Look Out Ahead:

How Ignoring Alliance Adjacencies Can Constrain Value

By David S. Thompson, CA-AM, and Steven E. Twait, CSAP

By managing and mitigating alliance adjacency issues—contractually defined limitations on the partnership—alliance managers help their company and partners maximize effectiveness while reducing inefficiencies and organizational friction.

In large part, alliances are created because each partner expects to gain something of value. That value might take the form of a new way of grouping products or services, a supply chain that lowers costs or offers customers a seamless solution, access to a new technology or talented people, or a means of reducing the risk of developing an expensive product or service. With these benefits always come expectations of what can and cannot be done by each partner over the course of an alliance, with these restrictions usually codified in a contract. These contractually defined limitations create what we call "alliance adjacencies."

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Adjacency can be broadly defined as the state of being near or contiguous to something. In the context of a formal partnership, alliance adjacencies represent the requirements and contingencies at the boundaries of an agreement—and how those limitations can affect the use and potential benefits of a company's own products and services as well as those it might offer as part of another alliance.

Adjacencies Start Early

To better understand alliance adjacencies, it might be helpful to consider what happens in a typical contracting cycle. The deal teams from each company—negotiators, lawyers, and key stakeholders—are tasked with making sure that the contract accurately captures what was agreed upon during the negotiations. The contract has to describe under what conditions value is exchanged and the rights each party has under the agreement.

In addition, almost all contracts define the alliance's duration, how to handle mutually generated intellectual property, conditions that would trigger the end of the alliance, how post-termination alliance assets would be allocated, and how disputes are to be handled. These rights and value statements, along with all of the other guidance given in the contract, define the boundaries within which the alliance will operate.

If not mitigated or addressed effectively, these contractual boundaries can become the source of countless alliance inefficiencies and other forms of organizational friction, which can become major problems for current and future partners. These inefficiencies might be called an opportunity cost by an economist; however, it has been our experience that simple opportunity costs are usually discussed as part of an individual deal and are fairly and adequately valued and accounted for in the contracting process. An economist's theoretical treatment of these costs lacks the ability to quantify weaker restrictions that a contract may impose on the parties, as well as the ability to predict the addition of future partners.

A Tangled Contractual Web

Looking across a company's alliance portfolio, adjacencies take a variety of forms—large and small, malignant and benign—with each contractually defined business deal containing multiple sets of unique commitments. While none of the deals are necessarily created to interact with one another, they do interact, often in unforeseen and strange ways. The analogies in the following paragraphs might be helpful in describing the potential impact of these adjacencies.

To a cook, alliance adjacencies would be like placing an unwrapped, pungent onion in the refrigerator and discovering that the onion has added flavor to the other unwrapped foods. To a reader of fiction, it would be a "Gulliver's Travels" experience in which Gulliver is tied down by the Lilliputians, one thread at a time. (While each individual thread is weak, the net effect of thousands of threads is effective in tying down the

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giant.) Finally, to those with summertime athletic tendencies, alliance adjacencies can be compared to a "three-legged" race, where pairs of contestants tie the inside set of legs together and run a race. Now imagine trying to win that same race with not a single pair, but many pairs of legs bound together!

In the onion example, while its strong aromatic properties might be desirable for a particular dish, the onion should be put in an airtight container to prevent its smell from tainting surrounding food. The similar need to "containerize" certain alliances might involve the creation of firewalls or other types of safeguards to ensure that information is appropriately protected. As you might imagine, creating such containers can be expensive and can introduce inefficiencies into an alliance.

Similar to the predicament encountered by the giant, an alliance's strength can be sapped by limitations on certain activities multiplied by the total number of a company's alliances. These prohibitions are contractual boundaries and represent a loss in a company's degrees of operating freedom. Examples would include limitations on the development of certain products during a period specified in the contract, prohibitions from having a salesforce sell similar products, and so on.

In the case of the three-legged race, each additional pair of joined legs exponentially increases the difficulty of movement. In alliances, this source of awkwardness comes in the form of inefficiencies created by the need to coordinate activities and processes to align the partners to their mutual objectives. An example would be developing the processes necessary to coordinate the activities of two sales organizations that are co-marketing or co-promoting a product or service.

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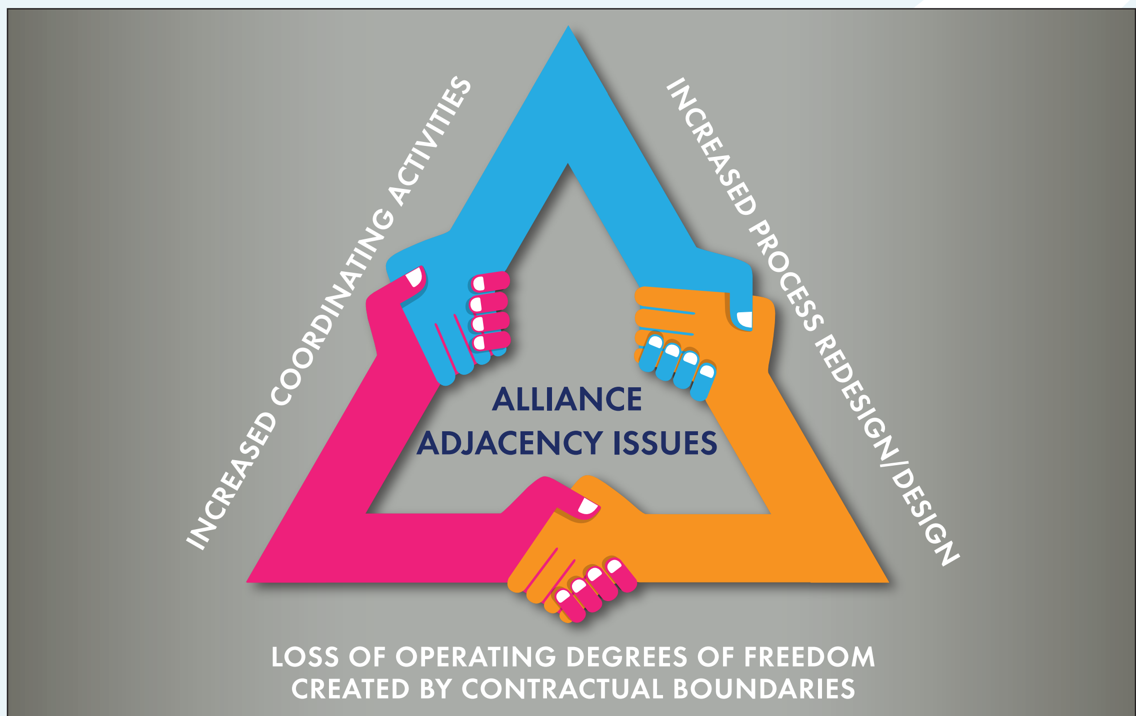


CASE Studies

CASE STUDY 1

The adjacency of a single alliance relative to a company that has only one partnership

The sales of a product are booked at a country level. The alliance was created at a corporate level with an upfront payment to the originator and subsequent milestone payments tied to sales. One country counts revenue equal to sales of product less cost of goods sold, which includes the royalty due to the partner company. The country does not see any benefit from the upfront payment or any of the milestone payments; therefore, a wholly owned product that has no royalty associated with it looks more attractive to sell than a product that has a royalty associated with it, even though the partner product may be more profitable overall to the corporation.

CASE STUDY 2

The adjacencies created by two alliances relative to a single company

Company A has an alliance with Company B and Company C to develop an electronic device. Company A has its own development pipeline that is targeted in a similar space as Company B's. To sign a deal with Company B, Company A promised that for the duration of the agreement, it would have no products that would launch in the same market space as the partnered product. (This agreement made perfect sense at the time of the contract signing, as Company A's products were still in development and their forecasted launches were nowhere near the launch of the product that Companies A and B had jointly developed.)

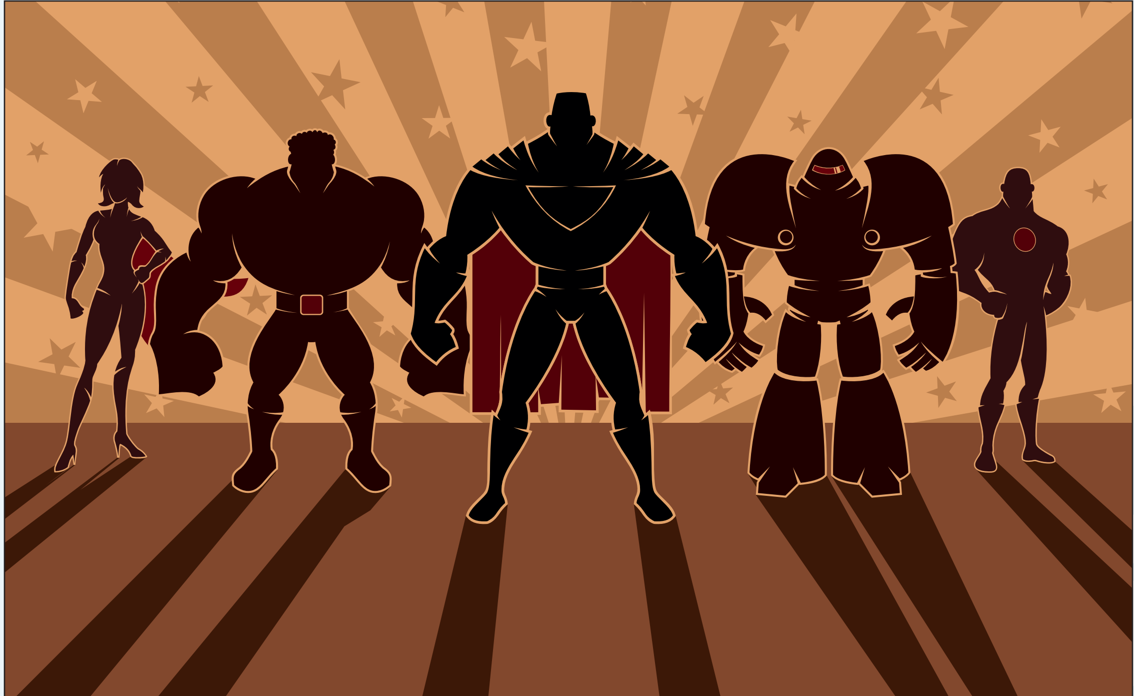
Company A's alliance with Company C had a breakthrough due to unforeseen technological advances, and their product will move ahead five years and launch sooner than anyone had expected. Their partnered product is a close substitute for the product that Company A is developing with Company B.

In both examples, Company A received a benefit by entering into an alliance; however, contractual terms have limited its degrees of freedom to act in a profit-maximizing manner with respect to its financial interests.

How might these adjacencies be mitigated by alliance management?

In Case Study 1, one option for the alliance manager would be to initiate an open discussion with the finance group and the line management component that owns alliance results. This discussion would seek to ensure that the right financial incentives are in place to better align all affiliates' incentives to the corporation's goals.

In Case Study 2, an alliance manager could highlight the contractual issues to line management and the legal department. The aim would be to develop a set of scenarios and appropriate actions prior to actually being in the uncomfortable position of a potential breach of contract, thus avoiding the situation entirely.



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Adjacency Hot Spots

Alliance adjacencies can create a space that contains particularly high concentrations of each of the three risk categories that alliance managers seek to mitigate: business risk, human risk, and legal uncertainties. ("High Risk to High Reward" Part I and II, Strategic Alliance Magazine, Q3 2011 and Q4 2011.)

While by no means complete, the following list catalogs a number of issues, activities, and functions that either contribute to alliance adjacencies or serve as harbingers of larger problems to come.

Contractual Boundary Issues

- Creation of firewalls
- HR personnel changes
- Sales force flexibility
- Internal team (commitment of resources)
- Budget constraints

Increased Coordination and Process Activities

- Changes to compliance standards, IT standards, corporate policy
- Investor relations interactions
- Press release creation
- Resource flexibility
- Ability to quickly change investment levels based on current corporate pressures
- Geographic limitations when deals are global (may not have strengths/resources in all areas)
- Product mix and selling strategies
- Development plans/unable to stop development without consent of the other party
- Differing and battling corporate compliance issues
- Loss of flexibility in manufacturing due to basic contractual requirements and back-up manufacturing requirements

Address Adjacencies, Add Value

While adjacency issues can never be eliminated completely, they can be significantly reduced to allow the alliance to focus on one of its main success factors: maximizing effectiveness. The key for any organization entering into a partnership is to reduce the natural inefficiencies, while also making

sure that the alliance contract doesn't inadvertently create additional problems.

To decrease alliance adjacency effects and to limit the loss of operating freedom, here are several actions you can take:

1. Establish a cross-functional group to review contracts, and specifically charge this group with looking at and identifying issues that might be caused by alliance adjacencies during the due diligence phase of contracting. (In large firms, this group must have membership that cuts across all corporate silos affected by an alliance, to effectively coordinate alliance activities throughout the company.)
2. Train alliance personnel to quickly identify alliance adjacencies, handle alliance-confidential information, teach others to effectively identify and manage alliance adjacencies, and quickly escalate adjacency issues to the senior management group that governs the alliance.
3. Institutionalize learning from the issues that have been created by alliance adjacencies, so as not to repeat them in the future.
4. Discuss thoroughly with the potential partner all known alliance adjacencies. Address these known issues prior to signing the contract, and document your agreement on how they will be handled.
5. Ensure that the alliance governance processes include mechanisms to deal with alliance adjacency issues.
6. Seek counsel from your legal advisors regarding how to best address any issues that arise after the contract is signed and how to best communicate these issues within your organization.
7. Mergers and acquisitions that carry existing partnerships will likely bring with them alliance adjacency issues. Ensure that these issues are being appropriately addressed.

Managing alliance adjacency issues is a key benefit that should be provided by the alliance management function. Be sure to capture alliance management's impact by monetizing and incorporating this work into a scorecard that will highlight the value that alliance management delivers to its clients. Alliance managers who learn to identify and manage the business risk, human risk, and legal uncertainties associated with adjacencies will directly contribute to maximizing the value of an alliance.

In a future article, we will continue to explore ways to manage a portfolio of partnerships, taking into account their respective alliance adjacencies. ■

The authors would like to recognize the valuable contributions to this article of Peter Johnson, adjunct professor of business at the Duke Fuqua School of Business, and vice president of corporate strategy (Retired) at Eli Lilly and Co.

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