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Anurag VIJ
Microsoft Asia

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DESIGNING SUCCESSFUL STRATEGIC PARTNERSHIPS

The Achilles' heel of digital transformation.

by Anurag Vij

Every industry is experiencing a massive disruption to its traditional business models owing to digitisation, and the COVID-19 pandemic has accelerated this disruption multi-fold. Healthcare, financial services, telecommunications, and transportation have all seen their erstwhile business models uprooted by innovations in telehealth, digital banking, and over-the-top (OTT) services such as WhatsApp, Telegram, and digital ride-hailers. These disruptions have been further amplified by born-in-the-cloud companies ('digital natives') that move at breakneck speeds due to the absence of decades of capital, people, process, and technology legacies that established players have to deal with while trying to digitally transform and compete. To overcome these challenges at speed and with scale, traditional industry leaders have been seeking to partner with global digital leaders.

This would not be the first time that firms are forging strategic partnerships to take advantage of market opportunities that could range from entering new markets to repositioning themselves in existing markets by bringing together core capabilities, intermediaries, and supply chains. Yet, an estimated 40 percent of these partnerships fail.[1] As businesses, governments, and communities across the globe rapidly pursue their digital evolution, such strategic partnerships remain an elusive means to achieving success.

What exactly are these strategic partnerships in the digital realm (or 'digital evolution partnerships' as termed in this discussion)? How are different organisations approaching them? And what are the different outcomes they have in mind? Do the managers engaging in such partnerships know what drives success? Given that digital transformation spending for 2022 has been forecasted to reach US$1.8 trillion and is further projected to grow to over US$2.8 trillion by 2025, these are key questions that need to be addressed.[2]

DIGITAL EVOLUTION PARTNERSHIPS (DEP)

A DEP is typically an alliance forged between an industry leader and a digital leader. For the former, its aim is often not just to acquire new technologies but to re-engineer its existing business model and innovate future cash flows. A common way for these organisations to start this journey is by introducing new digital technologies within their existing environments and portfolios. This entails moving their legacy IT infrastructure, applications, and business processes to cloud technologies, often termed as 'modernisation' in the digital world. This requires investments in people, process, and technology. Given the complexity of the technical debt, internal processes, and people change management, the underlying projects not only incur significant costs but also carry the risk of failure. Therefore, industry leaders often look for a shared-risk model with their digital partners as they embark on their complex digital transformation journeys. For their part, digital leaders use a range of methodologies to support this expectation, such as discounting their services, making upfront investments in training and headcounts, and entering new go-to-markets.

As businesses, governments, and communities across the globe rapidly pursue their digital evolution, strategic partnerships remain an elusive means to achieving success.

For digital leaders, they benefit from organic growth as industry leaders start using their platform. As the objectives of the partnership mature, and should the breakthrough happen, digital leaders would benefit considerably. The usage of their platform or technology would increase as the resultant product of the partnership gains traction and grows. In the case of a connected-car platform that leverages the cloud for real-time traffic patterns, direction, safety measures, car maintenance, analytics, and such, the more the number of cars sold, the greater the usage of the underlying cloud platform, which in turn would drive inorganic growth for the digital leader. Other than enhancing and building new cash flows, digital leaders also see these partnerships as an opportunity for them to learn about and enter new industries. For instance, a cloud provider's partnership with a bank provides an opportunity for the former to learn the intricacies of the banking industry. This further helps it fine-tune its technology which may eventually even open doors for the provider to enter that industry with a disruptive digital technology.

However, given the unknowns of the legacy environments and the future possibilities, most of these partnerships start off as open-ended co-explorations to seek value creation. Moreover, unlike traditional alliances, DEPs require an open mind regarding the fate of the partnership. An alliance manager of a global organisation put it like this, "In these alliances, you haven't really tied into something very specific early on. It deserves some exploration first... so you start with a kind of cooperation and then see what happens later. Maybe it will lead to a joint venture or maybe it will turn itself off... these [alliances] are a different kind of animal compared to traditional strategic alliances."

We conducted interviews with tens of CXOs who are engaged with such digital partnerships across traditional industries, as well as with digital leaders, and concluded that DEPs encompass the following four key pillars.

Given the unknowns of the legacy environments and the future possibilities, most partnerships start off as open-ended co-explorations to seek value creation.

1. Early-stage strategic partnerships

DEPs start with an intent to co-explore potential opportunities that could be created at the intersection of the industry and digital domains. However, the objectives are unclear in the early stages. Hence, these partnerships could lead to more formal and structured partnerships such as joint ventures and acquisitions, or they may simply fade away if the firms fail to identify a material joint opportunity.

2. Co-exploration at the intersection of industry and digital leaders

As mentioned, industry leaders, with their businesses deeply threatened by digital disruption, are looking to partner with large digital technology players to survive this disruption. In addition to acquiring technology and expertise, they also hope to leverage their industry expertise, combined with digital technologies, to create new markets and find new cash flows. Meanwhile, the digital leaders are hoping to benefit by expanding the market share of their platform and services, with potentially unlimited upsides should the partnership result in a breakthrough. Consider the partnership between Goldman Sachs and Apple to create a new phone-linked credit card, the Apple Card, as an example that has proved to be a win-win for both firms.

3. New cash flows with risk- and revenue-sharing

The key objective of the DEP is to seek new cash flows that emerge at the intersection of the industry and digital domains, such that the partners mutually benefit through risk- and revenue-sharing mechanisms. In the case of a car manufacturer partnering with a digital leader to build a connected-car platform, both parties invest, share the risk, and realise upsides, should they achieve a breakthrough.

4. Open-ended governance mechanisms

DEPs are open-ended in nature, especially in terms of how the partners will achieve the objective of generating new cash flows. They are based more on a risk- and reward-sharing model with open-ended governance structures such as memoranda of understanding (MOUs), rather than stringent underlying contracts like in the case of a joint venture. While this approach injects high levels of uncertainty and unpredictability, it better supports the objectives.

SUCCESS DRIVERS OF DEPS

Alliances, in general, have a high historical record of failure. In the case of DEPs, where the product or the solution does not yet exist at the time of formation of the partnership and the partnership is open-ended, it is highly challenging to have governing mechanisms such as comprehensive legal contracts to provide a thorough coverage of risk factors and related mitigation. Therefore, it is even more critical to develop structured execution frameworks for things like decision-making, conflict resolution, milestone success, and exit criteria during the planning phases of the partnership creation.

Through our research process, we identified seven specific *ex-ante* decision points that are likely to enable managers to address these challenges and increase the chances of success.

1. Involve technical experts early for better alliance fit

Digital partnerships are often formed by chief executive officers (CEOs) or other senior members of the organisations, and are usually supported by a small group of business development teams. However, since these partnerships are technology-focused, it is exceedingly difficult for business development or sales teams to decipher deep technical nuances or undo commitments based on wrong assumptions *ex-post*. Early-stage involvement of technology experts helps the actors determine a better alliance fit from an engineering and technology standpoint by exploring, evaluating, and shaping the 'fit'. Not only would this help the actors have a better assessment and understanding of the needs to meet the partnership objectives, but it also builds higher levels of confidence in the technical strategy of the partnership. It is worth noting that due to additional cycles required by the technical personnel to do due diligence, such early involvement of technical teams may lengthen the time it takes to close the deal. However, it reduces the time that technical personnel would take post deal-closure to understand the environments, the risk of wrong assumptions made *ex-ante*, and the time and resources required to mitigate these *ex-post*. Overall, it increases the probability of success of the partnership.

A sales director told us, "Executives typically don't understand their technical environments super well and rush for closure. We were given to understand they had the landing zones for cloud, they were already doing agile-based projects, had governance in place, and so on, only for us to discover later that all of that was at best in a sandboxed environment. The question then became who should pay to get the fundamentals in place. None of this was visible or discussed during the alliance formation. If we had taken the time to assess and address these upfront, it would have taken longer to sign but we might still have had a deal."

2. Extend deal team's involvement in alliance life cycle

The deal team consists of the senior executive who leads the deal conceptualisation and formation at the most senior levels, and is supported by others such as sales, finance, procurement, and legal professionals. Typically, the deal team's objective is to close the deal, and at deal-closure, it hands over the engagement to the delivery team and moves on to the next deal. In other words, the goal of the deal team diverges (i.e., pursuing a new deal) from that of the delivery team taking over the execution side of things.

DEPs are open-ended in nature, and are based more on a risk- and reward-sharing model with open-ended governance structures such as memoranda of understanding, rather than stringent underlying contracts.

It is critical to have a defined capped-gain for each party beyond which either the partnership terminates, evolves into other forms of alliances such as a joint venture, or leads to a renegotiation.

As the vice president of a deal approval desk commented, "You typically have corporate or business development teams doing the deal. Then they go away making whatever promises and it's someone else's job to make it successful. However, to ensure the success of the deal, I would say, 'Hey, if you did the deal, you need to stick around and run the deal to make sure it's successful after the fact.'"

Longer involvement of the deal team during the life cycle of the partnership helps in preserving the purity of the original commitments and the relationship. As the digital partnership evolves and encounters challenges, the deal team assists in overcoming the challenges involved in leveraging the insights and assets that typically delivery teams do not have knowledge of or access to.

For example, deal teams are privy to deep first-hand insights into the original commitments made by both sides, have relationships at senior levels where the deal was initially conceptualised, and have visibility of future potential multiplexity growth of the partnership between the firms (and, consequently, the related investments available). In contrast, delivery teams that are focused only on the execution of the partnership are usually challenged with a limited understanding of the promises made at the deal formation stages, limited executive-level relationships, and limited insight into the partnership multiplexity potential (and commensurate investment pools).

As a result, deal teams can yield better negotiation power, and assist with better resolutions and faster unlocking of trapped value during execution, as compared to delivery teams that might possibly view the challenges as constraints. Given their open-ended nature, the DEPs continuously evolve and surface additional opportunities. A deal team's ongoing engagement also facilitates faster identification and realisation of such opportunities.

3. Align deal team's incentives to ensure alliance success

Deal teams are typically incentivised at deal-closure with the size of the incentive tied to the size of the deal at the time of the deal announcement. The larger the deal size, the greater the signalling impact of the deal announcement, and the larger the incentives. Since incentives deepen goal commitment, the more the deal team's incentives are influenced by the size of the deal, the greater would be their focus on crafting and announcing the largest possible deal, rather than the execution details of the partnership. This, in turn, is likely to have an adverse impact on the performance of the partnership.

Consider the experience of the delivery executive of a global consulting firm who said, "The deal team signed this multimillion-dollar contract and threw it over the fence to us. The expectation is to realise the consumption of the deal in three years. It's a joke since none of the fundamentals are in place and by the time we get this done, half the period would have passed already. I can clearly see how we are walking on thin ice here and expect this to blow up in a few months when both teams realise how oversized this whole engagement is… if the deal team still had skin in the game versus collecting their cheques at announcement and moving on, the deal structure and size would be so different…"

Therefore, adjusting the deal teams' incentives to tilt towards post-announcement alliance performance will motivate the deal teams to consider tactical implementation factors appropriately,[3] and accordingly structure and size the deal during the deal formation stages. This, in turn, will result in achieving alliance success not just at-announcement but also in post-announcement performance as it is more likely that the promises can be delivered, bringing the deal teams' success criteria closer to alliance success criteria, i.e., cash flow generation for the actors.

4. Define risk-reward capping during alliance formation

Risk-reward capping refers to the degree to which the partners in a DEP conceptualise and agree on a financial framework that balances the downside and upside financial payoffs for both parties, and also outlines the limits of the same for each party.

For instance, the senior vice president of a global consulting organisation with extensive experience in such alliances noted, "These contracts start very loosely and are normally set up as MOUs. And even as they get more diagrammed, everyone is assuming that success is a given… and will be happy to share the pie in a certain ratio. However, this is where I think they must be clearer from the get-go–in the event of failure, it's about what's in the exit cost and criteria. And wild successes are equally troubling because then you get the sharing problem… so pre-define, as the pie grows, up to what size of the pie they are happy to share and what happens beyond."

Firms can develop the perception of imbalance in losses during the execution, especially as the losses become material and trust starts eroding. Similarly, as the alliance starts delivering success, firms can develop a perception of imbalance in fair-share beyond the initially expected upsides. This contention may not seem obvious amidst the excitement of the DEP formation. Therefore, whilst a progressively successful partnership may have a clearly defined proportion of gains that each party enjoys, it is also critical to have a defined capped-gain for each party beyond which either the partnership terminates, evolves into other forms of alliances such as a joint venture, or requires a renegotiation.

Correspondingly, it is also critical to have a defined stop-loss limit for each party beyond which the actors can decide on a termination or a renegotiation. Hence, a well-defined risk-reward capping during the alliance formation allows for increased predictability of deviation from original expectations and potential conflict for the actors, thereby providing a mechanism to protect their expected cash flow objectives.

5. Establish financial renegotiation mapping

Financial renegotiation mapping is the degree to which the DEP partners envision, outline, and agree on the set of future contingencies that will trigger renegotiation of the financial terms and conditions of a DEP. Given that the DEPs are open-ended in nature and carry diffused objectives, adaptability by both parties and the ability to renegotiate are critical during partnership evolution.

For instance, if the new-to-world product ends up delivering significantly lower returns for one of the actors, financial renegotiation mapping will trigger a renegotiation arrangement enabling the firms to revisit prior assumptions and make amends to address financial asymmetries. Several other scenarios may emerge about the investments and other factors impacting financial interests of the firms during the alliance evolution, as explained by the alliance director of an emerging market IP firm, "Had we had the foresight during deal negotiation to agree on specific criteria which drives amicable renegotiations when an imbalance in investments versus returns occurs, the alliance might still be alive. We felt like we were being taken advantage of… they were maximising their returns based on a very loosely defined playbook. One must have the hard discussions upfront before embarking on the alliance."

Therefore, financial renegotiation mapping provides a mechanism for the partners to plan for the contingencies during partnership formation, to enter expected renegotiations during execution as triggers are reached, and thereby avoid the undesired costs and increase cash flow generation.

6. Institute structure renegotiation mapping

Structure renegotiation mapping is the degree to which the DEP partners envision, outline, and agree on the set of future contingencies that will trigger renegotiation of not only the roles and responsibilities, but also the hierarchies and reporting relationships of the personnel involved in the DEP. For example, in the advanced stages of a DEP between a brick-and-mortar retail firm in an emerging market and a global digital leader to create an online retail business, the latter will not have enough power parity to prevent the retail firm from integrating its supply chain with other competing digital firms, thereby impacting the final product.

Similarly, a digital leader may want the product's positioning, and look and feel to be consistent with its global branding while the industry leader may want a more local flavour. Similar imbalances in hierarchies of relationship or roles and responsibilities, such as who makes the decision on underlying technology, the look and feel and the cultural appeal of the interface, ecosystem integration aspects, and so forth, can emerge throughout the evolution of a DEP, disrupting its embeddedness and triggering managers to take undesired actions.[4] As the president (Asia) of a Fortune 50 company noted, "… they have a culture of 25-minute-long meetings. We do

30 minutes. Whose word prevails? This is the smallest example but consider that you are making very different and impactful decisions depending on the stage of the alliance evolution. It's critical to be clear who leads in which situation, and equally critical to know when you need to collectively go back to the drawing board to redefine the roles and responsibilities, and the authority structure... If not, you can lose a lot of time and money, not mentioning the obvious opportunity cost..."

Structure renegotiation mapping provides a mechanism to address these asymmetries in a systematic and expeditious fashion, thus preserving and fostering a sound relationship between the partners and avoiding adverse impact to the cash flow generation objective.

7. Use alliance exclusivity wisely

Exclusivity in alliances can be conceptualised in terms of a continuum–from unilateral constraints on one party to reciprocal constraints on both parties over the duration of the alliance. The US$750-million exclusive agreement between Google and ADT demonstrates such a continuum.[5] As part of the agreement, Google picked up a seven-percent stake in ADT. In return, ADT, which previously sold various types of smart-home hardware, would exclusively sell Google's Nest products to consumers and small businesses. Depending on meeting certain conditions, the two companies are expected to invest another US$150 million over the coming years in marketing, training, and product development, and ADT will have access to specific Google technologies.

Structure renegotiation mapping provides a mechanism to address asymmetries in a systematic and expeditious fashion.

Although the extent of investments, the intent to co-create, the multi-year nature, and the hype involved in signalling benefits with DEPs may suggest that the actors desire a high degree of alliance exclusivity as a safeguard against expropriation of specific investments and other forms of opportunism, restrictive contractual arrangements or alliance exclusivity is uncommon. In most cases, these alliances seek to build their exclusivity by means of co-creating something unique while seeking new cash flows, and not through restrictive contractual agreements that block them from partnering with other firms. As the business leader of a digital consulting firm averred, "Contrary to popular belief or even the desire, you won't find a ton of exclusivity in such agreements around the world. You will find some exclusivity when equity is involved but even then, it's not truly exclusive in most cases. The only exclusivity that makes sense in these kinds of alliances is when you create something unique together that others can't replicate."

Consider the case of the multibillion-dollar Microsoft and AT&T non-exclusive alliance where AT&T will use Microsoft's cloud services, and the two firms will work together on developing tools for Artificial Intelligence and high-speed 5G wireless for their mutual customers.[6] In the same week, AT&T and IBM announced another multibillion-dollar alliance where AT&T will use the IBM cloud for its business applications. The two firms will team up on developing cutting-edge computing platforms that harness 5G networks and Internet-connected devices.[7]

As the agreements are non-exclusive, AT&T is able to attract both Microsoft and IBM to enter into agreements that drive risk-sharing for AT&T, achieve technology diversification (across Microsoft and IBM clouds), gain higher signalling impact by expanding the target ecosystem than it would have by entering into an exclusive agreement with just one digital leader, and create a healthy competitive environment that will motivate digital leaders to offer their best to AT&T. These include benefits such as emerging technologies through the duration of the alliance. Collectively, these benefits have a positive impact on AT&T's cash flow generation objectives.

As seen from these examples, an industry leader can increase its attractiveness and deal negotiation power by adopting a diversified technology strategy, and desiring a lack of or a lower degree of alliance exclusivity during the alliance formation stages. In such cases, digital leaders tend to dig deeper into their pockets and use a range of their assets from across their ecosystems (e.g., training, reach, assisting with initial cloud transition, and joint media activities) in the form of investments to win over the industry leader. Digital leaders consider these investments necessary for them to win the logo in the short term and open doors for the long-term potential, even when the deal sometimes may not seem profitable in the short term. For digital leaders that have high levels of niche that overlaps with their competitors (e.g., Google Cloud and Amazon Web Services), this effect can be even more pronounced.

Interestingly, this is not a one-time event in the relationship. Industry leaders use the lack of exclusivity and their multi-technology strategy as an ongoing lever for negotiations with digital leaders, especially as the degree of alliance success and/or multiplexity grows. They would also try to avoid committing too much at the same time, keeping the pressure on the digital leaders, and enhancing their chances of ongoing negotiation through the duration of the partnership. While the digital leader consequently experiences a lower signalling benefit than it would have, had the partnerships been exclusive, those that approach with lower or no expectations of exclusivity increase their attractiveness, compared to those that expect high degrees of exclusivity. Once the alliance is formed, digital leaders strive to gain share and increase cash flow generation using various strategies, including platform enveloping.[8]

CONCLUSION

Over the last decade, organisations have generated US$3 trillion by making digital investments in growth and innovation in platform-based business models and improving operational efficiencies.[9] It is expected that digital transformation will continue to disrupt industries and businesses at breakneck speeds. As a result, firms will continue to form DEPs at an increasing rate in the foreseeable future. While there is no one-size-fits-all playbook to develop successful DEPs, research-based concepts and structures noted in this article can serve as a reference for leaders and managers engaged in such partnerships to enhance their chances of success. AMI

Dr Anurag Vij

is General Manager, Azure Cloud & AI Practice, at Microsoft Asia

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