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Open Source Business Models in Transition

Part 3: Strategic Alliances – turbo boosts for business

Hardly a day goes by where, especially in the IT branch, the market changes. Businesses active in this environment must be aware of the constant changes and keep pace with various strategies. Having presented offshore development as well as strategies for difficult times in the last two editions of T3N, the final part of this series will present strategic alliances, their variants and creational possibilities.

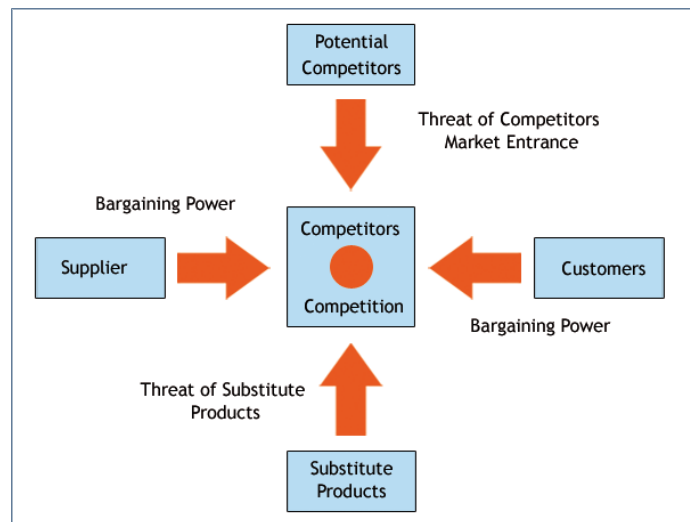
Especially for small and medium-sized businesses, strategic alliances are an excellent means of quickly and comprehensively coming to grips with the field's constant changes in technology and the market. But what exactly is a 'strategic alliance'? Especially the word 'strategy' is often used as a hollow buzzword and yet, at least in the present context, there is more to it than that. An alliance goes beyond merely superficial or transitory collaboration and gains strategic significance when it touches upon or indeed alters a business's core strategy, ie its business model. Strategic alliances are immeasurably more potent and comprehensive in their character and effect than project-defined collaborations. This applies equally to mergers, acquisitions, joint ventures or 'merely' contractual strategic alliances.

Sharing business – why exactly?

It seems to be a human characteristic that managers tend to exercise defence mechanisms when their own business is to work particularly closely with another. All kinds of anxieties appear: the fear of loss of control is just as prevalent as a general mistrust of one's counterpart's intentions. Managers jealously guard their own (often overvalued) acquisitions while undervaluing the other's potential. Sooner or later the stiff-necked 'I can do that myself' syndrome makes some kind of appearance. The fact is overlooked that firms such as Microsoft or Goggle, or the media tycoon Rupert Murdoch have a good reason for paying high 'strategic' prices for diverse online businesses, though they could doubtlessly 'do it themselves'. The reason is to gain time. And yet while American businesses objectively test alliances simply because they want to make money, Europeans seem to tie themselves in knots for the sake of their independence. Be this as it may, there has to be a good reason for a strategic alliance.

Speed is an important aspect. No business can move in a certain direction through generic development as quickly as it could as part of a strategic alliance. An alliance enables the creation of a new organization through the stroke of a pen on the bottom of a contract. All at once resources are made available. Suddenly one has the know-how and experience which would have taken a long time to acquire. Quickly one has access to previously un-dreamt-of markets and technologies. And in record time a business is created with significantly more attractive cost structures. This speed advantage cannot be trumped by even the most expeditious management or the speediest generic business development. It is especially important when one has missed a development in the branch and needs to catch up or when one wants to create a head start over the competition. Markets change very rapidly and the players don't have the time budgets to constantly make adjustments.

The size advantage is important too: again and again the size of a business emerges as an almost political topic. There are ego-maniacs whose businesses can never be large enough, and there



The 5 forces industry analysis of ME Porter functions as a rubric for the five basic options for a strategic alliance.

are those who like to keep things small and delicate.

Both positions lack an objective foundation. The size of a company can be relevant in many respects. From time to time business possibilities arise which require a minimum business size. Clients demand the stability which is often improved through size. Projects require minimum capacities without which there is little prospect of successful completion. The disproportionality between business size and individual large assignments can even have weighty consequences. The existence of a business should not be threatened by a large project. Often a minimum size is required to be able to compete at all with favourable cost structures while being able to offer cost-covering prices (keyword: break-even point). Often a business requires a minimum size to be able to cover the risks and development costs out of its own portal project or software product. Two cooperating businesses are much better able to afford that expensive Linux core, that Perl or Oracle developer plus the necessary headhunting fee, plus many additional investments.

Scalable business models practically cry out for growth. In many markets growth is of such great importance because greater influence on markets and market participants results from growth and business size. That applies even when the goal is merely to reduce one's dependence on market segments, individual clients or individual suppliers and to be in a stronger position when negotiating prices and other conditions. For better or worse bargaining power is an important factor in business. To the person who asserts that one can grow on one's own the reply must be made: that the business which makes an alliance and continues to grow at the same time will always be a long way ahead of the business fighting on its own.

One further argument: with its participating companies a strategic alliance can afford access to markets where none has been before. Whether the issue is accreditation and certification, the mastery of certain technologies, the understanding of a market's inner workings, the 'branch-speak' or simply the familiarity, image and standing of a company, entry barriers are elegantly surmounted. Using conventional means doing so would normally cost a lot of time, energy and money.

The same applies – especially in the IT branch with its extremely tight labour market – to the building up of technological abilities and capacities. Whoever wants to gain wide ranging competencies in a new field will have to spend time and money for training while the outcome remains uncertain for a long time. By contrast alliance partners enjoy the advantage of being able to exploit their own technology and their own know-how. The partner is compensated with improved efficiency at good prices; in the form of licence fees; or, in the case of a merger, simply with higher profits.

Alliances have particular advantages when it comes to internationalisation. Building presences in foreign countries or indeed continents necessarily demands a large budget, which can take years to pay itself back. It usually makes no difference whether one internationalises in order to sell or produce one's products. Armies of small businesses have attempted to go international alone, and have returned home with burnt fingers. Thus international strategic alliances have unbeatable advantages in the era of globalisation. One can make oneself a globalisation success without having to make one's own risky foreign investments. Those avoiding alliances will normally not do as well. Especially software development, which is practically free of logistical problems, will become even more internationally cooperative in t

he future. Asian development costs are a fraction of those in Europe and the USA. The high sales necessitated by low licensing prices can often only be achieved by international software distribution. Media corporations of all kinds also tend to achieve the requisite user numbers, revenue and profits only through international positioning and distribution.

The variety of the advantages presented above already demonstrates in how many ways strategic alliances can be 'knitted together'. The model for a strategic alliance will vary depending on which advantages are worked towards by each partner (they can be different for each partner). Additional variations result from the combination of different business positions within a branch.

From Stranger to Friend

In each branch it is possible to examine typical combinations of two businesses through the strategic 'five forces' [1] rubric. First the rubric helps reveal all the options. Secondly it supports the creative process involved in finding ideas. When at least one of the partners is from the centre of the branch (in this case web development) and the other is from one of the five forces domains, then five basic kinds of strategic alliance are possible.

If both potential partners are in the thick of things, namely web development, then that alone determines the possible advantages of an alliance: size advantages and the potential for rapid growth, risk distribution across different specialisations and different target groups, capacity and resource reinforcement within the same specialisations and target groups (sensible for two direct competitors), consolidation of technological competencies, or – when the home markets differ – regionalisation or internationalisation advantages.

If the partner is from the immediate client circle, then the resulting alliance will correspond to a so-called 'forward integration'. Part of the client's added value is taken on by oneself. Suddenly

one has access to additional know how and supplementary capacities with complementary experiences that make a sensible contribution. That in turn allows one to offer additional services (such as increased outsourcing) which competitors will not be able to offer. One's own value grows and with it the returns dependent on one's value. One gains a potentially important differentiation advantage that could allow one to charge higher prices. Examples of this are the web developer which aligns itself with a travel agent in order to become active in the tourism branch, and the web developer which cooperates with a tourism IT provider in order to offer its new client a comprehensive service.

If the partner comes from the immediate field of suppliers, the resulting strategy is called a 'backwards integration'. One adopts some of the value adding benefits of the supplier. The alliance allows improved access to necessary services and technologies for one's own business. That too can lead to differentiation benefits with relevance to returns. Example: a web developer and a specialist hoster cooperate with respect to complex applications. Particular demands can be met with one's combined capacities and customer relations are improved.

If the partner in question is nothing more than a potential competitor who intends to but has not yet entered the branch, new aspects reveal themselves. For example, a print-orientated marketing agency can increase its capacity by cooperating with an online agency. The clients of each of the businesses can be offered the services of the other partner, and one is in the position of being able to offer integrated online/offline campaigns. Revenue and profit growth will also result, for the volumes combine themselves. Clients are found who could not reach the partners individually. Printing presses and many other business models could also make interesting partners.

Finally cooperation with providers of new replacement products fundamentally makes sense. An alliance with, say, providers of online 'construction sets' can result in the development of specific construction sets (through the application of branch know how or particular functions) so that one's range of services is rounded out. One can gain new clients or retain old ones, who would otherwise move on to a different provider. In this way one's own stomping ground is preserved. In addition one has easy access to one's clients partners with their increasing needs. Here too a number of sensible combinations can be conceived.

Unification techniques

When two businesses which are willing to cooperate have identified one another as interested, recognised their individual advantages, and found one another suitable in other respects (common goals, suitable corporate cultures etc), then they are ready to take the next step: the letter of intent (LOI) [2]. A letter of intent is a binding declaration of secrecy and silence in the context of an investigation into the detail of a (yet to be decided) strategic alliance. As a rule such a letter is recommended. If one business is simply to be taken over by another, then at least the potential buyer/receiver is bound. After all it is the vendor in particular who lays him or herself bare in detail. Nevertheless mutual LOIs (aka memorandum of understanding (MOU)) are not to be scorned in this case. Of course this really begins to apply where deals are envisaged 'at eye level', ie where the partners have equal rights. The term 'non-disclosure agreement' (NDA) signifies the same.

Due diligence [3] is the next step. The partners in spe, especially potential buyers of business interests, obviously have an urgent and vital interest in carefully examining the object of their desires before it comes to valuations, further negotiations and entry into contract. This is understandable, for who likes to buy a pig in a poke? In practice the due diligence examination is often

left to an experienced practitioner. Primarily the legal circumstances (from commercial register entries and commercial articles to all important contracts) and the business administration numbers reaching many years back are carefully examined. Further areas of interest include the organization, personnel, market position and business plan. Longstanding financial liabilities of all kinds are also investigated. Normally all relevant documents are placed in a separate 'data room' in which the appointed person can do his or her work over a period of days. Extensive discussions and interviews with key persons in the business are just as commonplace as the scrutineering of individual documents, statements or facts. Here too, if an equal partnership is sought, the due diligence examination is mutual.

The third and final step before the decision is the business valuation. This is very complex but essential in the case of an acquisition, merger or joint venture. Strategic alliances which merely take place on the contractual level often do not require valuation, even though a valuation can often be interesting. The classic valuation model of tax consultants, the so-called Stuttgart model which is mentioned in all manner of business contracts, is by no means adequate for an economically sound valuation. It places too much emphasis on the balance-based 'substance share' and not enough on the 'profit share'.

Differences also arise over the question to what extent (and how boldly!) projected numbers should be taken into account by the valuation. Risk deductions are common among evaluations. Businesses in crisis can therefore be valued at much less and may even be assigned negative values. On the other hand medium-sized businesses in good shape and with development opportunities are usually valued at three to eight-times their operative profits by professional investment companies. The reason for this is the consideration that the buyer values his investment in the price through the amortization of profit shares of future years. Incidentally, Google and co make different calculations: relevant for them is the strategic value a potential share has for the buyer. However, when all the complex calculations of specialists are done, a business is worth exactly as much as a buyer is prepared to pay for it.

Settlements – the transaction

The purchase or fusion of a business are mere variants and not every strategic alliance needs to be built upon the firm foundation of corporate law. The alternative consists of a very close union which is effected by a contract or framework agreement. This form of legal union can, if desired, go just as far as the union effected by the 100% takeover by one party of another. In some cases it can bind its participants even more closely than a takeover. To go into the various options would be to take up much more space than is available here. Thus only the main relationships following merger and acquisition (M&A) deals are set out here. It is worth mentioning, however, that a contractual union is well suited as a prelude to a later agreement at corporate law, for during the prelude there are ways of going back.

When an alliance is to be ordered according to corporate law, there are two kinds of complete takeover. In so-called 'asset deals' all the assets on the active side of the balance of the business being bought are acquired by the purchaser. Thus everything is bought from individual trademarks and similar rights to the business accoutrements and inventory. The contract is therefore an ordinary contract of sale. All running contracts with employees, suppliers and clients are (with the consent of the partner) written over. Notarisation is not necessary as a rule. Nevertheless, the whole procedure tends to be cumbersome because many contracts must be entered into.

The alternative is the purchase (legally: the transferral) of business assets. However, this is only possible for corporations such as a limited liability corporation (german GmbH), public company (german AG) or limited commercial partnership (german KG; share deal). Here one does not buy the object but rather, as it were, the ownership of the object. One automatically steps into contracts signed by the previous owner. The German legal forms named above exist in essentially the same form in Switzerland and Austria as well as in most other jurisdictions from China to the USA. Ltd (limited) denotes British corporations, which was adopted by the laws of most Commonwealth States along with the common law. In the USA the corporation is denoted by LLC (limited liability company). International alliances are thus not fundamentally more difficult than purely national alliances.

Fusions can also be organised as the founding of a new corporation, in which either the capital and contracts or the market share of the partners are brought in as consideration. In principle a joint venture is formed in exactly the same way, only with the difference that the partners only bring part of their businesses with them. If alliances are to be created for more than one market and more than one alliance created, joint ventures or contractual partnerships are the suitable means. However, especially as a small business, one should not spread oneself too thinly and get involved in too many such deals.

The takeover of other businesses via assets or shares, in whole or in part, can be financed too. The acquisition of assets is subject to the normal financing rules for real investment. After all, it does not matter who the vendor is. Similarly the financing of share deals is also doable as external financing but needs ongoingly good cash flow on the part of the participating business. If growth and increased combined value are to be expected venture capital may enter the equation – in the case of small companies primarily through Business Angels and not through VC corporations.

Conclusion: 1 + 1 = 3

The time pressure resulting from the often extremely rapid market and branch changes demands swift and decisive action in adapting business models so that future possibilities may remain open. It is no coincidence that the media is reporting more and more frequently on the conclusion of strategic alliances. Together with a suitable partner one is simply stronger. By means of a simple combination additional value can be forged from 'nothing' where it would normally be reachable only through high costs. Humans, to be sure, are not fond of change. And because managers are human too, emotional reservations are often pronounced. It is recommended, however, to examine what is best from a commercial perspective soberly and free of emotion.

The ego of the decision maker should certainly not be the decisive criterion. And before making a decision it is not advisable to depend solely on tax consultants and lawyers. They are usually inexperienced in 'trendy branches', typically ignorant of M&A deals, and they will advise against a sale or a merger for no other reason than to keep a client. Often the best advisers are managers one has befriended. Tax and law may be important, but they should remain on the periphery when the future of a business is being decided.

| Glossary | |
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| Merger | Amalgamation of two corporations |
| Acquisition | Part or whole purchase of a business |
| M&A | Acronym for 'mergers and acquisitions' |
| BEP | break-even point: the point at which costs or expenses and revenue are equal |
| Scalability | Is present when a business model can be broadened practically at will, with corresponding turnover increases. |

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| Strategic investor | An investor from the same, closely related or complementary branch |
| Finance investor | An investor without strategic goals, whose primary objective is to take part in profits and increased value |
| Joint Venture | A new, joint business (affiliated corporation) of two already established businesses |
| Share deal | A M&A deal in which shares are transferred |
| Asset deal | A M&A deal in which assets rather than shares are bought or sold |
| Transaction | The actually, legally efficacious buying or selling of the company and its cash flow |
| Forward integration | A type of strategy where a business partly takes over the value adding of clients |
| Backward integration | A type of strategy where a business partly takes over the value adding of suppliers |
| Due diligence | The pre-inspection of a business by a representative of the potential buyer |
| Data room | In which due diligence is conducted and in which the necessary documents are made available |
| Business valuation | Process in which the value of a company is established |
| Capital raising | Raising the nominal, liable capital of a corporation. The payment may be staggered over time. |
| Return value | The return value of a business results from the returns which the company yields |
| Substantive value | The substantive value of a business results from its assets minus debts |
| Stuttgart model | Outdated procedure for valuing companies which was developed by financial auditors |
| Operative profit | Profit, calculated without reference to out of the ordinary gains or expenditures |
| Cash flow | What remains when net expenditures are deducted from net revenue ('cash loss' when this is negative) |
| NDA | 'non-disclosure agreement' – an agreement to secrecy which is normally reached before serious M&A discussions begin |
| LOI | 'letter of intent' – a declaration of intent by a potential buyer, usually with a NDA, not yet binding |
| MOU | 'memorandum of understanding' – an agreement between two partners before serious negotiations, usually kept more general than the NDA and LOI |

Links and Literature

 *Softlink 2007*

- [1] Wikipedia - 5-Forces-Branchenanalyse: http://en.wikipedia.org/wiki/Porter_5_forces_analysis
- [2] Wikipedia - Letter of intent: http://en.wikipedia.org/wiki/Letter_of_intent
- [3] Wikipedia - Due diligence: http://en.wikipedia.org/wiki/Due_diligence

THE AUTHOR



Thomas Schlichtherle (43) studied business in Munich and, following his graduation, joined the international strategy consulting firm Mercer. In the past 20 years he has attended hundreds of businesses of all sizes. Since 2000 he has been working independently, and since 2005 he has been concentrating with the 'strategy factory' (www.tssf.biz) on the long-term attendance of SMEs in the TIME sector. He works as a business angel for companies with good prospects and brings to bear expertise in capital and contact procurement as well as in business and strategy. One of his many focuses is his work with open source ventures.