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An expansion strategy doesn't always need to be M&A driven. Hunton & Williams LLP partners **Robert Acosta-Lewis** and **Susan Failla** make the case for strategic alliances.

When considering expanding into emerging markets, companies often look to traditional M&A opportunities or explore possible distribution or sales representation relationships. While both of these avenues may offer potential advantages, they also carry risks and limitations. A traditional M&A deal is an "all in" strategy both in terms of risk and reward and does not allow the acquirer to harness all the possible advantages that may be available from the seller. A simple distributorship or sales representative relationship is limited in flexibility and may not provide the desired economics, market presence, or brand building opportunities.

Rather than limiting consideration to these types of strategies, companies seeking to enter emerging markets should explore the possibilities of a strategic alliance that would allow for the creation of a structure where the parties can allocate risks and rewards, create customised economics and craft the manner and degree to which each of them contributes assets and expertise to the business opportunity.

The tool box

What do we mean by a strategic alliance? A strategic alliance is constructed using familiar commercial and legal relationships, or "tools", used in combination to allow the parties to take advantage of particular features one or more of those relationships offers. Those relationships can include contractual or legal joint ventures, distributorships, sales representations supply agreements, contract manufacturing/tolling agreements, and licence agreements. Most businesses have used one or more of these commercial relationships in isolation. The challenge and opportunity lies in using them in effective and creative combinations to harness the assets and expertise of the parties to the best advantage of the alliance.

For example, consider the various compensation models available through the tool box components in the context of building a long-term comprehensive business strategy. Licence agreements can be used to make intellectual property available to an alliance and generate royalty streams. Those royalty streams can be designed to accurately compensate the contributing party for the value of the contribution over time by being structured, for example, as a percentage of net sales. Sales representation relationships will lead to commission income and offsetting expense, while employees can be made available under service agreements or can be employed by the alliance itself. Depending on the approach used, employee liabilities and benefit compensation triggers may be avoided.

Manufacturing can be conducted on a cost plus basis, or it can be conducted under a tolling agreement where the manufacturer earns a service fee for converting goods owned by others.

Here's one example of how a strategic alliance might work: a party with a significant brand may desire to expand into a new market but does not have the market expertise to do so within acceptable risk parameters. Once a suitable alliance partner has been identified, for example, one with established in-market distribution, expertise and influence, it can use the alliance "tool box" to create an acceptable structure. Brands can be licenced, manufacturing resources can be utilised, favourable contracts for raw materials can be leveraged to the advantage of the alliance, a local workforce can be supplemented with additional brand building and marketing expertise, all while considering and addressing the risks that are associated with each of these relationships and allocating them, as well as the desired economic rewards, accordingly.

Building the alliance

Parties who have pursued these alliances cite various reasons for doing so. They are seen as a launching pad for a new market entrant that can provide immediate and continuing access to local expertise and influence. The risk of competing in an unfamiliar market and legal environment is reduced. Unlike a traditional M&A transaction, each party has continuing "skin in the game" as it relates to risk avoidance and brand building. Using the available tools in different combinations, the parties can make the best use of shared opportunities and economic incentives to create win-win scenarios that leverage each party's strengths. Assets and expertise can been made available by each party in different ways under different economic terms.

The key to a successful strategic alliance lies in large part in the advance work of the parties. Most importantly, you must know your partner. How does your partner approach its business operations, its relationships with its employees and its various stakeholders? In short, are the business cultures of the two partners compatible? The parties should discuss their objectives with respect to growth, profits, competition, markets, new developments, business opportunities and expected commercial relationships. Particularly when entering into a relationship with a partner that has multiple business lines it is important to ask the question: "what's in and what's out," of the alliance? Does the partner expect to provide goods or services to the alliance from its operations outside the arrangement? If the market entrant seeks to expand, must it do so through the alliance?

Another important element of this initial investigation concerns risk identification and allocation. Here the approach of a strategic alliance allows the parties to address different risks differently. The pre-existing tax, labour, environmental, and other risks that may exist within one partner can be isolated from the operations of the alliance through the use of the correct commercial relationship. Assets can be protected from exposure to alliance risk by being licenced to the alliance rather than contributed. Similarly, if structured correctly an alliance partner can avoid the risk of pre-existing employee liabilities of the other partner that can come through a claim of "successor liability." The alliance will also have risks associated with its ongoing operations. As with pre-existing liabilities, these liabilities can be allocated in a manner that has the party responsible for the liability bearing the risk burden.

In addition, the parties should be sure that they agree on accountability, governance, and, perhaps most importantly, exit strategies and consequences, discussed below. With respect to governance, the parties must agree on a structure for decision making and dispute resolution that does not impede the business and provides an avenue for quick resolution of business issues. In this regard, the parties should understand that effective pre-litigation/arbitration dispute resolution will be essential to the successful operation of the alliance. If disputes cannot be resolved short of arbitration or litigation, then the alliance will surely founder.

Think about the exit

In the heady days leading to the formation of an alliance and the process of building trust between the parties, neither party will likely want to engage on the subject of termination and its consequences. However, it is essential that they do so. Many variables can lead to a decision by one party or the other to exit the alliance. For example: the parties' business objectives can change or diverge, markets can change, and the regulatory environment can change and negatively impact the alliance's operations. Of course, the alliance may simply fail to meet one or both parties' expectations, or one party may irreparably breach its obligations.

Although each termination will be unique, it can be assumed that at a minimum, each party will have an interest in preserving any value that has been created. In this context they should consider what arms-length relationships may need to survive the termination of the alliance. Termination provisions should include termination triggers, provisions for transfer and assignment of assets and contracts, objective and agreed valuation mechanisms, allocation of jointly developed assets, and enforceable non-compete and non-solicitation provisions.

The parties should also agree in advance how they will account for and value the assets and operations of the alliance in the context of a termination. How the parties envision the termination and winding up of the alliance will impact how they structure it from the outset. When considering termination, the parties should acknowledge that they will be creating a jointly-owned and controlled business operation. Within that operation, each party will likely have areas of greater and lesser ownership and influence. It is also likely that the alliance will have interdependencies with assets and operations of each of the parties outside of the alliance. The parties should also consider whether a less drastic remedy than termination may be sufficient to address the issue.

The challenges

Because a strategic alliance assumes the creation of a long-term relationship with shared risks and rewards, it raises a number of issues distinct from those that must be addressed in the context of traditional M&A deals. At the outset, in order for each party to access the potential value of the alliance, the profit and loss allocation must be incorporated into a business valuation model with many more variables than a typical M&A valuation model, with each party responsible for making different contributions and bearing differing risk allocation.

In addition, the two partners should share their views of corporate governance and compliance and overall corporate culture to make sure that these are compatible with each other. Decisions will no longer be made unilaterally and each party's business conduct expectations must be acceptable to the other party.

Each party should also be very cognisant that entering into the strategic alliance involves not just obtaining access to the opportunities and benefits offered by the other party but that it is also exposing oneself to reputational risk for the conduct of the other party. If the parties are going to be publically identified as alliance partners, then the acts of each will be imputed to the other.

By drawing on a familiar "tool box" of commercial relationships, but using them in combination and in creative ways, parties can create a strategic alliance that achieves desired economics, is best suited to their risk tolerance and that harnesses the assets and expertise of each party to the best advantage of the alliance. Choosing the right partner and careful up-front planning will significantly increase the alliance's prospects for success.