often than not, the game itself is subject to change at unprecedented speed...and often without advance notice.

Today we define strategic alliances as “**the strategic means of collaborating with others with the primary purpose of creating and preserving superior value and market power**”. The synergy of the partners needed to create that value depends on a shared vision of what they need to accomplish, recognition that they need each other to accomplish it, and a willingness to invest in a synergistic value creation model where $2+2=40$ or more! Sustainable value creation can only occur in an alliance where a shared vision is accompanied by a partnership of shared information, shared control, shared risks and benefits, and alliance management skills and know-how.

According to a 1998 Booz-Allen survey, 32,000 new alliances were formed around the world in the preceding

2 years, 3/4 of them across borders. Strategic alliances are growing at a rate of 25% per year and alliances of all types now account for over 20% of the revenues of America's largest companies.

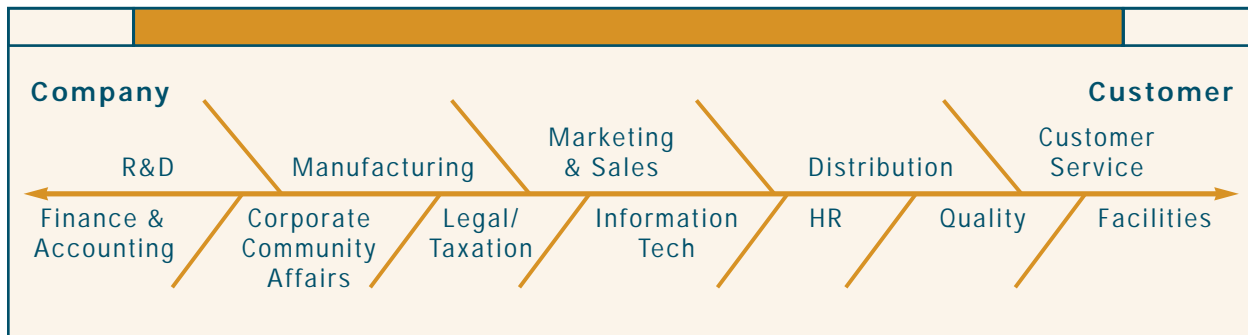
Why the explosion in alliances?

Many recognize that the global business world and the technology that drives it is moving too fast for most companies, if any, to “go it alone”. Whether a startup taking its first steps, or a legacy company emerging from the twilight zone of the post-restructured corporate world, the ability to successfully gain strategic access to critical business and technical competencies can mean the difference between winning and losing.

Why Forge Strategic Alliances in the First Place? Access! Access! Access!

VALUE CREATION THROUGH ALLIANCES	
<p>1. Accelerate Revenue Growth via:</p> <ul style="list-style-type: none"> • Geographic expansion • New technology • New products • New markets • Faster entry • Leveraged assets 	<p>2. Decrease costs via:</p> <ul style="list-style-type: none"> • Scale economies • Consolidation/divestitures • Product/process rationalization • Reduced overhead/outsourcing • Procurement efficiencies (raw materials, components, sub assemblies) • Shared marketing costs
<p>3. Leverage Risk via:</p> <ul style="list-style-type: none"> • Lower capital investments • Accelerate ROI • Diversify product portfolio • Limit foreign exchange exposure • Address foreign tax and legal issues 	<p>4. Build needed skills and competencies Intelligence gathering/knowledge creation by close proximity and access to partners:</p> <ul style="list-style-type: none"> • Technology • Processes • Decision-making skills • Connections <ul style="list-style-type: none"> —governments —buyer groups —competitors —complementors —suppliers —information networks
<p>5. Create new industry standards “Changing the rules of the game & even the game itself!” Joint development of new technology to set new Industry standards and platforms to:</p> <ul style="list-style-type: none"> • Grow an industry • Protect/consolidate an industry • Create a new industry 	

Where Are the Best Alliance Opportunities In the Business Value Chain?



Value creating alliance opportunities can occur anywhere throughout the business value chain — from R&D through distribution and customer services. Management’s challenge is to determine its alliance priorities based on the magnitude of the opportunity, the relative strength or weakness of a particular link in the value chain, and equally important, its internal alliance skills capabilities.

Recently, the big three auto makers concluded that it is not cost effective to compete in those areas of the value chain that do not add value to their customers, or provide them with a distinct competitive advantage. As a result, on February 25, 2000, Daimler-Chrysler, Ford and General Motors forged a strategic alliance combining their B2B efforts for the express purpose of sourcing non-essential materials in order to reduce costs. In April, Nissan and Renault announced their intention to join the exchange. Covisint, as it is known today, will be established as a stand alone automotive e-business integrated supply chain that will initially facilitate \$240B annually in parts and raw material purchasing transactions with more than 30,000 suppliers in the extended supply chain. Covisint will become the world’s first automotive online supply chain network, and the world’s largest business-to-business electronic network. This new online automotive marketplace is expected to dramatically reduce costly inventory at all levels of the supply chain, reduce purchasing costs and increase its operating efficiencies through an integrated Internet supply chain system. Further, it will extend each manufacturer’s core business into a virtual e-business enterprise allowing direct connections of the supply chain to the consumer in order to reduce time to market.

Covisint will allow the partners, including its suppliers, to capture savings and reduce the costs for sourcing vehicle components. Taking advantage of the inherent cost savings associated with Internet-based transactions, the new alliance model initially will promote procurement efficiencies and allow purchasing professionals to focus on product quality, supplier competitiveness and performance, and speed to market.

Oracle and Commerce One will provide the software, implementation and support, as well as host and manage the Covisint network. Powered by Oracle Exchange, Oracle’s online e-business marketplace, it is anticipated that the Covisint’s supply chain capabilities will ultimately expand to support other initiatives such as warranty, performance and design collaboration.

Alliance Competency—Good News/Bad News

The explosion in global alliance formation around the world is occurring at lightning speed and has far outpaced the supply of proven alliance management “know-how” and experience. This can be good news if you’re an alliance consultant, but very alarming if you’re an investor who has placed considerable value on a business model that calls for proprietary technology being sustained and/or leveraged within or across industry lines.

One key alliance management skill centers on the ability to safeguard the firm by protecting its critical technology, its core business processes, its brand, its culture, and other proprietary and non-proprietary assets. Some or all of these assets can be at risk in the hands of an unskilled alliance practitioner.

According to the American Society of Industrial Security's Fortune 500 Survey in 1998, "Giving away the store has cost US companies over \$50 Billion annually (about half of the nation's trade deficit) by forfeiting technology to foreign competitors."

The classic textbook award for "giving away the store" has repeatedly gone to Schwinn, America's former premier manufacturer of bicycles. Hailed as a landmark tale of "no hands" alliance management, the Schwinn story points to their disastrous alliance experience with Taiwan's Giant Bicycles. What started out as a low cost manufacturing outsourcing deal led to a one-sided

transfer of process and technology know-how that drove Schwinn into bankruptcy and catapulted Giant into the largest bicycle manufacturer in the world.

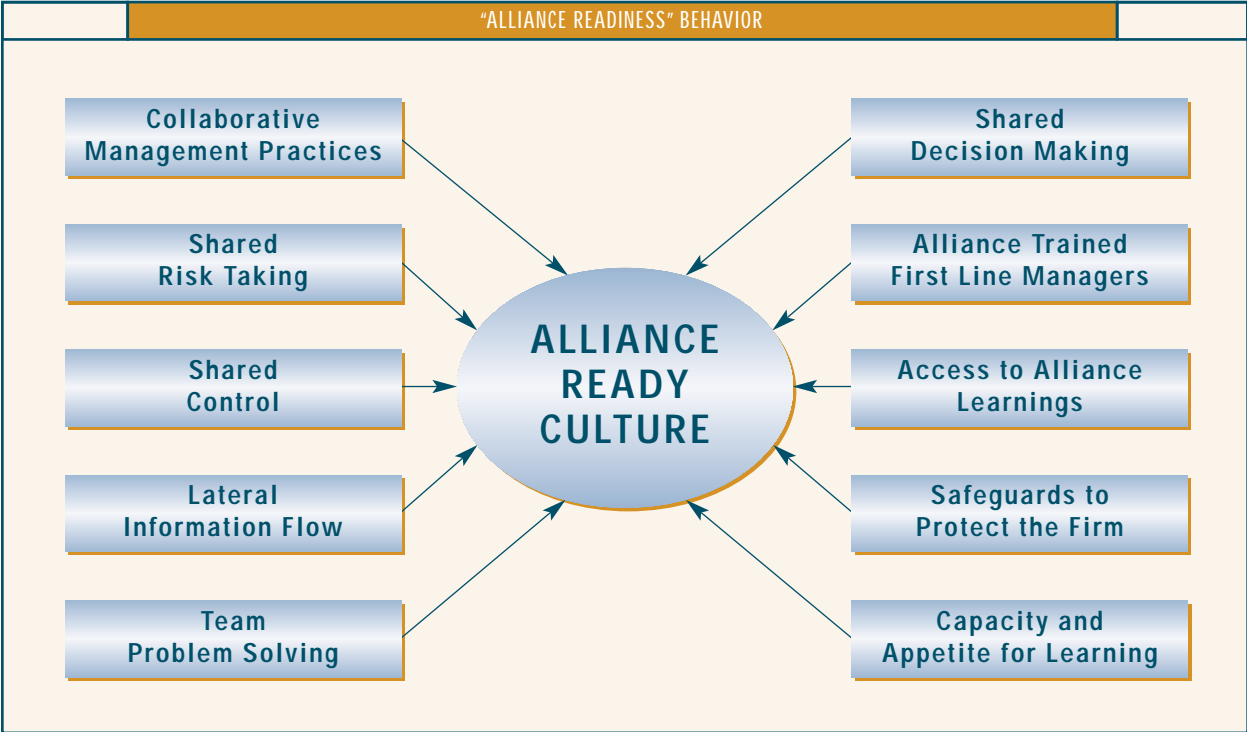
How do you assess "Alliance Readiness" and what are the common characteristics of world class alliance cultures? Here is a quick and effective "first pass" tool to help you calibrate an organization's alliance readiness vis-a-vis best practices. (Note: Any "Disagree" or "Strongly Disagree" response should be interpreted as an alliance readiness weakness area worthy of deeper understanding and attention.)

ALLIANCE MANAGEMENT READINESS ASSESSMENT TOOL				
<i>For each of the following statements, indicate the degree to which you believe they apply to the senior management team of the organization.</i>				
	Strongly Agree	Agree	Disagree	Strongly Disagree
1. The company has an established strategic alliance function at the senior management level.....	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
2. There are written alliance policies, or standard alliance guidelines readily available to all personnel.....	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
3. Alliance experiences in the organization are shared in an effective manner within and between business units and functional support groups.....	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
4. Top management believes that alliance management is a necessary skill for all middle and senior level managers.....	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
5. Managers experienced in alliance management are easily accessible for guidance and counsel.....	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
6. The company currently offers alliance management training to all middle and senior managers.....	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
7. The company's senior management team believes strategic alliances are the key to the future growth of the company.....	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
8. The company's senior managers periodically benchmark their alliance skills with a variety of successful growth companies inside and outside their industry.....	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
9. Successful alliance managers at the company are clearly recognized and rewarded for the skills they possess and their successful application.....	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
10. The company culture and organization is clearly "alliance-ready" both in terms of attitude and appetite.....	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<i>To score responses, give the organization 4 points for every question answered "Strongly Agree", 3 points for each "Agree" answer, 2 points for "Disagree" and 1 point for "Strongly Disagree". Total score and compare to the chart below.</i>				
31-40 points	STAGE III — <i>The organization ranks among best in class.</i>			
23-30 points	STAGE II — <i>Solid alliance basics in place—areas for improvement.</i>			
22 or less	STAGE I — <i>The organization needs to accelerate building its alliance skills.</i>			

As the alliance due diligence process continues, it is important to assess the alliance readiness of the culture itself. Here are some best practice descriptors of successful

alliance cultures found at six “best in class” alliance companies (Hewlett-Packard, Oracle, IBM/Lotus, Corning, Xerox and FedEx).

**With Top Down Leadership by Example, an Alliance Ready Culture Nurtures and Rewards
“Alliance Readiness” Behavior:**



Our client experience over the past six years has proven that when two or more prospective alliance partners come together, the ultimate terms, structure, and overall value of the alliance itself are shifted to the advantage of the most alliance ready organization — regardless of relative size. We have consistently seen the playing field shift to the advantage of the skilled alliance management team without regard to which partner was Goliath.

Consider this example. In 1998, a relatively small Ohio-based technology company sought to expand into new markets by extending its technology to new applications. Of the many opportunities explored, the firm chose to test the feasibility of applying its technology to alleviate counterfeiting and pilferage problems faced by many consumer packaged goods manufacturers. In order to commercialize this technology, however, the firm

required access to the retail market, to the brand power of entrenched players as well as R&D funding. This firm approached four Fortune 50 companies and successfully formed a strategic alliance designed to create a new industry standard. The privately held firm, capitalized at roughly \$1M, leveraged its alliance expertise, experience and “alliance ready” culture to initiate and lead the alliance discussions, negotiations and terms of the venture with firms more than 10,000 times its size.

Conversely, companies lacking any or all of the alliance skills required to win, put themselves at great risk when entering alliances. IBM learned this in the 1980’s when it forged alliances with Microsoft and Intel. IBM lost its dominant position in the PC market to others, in part, because it failed to identify and consider its partners’ long-term goals and safeguard against them.

Alliances—More than “Doing the Deal”

We all know that the vast majority of seasoned managers can successfully “get the order” and “do the deal”. Simply finding a willing partner and “doing a deal” isn’t enough. At best, you’ll have a “deal”, not an alliance. “Doing the deal” is the fun job, but just as “doing the deal” is not the be-all end-all in most aspects of business, it is clearly not sufficient in the complex world of strategic alliances. In

retrospect, the alliance highway is littered with failed alliances that would have created more value if “the deal” had never been consummated in the first place.

Here is a 10-step alliance management process that highlights the essential steps that precede and follow “doing the deal”. Focused management attention to the steps in this process can often mean the difference between an alliance success and an alliance disaster.



Alliance “Know-How” Can Improve the Odds of Success

Research has shown that firms that have superior alliance capabilities can increase the success rate of their alliances from a mere 30% to an impressive 90%. However, very few firms are able to assess their capabilities with any degree of accuracy. Recent evidence also indicates that firms are spending too much time forming new alliances, recruiting new partners and not spending as much time developing a capability for managing them. Exceptional firms such as Hewlett-Packard, FedEx, Visa, and Microsoft have developed a capability and reputation for extracting the most from diverse alliance relationships spanning all product and geographical boundaries.

To remain competitive, firms can no longer afford to invest millions of dollars in alliances without being able to extract demonstrable value from them. As much as companies have been striving to build and harness their core competencies in technology and product and process development, they also need to build a competence for managing, sustaining and creating superior value with their alliance relationships.

VCs need to determine and then value the degree, or lack of degree, of “alliance readiness” that any given company leadership and culture offers prospective investors and partners. Investors should be looking for answers to the following questions:

- ⦿ How “alliance ready” is the management and culture of the organization?
- ⦿ Does the organization have the required level of experience and expertise to initiate, structure and manage successful strategic alliances?
- ⦿ Does the organization have the tools and necessary processes in place to successfully drive and sustain measurable results from a network of alliances that can (and probably will) expand at lightning speed?
- ⦿ Can the organization create significant value through alliances and with better odds of success than the 50 - 75% alliance failure rate as indicated by our research?

Investors should be alert to signs of alliance weakness in an organization, as demonstrated by:

- ⦿ The absence of senior leadership that is visibly committed to forging an “alliance ready” culture to drive the long-term growth of the firm.
- ⦿ The absence of a clearly articulated strategic alliance planning process and the alliance implementation skills and processes necessary to meet or exceed value expectations.
- ⦿ The absence of internal and external processes that address well-founded concerns regarding protecting the technology and intellectual property of the firm.

- ⦿ The absence of incentives and rewards that encourage the demise of corporate arrogance that often preempts the ability to build a successful alliance culture and a true learning organization.

Summary

We believe that alliance “know-how” will prove to be THE management skill of the 21st Century. The “21st Century Leader-Manager” will have to be able to meld employees from disparate cultures, negotiate and mediate conflict, solve problems through compromise, share decision making and control, as well as blend vision and strategy with operational excellence. Start ups and legacy companies alike will find that the ability to successfully initiate, structure and manage strategic alliances will separate the winners from the losers in the next millennium. We also believe that the VC Professional can play a critical role in helping identify, guide and nurture the winners.

VCS can and should incorporate an alliance audit in their traditional due diligence process. Superior alliance management skills and processes that support a collaborative culture will pay big dividends to those engaged in the traditional JV alliance, the more complex alliance networks, as well as those operating in the world of mergers and acquisitions. Knowing when, with whom, and how to partner is more than “doing the deal”. IT IS THE DEAL.

The Strategic Triangle, Inc. was founded in 1994 by Pete after a highly successful 30-year international career with the Eastman Kodak Company. An accomplished Kodak Corporate Senior Vice President with significant domestic and international experience in several industries, Pete has managed fully integrated worldwide businesses with annual revenues from \$1.5 billion to over \$6 billion. During his career, he initiated and managed several major strategic alliances in the US, Europe and Asia including the historic joint technology alliance between Kodak, Canon, Nikon, Minolta and Fuji.

Pete provides STI clients with results-oriented assistance in the analysis, development and implementation of multi-faceted strategic alliances. Most recently, Pete initiated, structured, and managed a global consortium of consumer packaged goods companies including Johnson & Johnson, Procter & Gamble, Gillette, Kodak and NovaVision Inc. His highly acclaimed seminars, “Global Alliances in the 21st Century”, and “21st Century Alliance Workshop” are designed to deepen widespread alliance understanding and provide management teams with proven alliance planning and implementation tools and processes. Pete serves as an alliance coach to a wide range of clients, from pre venture funded .com startups to well established legacy companies. Pete earned his BA from Bowling Green University and his MBA from the William E. Simon Graduate School of Business Administration at the University of Rochester.