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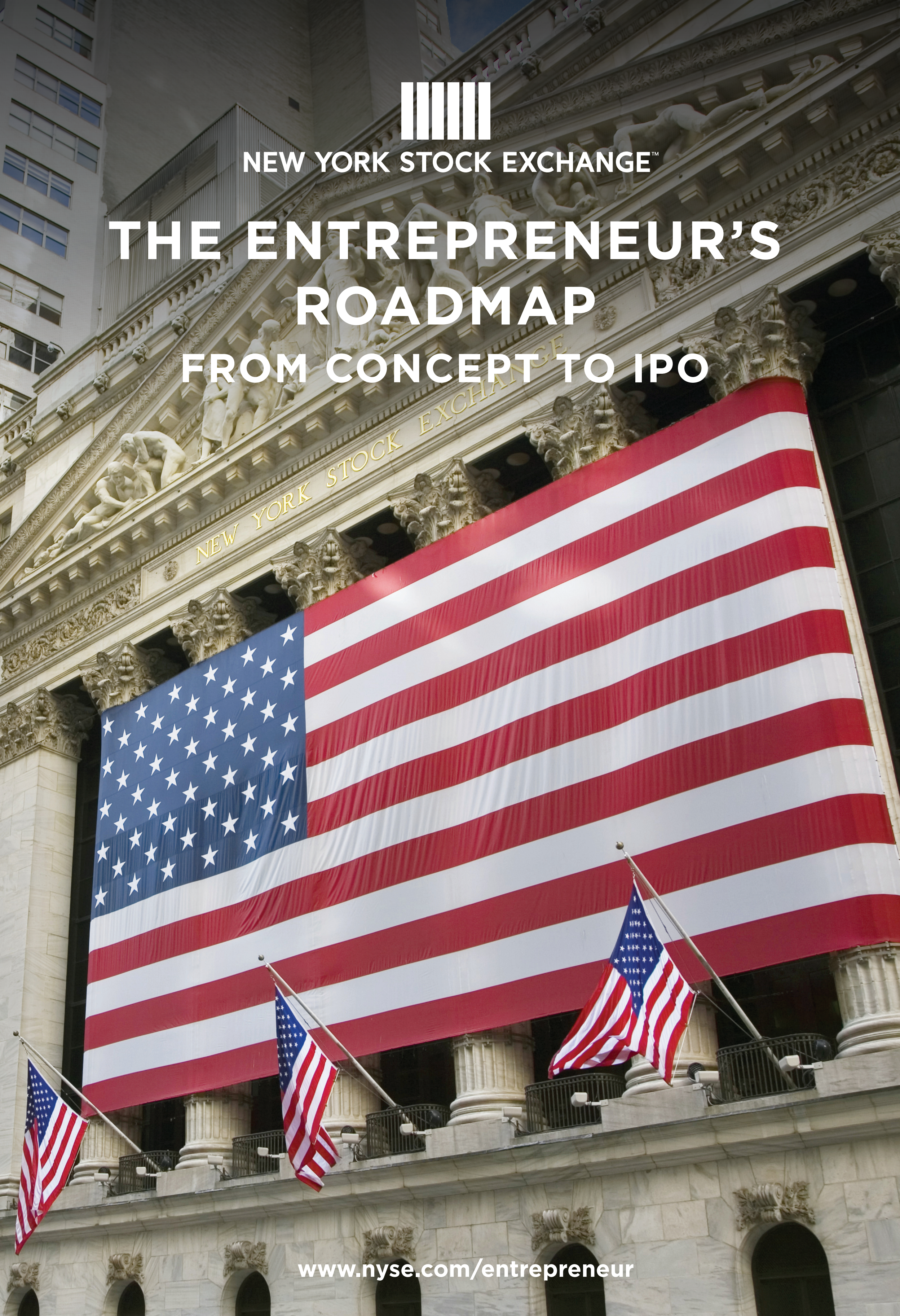

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STRUCTURING A STRATEGIC ALLIANCE

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Emerging growth companies at some point generally will need to develop strategic alliances with other businesses. Partnering with an established company can provide a wealth of benefits for a startup, not only in terms of access to the larger company's resources but also from the increased visibility that such a relationship can generate. However, studies have shown that the failure rate of strategic alliances may be as high as 60% to 70%.[1] Therefore, it is prudent to consider some of the ramifications of these relationships so that reasonable expectations are set.

WHAT IS A STRATEGIC ALLIANCE?

Broadly speaking, a "strategic alliance" is a relationship among two or more parties who for mutual benefit desire to share resources. These resources may include money, intellectual property, distribution channels, and expertise.

Strategic alliances can be formed to achieve one or multiple objectives. Some common examples of these objectives include:

Business development or referral: Your company seeks out a marketing partner that has broad reach within a customer base that your company desires to penetrate, or access to an analogous customer base that offers your company an expansion opportunity. Headspace, a developer of guided meditation courses offered via an app or online, developed marketing alliances with companies such as Starwood Hotels and Virgin Atlantic, recognizing that stressed-out travelers presented an attractive market to tap. Stand-alone referral or affiliate marketing relationships, such as those offered by companies like Amazon, can be as simple as links between two companies' websites; broader marketing arrangements with stated budgets and deliverables can be more complex. If your company is pursuing such a relationship, you should be considering what the referral partner can offer you in terms of reach and support.

Supply chain/OEM alliances: In this type of alliance, businesses seek to create streamlined and efficient supply chains that lead to increased sales for both parties. SiriusXM has relationships with many automobile manufacturers to supply satellite radio and telematics services, among other items. Makers of artisanal food products desire relationships with large retailers such as Whole Foods to increase sales and distribution. As with business development marketing alliances, supply chain alliances permit suppliers to leverage the broad reach and brand of the OEM to better penetrate an existing market or to enter into a vertical arrangement that may not otherwise be possible for a smaller company. However, there is a risk that a small company may become overly dependent on OEMs for its sales and marketing and does not establish its own presence and pursue other channel opportunities.

Strategic integration: In this type of alliance, companies collaborate with each other to offer joint products or services to their respective customers. These relationships may have features of supply chain/OEM alliances but also entail some integration of the product or service offerings. These alliances are common among technology companies—a PC manufacturer that ships its product with preloaded third party software, or two software companies or app developers that may work together to allow their products to communicate with each other, such as Google integrating its mobile mapping service with Uber. Issues may develop concerning which alliance partner actually "owns" the customer.

Development alliances: Development alliances feature collaboration on research and development activities among parties with shared objectives. Such relationships often entail each party bringing a specific set of resources such as know-how, expertise, or capital. Typically, the objectives include mitigating the risks and costs associated with R&D and leveraging the resources of the other participant. Sometimes a separate legal entity may be established for a development alliance so it is treated as a standalone entity for operational, legal, and accounting purposes. Because these relationships often last several years and entail significant contributions from the participants, monetary and/or nonmonetary, development alliances can be complicated to structure and document.

Cobranding alliances: Cobranding allows two or more companies to present products or services to a target audience. The purpose is to increase customer awareness of the business's brand and help shape its image by partnering with, and leveraging the brand awareness of, another business. Examples include: high-end smartphone manufacturer Vertu partnering with Italian automaker Ferrari to create a limited-edition smartphone inspired by the automaker's design features; British Airways and Citibank offering a credit card that provides automatic membership to the British Airways' Executive Club; and Spotify and Starbucks partnering to link Starbucks retail outlets and Starbucks loyalty card holders with the Spotify music-streaming service.

ADVANTAGES AND DISADVANTAGES OF STRATEGIC ALLIANCES

If deployed judiciously, strategic alliances can help a startup accelerate its growth by providing access to vital resources such as cash, product development, and marketing and sales support. Attention needs to be paid, however, to the appropriate timing in your company's development path for entering into a strategic alliance as well as selecting appropriate strategic partners. To make these determinations, it is helpful to consider the advantages and disadvantages of strategic alliances:

Advantages:

- If planned and structured properly, they can help your business grow faster and with less capital.
- Your visibility may dramatically increase from the publicity, reach, and services that your partner may offer.
- Your credibility may increase by having a recognized brand name willing to partner with you.
- You can mitigate risk by outsourcing a service or function to a strategic partner at less cost than trying to provide it yourself.
- If successful, the relationship can turn into a possible investment or M&A opportunity.

Disadvantages:

- Opportunity cost—does choosing a particular partner preclude you from working with that partner's competitors (even if there is no stated exclusivity, as discussed below)?

- Your business is not likely to be your partner's highest priority (or maybe it was at one time but isn't any longer), and it can be difficult to get the attention and responsiveness you may need.
- The players may change—the project leaders who initially championed your strategic alliance are no longer there, and their replacements may not share the enthusiasm or the mandate of the original team.
- Larger companies tend to be bureaucratic and slow-moving, creating communications and decision-making challenges.
- You may be locked into a contractual relationship that may last several years, with ramifications if you breach the terms.

KEY FEATURES THAT YOU MAY EXPECT TO ENCOUNTER IN NEGOTIATING A STRATEGIC ALLIANCE

Here are some deal terms that we frequently see in strategic alliances with emerging companies:

- *Strategic investment:* Requests for equity relationships with emerging-growth companies are particularly common when venture markets are frothy and large companies to benefit from a strategic relationship not only through results from operations but also through an "investment strategy." (Note that this discussion will not focus on the types of corporate investment funds that function independently from a company's corporate decision-making and more like true venture capital funds that are primarily focused on investment returns.) The equity relationship between an emerging company and a corporate partner will typically take one or more of two forms: an actual cash investment or a warrant.

  A cash investment from a strategic partner can enhance the visibility and perceived viability of a fledgling company. In addition, it may be expected that the corporate partner will support the cash investment with valuable expertise and strategic guidance from key members of management.

  A strategic investment very early in a company's development, however, may place that company "off limits" to the strategic investor's competitors. This can create challenges (both real and perceived) for an emerging company in expanding its market reach and in attracting future investors. In addition, strategic investors often require investment terms that may be unacceptable to a purely financial investor. For example, most institutional venture investors will require that the investment documents of its portfolio companies contain a "drag-along" provision, requiring all stockholders to support and approve a sale of the company that is approved by a certain threshold of the company's stockholders. The logic of such a provision is to facilitate the sale process and increase the likelihood of a successful exit. Strategic investors, however, may balk at such a provision, fearing potential embarrassment from letting a good acquisition opportunity slip away (particularly if the acquirer is a competitor of the investor/partner), or because the investor/partner wants its own opportunity to submit a bid. Strategic investors also may not have the experience (or tolerance) of VCs in working with early-stage companies or with the vagaries and cycles of the venture markets, leading to culture clashes or worse. An emerging company would thus be well-advised to consider the ramifications of accepting a strategic investment and to explore the strategic investor's track record and reputation in terms of being supportive to its investee companies.

- *Performance warrants*: A warrant is the right (but not the obligation) to purchase equity in your company for a specified price prior to an expiration date. A strategic warrant is generally a "kicker"—the warrant holder does not typically pay cash to exercise the warrant. Instead, the warrant holder will typically wait until there is a liquidity event (sale or IPO) and undertake a "cashless" exercise of the warrant, in which the warrant holder surrenders its warrant in exchange for the incremental increase in value of the warrant over its exercise price.

The metrics for performance are often measured in terms of revenue: a referral/business development partner may seek warrants based on the amount of business that it delivers; a supply-chain partner may earn equity based on the amount of purchases it makes from the emerging company. Warrants may also vest based on the duration of the relationship. The revenue goals may be set in terms of a short-term time horizon (perhaps for a single year or until an aggregate amount of revenue is achieved) or perhaps in terms of annual quotas over a longer period.

Key considerations in issuing strategic performance warrants are (a) matching the incentive to performance and (b) providing realistic incentives. Thus, both the duration of the performance period and the attainability of the performance goals need to be assessed. Warrants that are either earned too quickly or vest based on unattainable metrics may each result in a strategic partner losing its motivation to continue to provide support. Keep in mind that for purposes of calculating your fully diluted capitalization, maximum exercise of the warrants will be assumed. Therefore, when a VC prices your company, the strategic warrants that you assume will never be earned will be every bit as dilutive to your stockholders as the other types of equity (employee options, investor shares, etc.) that you issue. Naturally, the longer the period over which the warrant targets are achievable, the more likely your partner will be motivated to add value. In addition, you should expect that your company will increase in value over time and thus the targets you set should also increase over time commensurately.

- *Exclusivity:* There is no need to immediately stop discussions with a potential strategic partner because exclusivity is raised. In fact, a request for exclusivity in a business relationship can be used to your advantage.

  It is important to understand the rationale for the request for exclusivity. Sometimes there is no rationale—the larger company is simply trying to use its perceived leverage to exact a term in a negotiation. If that is the case, then you have a decision to make about the opportunity cost of granting exclusivity. If, on the other hand, your strategic partner appears to have a solid business rationale for its request for exclusivity, then it is incumbent upon you to take advantage of this desire, consider the commitments that you would want from your strategic partner to support your business, and then carefully balance the value to your business of these commitments against the risks of the specific type of exclusivity that is sought. This analysis will vary depending on your industry, the type of product or service you offer, and the type of alliance you are entering. For example, the length of exclusivity would be of great concern to a technology startup in a competitive and fast-moving industry. In any case, you should aim to be specific in terms of spelling out your expectations in the alliance agreement.

  Negotiation points pertaining to exclusivity include the following:

  - *Scope of exclusivity*: Be as specific as possible in granting exclusivity. Are you willing to be wedded eternally to only one ally? Such a relationship will likely limit your exit alternatives and your valuation upon exit. Can you limit the scope of restriction to a list of competitors? Can you put a time limit on exclusivity or perhaps offer a "first-mover" period during which you grant your partner exclusivity, after which you can offer your product or service to others? Can you limit exclusivity to a specific-use case? Can you tie continued exclusivity to achievement of specific metrics such as revenue targets or milestones? Would your partner be willing to agree to not work with any of your competitors? Can you unwind the exclusivity in the event that you are acquired?

- *Marketing support:* How will your strategic partner help you to expand your business beyond simply supporting its relationship with you? Will it be willing to participate in co-marketing activities to increase your visibility and customer base? If so, it is best to specify terms in the alliance agreement, such as names of project leaders and amount of spend.
- *Publicity:* Will your partner actively participate in publicity efforts regarding the strategic alliance? Will it allow a press release mentioning its participation? Will it be willing to tout you (or allow you to tout the relationship) on an ongoing basis at industry conferences? Will you be accorded some sort of "premier partner" status?
- *Technical integration*: If you are developing a joint solution or custom deployment for a strategic partner, what kinds of resources will be made available to ensure the success of the deployment? Would you have access to your partner's tech team? Is there a defined timetable for the project with specified milestones?
- *Acquisition offers*: A large strategic player may view a strategic alliance as a precursor to a possible acquisition of your company. That motivation may be obvious at the outset: your conversations with a strategic partner may have begun as a discussion about an acquisition, but one or both parties may have decided to pursue an alliance instead. In other instances, the concept of rights with respect to acquiring your company may come seemingly out of the blue. As with other terms, try to understand your partner's point of view in making the request. Your partner may feel that because of its vital role in fostering the growth and development of your company, it should be afforded some sort of special "insider" right if you decide to sell the company. Your partner may also want to prevent having your company fall into the hands of one of its competitors and thus request notification when you propose to sell and to whom.

The types of requests for special acquisition rights that you may encounter can include one or more of the following:

- *Right of first refusal:* This is a right to receive notice of an acquisition offer and a right to match its terms. This term may have a "chilling effect" on potential buyers. First, a potential third-party buyer, upon learning that another party has a right of first refusal, may not be willing to do the legwork required in exploring an acquisition opportunity. Second, if the right of first refusal has a long notice period, the third-party buyer may not want to wait for that period to elapse. And even if your strategic partner agrees not to match an offer, your potential buyer may wonder why. Is it because the potential buyer's offer is too high? Does your strategic partner know something about you that the potential buyer doesn't know?
- *Right of first offer:* A right of first offer can provide that once you have determined to sell your company, you would be required to provide your strategic partner with a first right to submit an acquisition offer. If your partner elects to submit an offer, you can decide to either accept the offer or, for a limited period, pursue a better offer from a third party. In theory, the right of first offer mitigates some of the concerns raised by rights of first refusal regarding the discouragement of third-party offers, and you may suggest this term in response to a request for a right of first refusal. In practice, however, your strategic partner may feel that it would now be the "stalking horse" and thus not be willing to accept this term.
- *Right of notification/negotiation:* This alternative provides your strategic partner only with notification that you are considering an acquisition offer, typically followed by a limited exclusive negotiation period. The right would be triggered upon receipt of a third-party offer or perhaps at your discretion if your company is considering putting itself up for sale. Unlike a right of first refusal, the terms of a third-party offer need not be revealed to your strategic partner; all your partner is told

is that there is a process either under way or expected to commence. You may be required not to enter into a binding commitment until the end of the exclusive negotiation period, but that period is usually relatively short (generally 14 days or less).

CONCLUSION

If your company is considering a strategic alliance with a larger corporate entity, consider the longer-term ramifications of partnering with the specific ally and whether your company is positioned to take advantage of the alliance.

Remember that an alliance is a two-way street: explain the value you can offer your alliance partner and not just what your alliance partner can do for you. At the same time, be mindful of your company's goals in seeking the alliance and set forth specific commitments from your ally in the alliance agreement.

REFERENCE

1. Jonathan Hughes and Jeff Weiss, "Simple Rules for Making Alliances Work," *Harvard Business Review,* November 2007.

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