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Strategic Partnerships

LESSONS FROM THE FIELD

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MANAGEMENT ACCOUNTING GUIDELINE

CASE STUDY

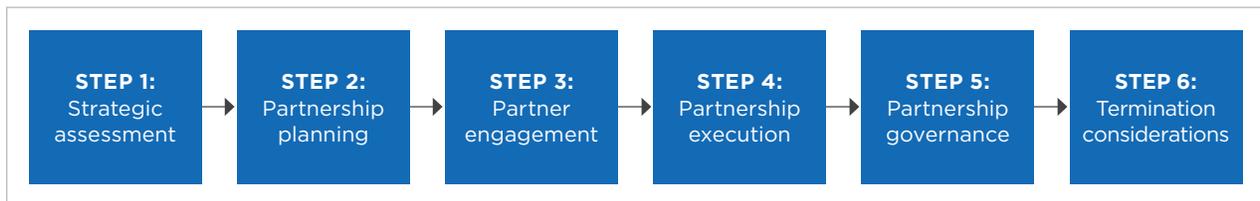
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Applying a Structured and Disciplined Process

The case studies in this publication, Patient Diagnostic Corp. and the Academy for Scientific Research, use the six-step process ([Figure 1](#)) described in the Strategic Partnerships [Guideline](#).

FIGURE 1: STRATEGIC PARTNERING PROCESS OVERVIEW



Case Study 1: Patient Diagnostic Corp.

Background

Patient Diagnostic Corp. (PDC) is a health care information company headquartered in Cleveland, Ohio. PDC creates clinical databases and delivers them to doctors, pharmacists, and nurses for patient treatment in hospitals, clinics, and nursing homes. These disease and drug data-bases, developed by teams of physicians and pharmacists and based on the most current findings in medical literature, are well entrenched within health care organizations in Canada, the United States, the United Kingdom, Australia, and New Zealand.

The company's products, sold on a subscription basis by in-country sales representatives, enjoy exceptional renewal rates (over 95 percent) in their established national markets, making the associated revenue streams virtual annuities for PDC. In the past fiscal year PDC's annual revenue reached US \$180 million and generated a very healthy EBITDA of 25 percent.

However, for several years the company has demonstrated anemic growth — the growth it has experienced has been almost entirely the result of price increases. Ironically, the company's stagnant position is largely attributable to its success: its product portfolio, which covers mission-critical areas of medical practice, is quite extensive and the company has effectively saturated the markets it serves. As a result, PDC has been largely unsuccessful in its recent product development and market expansion efforts.

STEP 1 Strategic Assessment

In response to its growth challenges, PDC has developed a two-pronged strategy: translating its database content to other languages to penetrate larger national health care markets and searching for potential alliances or acquisitions to broaden its scope and leverage its superior market position. Responding to said challenges also demonstrated the need to employ some or all of the drivers of the RAISE philosophy to ensure their resilience, adaptability and innovation in the face of continuous change and disruption.

Accordingly, the company's business development group recently held a strategic planning meeting and identified a number of promising companies as potential candidates for alliance/acquisition. In response, PDC's CEO emphasized the need to accelerate the prospecting process and assembled a team consisting of the senior vice-president (SVP) of business development, the SVP of sales and marketing, and the CFO to review the potential alliance/acquisition companies and develop an action plan and supporting analysis for his review.

STEP 2 Partnership Planning

When the business development group presented the final draft of PDC's strategic plan to its executive staff, the CEO endorsed it and reiterated the need to act on it with a sense of urgency. He also informed the group that he had assigned a team to pursue the alliance/acquisition component of the plan aggressively.

Candidate company identification

The team prioritized candidate companies based on the following criteria:

- That the organization provided mission-critical information and/or services to PDC's institutional market.
- That its offerings had international application.
- That its offerings were premium priced.
- That industry peers viewed it as a quality organization and that it had a reputation for customer satisfaction.
- That it had apparent, significant, and unrealized market potential.

The primary candidate that emerged from this process was a small, Cincinnati-based company, Hospital Care Excellence (HCE). HCE had developed a remediation service that identified and addressed avoidable adverse events in hospitals (e.g., hospital-related infections, patient falls, extensive pressure ulcers, and the administration of improper drugs). The service, integrated safety solutions (ISS), consisted of collecting data, using software that utilized a proprietary taxonomy to sort and analyze the data, and having nurses perform corrective training. It enables hospitals to pinpoint and correct areas of systemic weakness, thereby reducing medical complications that result in fatalities, extended hospital stays, and additional medical costs.

While ISS subscribers rated it highly, it was evident that a lack of resources had prevented HCE from gaining traction outside a number of metropolitan areas in Ohio. The PDC team estimated that HCE had generated US \$4-6 million over the past two years (based on its price point and the number of hospitals it served), which was, at best, only marginally profitable.

Despite HCE's seeming inability to grow its business, the PDC team believed that ISS was the only service of its kind on the market. Furthermore, the team believed the market potential for the service was substantial for two reasons:

1. Adverse events in hospitals are universal problems. As such, governmental and health care organizations put significant pressure on hospitals in all of PDC's major markets to address adverse events.
2. Common medical nomenclature used throughout these markets makes the service broadly applicable to health care institutions outside the United States.

Preliminary plan development

The PDC team assessed ISS's potential, based on it having the benefit of PDC's sales and marketing capabilities. The output of that assessment was a three-year plan that projected revenues expanding to US\$20-25 million, with pre-tax profit margins of 15-20 percent. Importantly, the plan estimated that this growth reflected only 10 percent penetration of PDC's major markets and that there was potential for substantial additional growth subsequent to the plan period.

Although the team was optimistic about ISS's potential, it did identify a potential barrier to broad market acceptance: given the intrusive nature of the service (it required hospital management and personnel to embrace the idea of identifying internal deficiencies and systemic weaknesses), there was a risk that the broader market might resist adopting it.

All factors considered, the PDC team requested approval from its CEO to engage HCE in discussions. The request included a framework for a potential alliance, which included the following major elements:

- An initial minority interest in HCE with an option to acquire a 100 percent interest;
- Representation on HCE's board of directors;
- Utilization of PDC's North American sales force to penetrate Canadian and U.S. hospital markets in order to validate ISS's market potential;
- A three-year window for the alliance to demonstrate "success," defined as an approximation of projections presented in the accompanying plan;
- A prospective purchase price based on pre-established metrics (e.g., multiples of revenue or EBITDA) if market potential is validated;
- An exit plan if HCE decides not to exercise its option.

PDC's CEO approved approaching HCE management with this framework to determine if a relationship was possible.

STEP 3 Partner Engagement

PDC's SVP of sales and marketing, Richard Kent, who had participated in the internal planning process and who knew HCE CEO Raymond Zoeller personally, was nominated to make initial contact. The two agreed to meet at an upcoming trade show to discuss possible forms of intercompany collaboration.

At this initial meeting, Zoeller, who held 90 percent of HCE's outstanding shares, made it clear that he had no interest in an outright sale of HCE to PDC. He felt that a sale at this time would be premature because he believed HCE's value (i.e., its selling price) would be significantly sub-optimized. Zoeller did agree that an association with PDC would very likely accelerate HCE growth. Kent floated the idea of PDC acquiring a minority interest in HCE with the possibility of acquiring the company outright at some future date. Zoeller indicated that this prospect was interesting enough to warrant another meeting, this time with a small group of each organization's executives, to discuss potential synergies, market opportunities, and company philosophies. Because they would be exchanging proprietary information, they agreed to execute nondisclosure agreements in the interim.

Meeting to establish strategic and cultural compatibility

Representatives from the two organizations met and discussed their respective views of the hospital markets, the potential of ISS, the ability of PDC's sales force to sell the service, and any perceived impediments to collaboration. There was general agreement that the companies were a good strategic fit. Both operate within the hospital information market and service the same constituencies, namely nurses, pharmacists, and physicians. In addition, there did not appear to be major differences in corporate culture or management approach. The only cultural issue that surfaced was the product versus service orientations of the two companies, but the representative agreed that this gap was bridgeable by training PDC sales staff and familiarizing HCE personnel with PDC's products. Zoeller also agreed in

principle (and subject to negotiation) that the best form of the relationship would be a minority equity interest by PDC in HCE. He further agreed to provide PDC with detailed financial information as well as access to HCE's CFO and outside accountant if clarification was required on any issues. Subject to a satisfactory result of this due diligence review, the representatives of the two companies agreed to re-adjoin to develop a joint three-year business plan.

Joint business plan

When the representatives re-adjoined to move forward on the three-year business plan, they identified the best prospects in the North American hospital market and projected revenue of US \$24 million by the end of the third year, which was generally consistent with PDC's internal estimates. The projections assumed an aggressive effort by PDC's sales force, led by PDC's director of North American sales, along with the leveraging of established relationships between PDC sales representatives and key decision makers in PDC's customer base. The plan further assumed that HCE would only incur the commission expense associated with sales of ISS. PDC agreed to provide IT support to HCE, but all other functions (e.g., customer service, fulfillment, billing and collection) would be the responsibility of HCE.

In a separate session, and in anticipation of final negotiations, Zoeller and Kent discussed the terms of PDC's investment. Both parties saw the relationship as a bridge to a full acquisition if they achieved the results outlined in the joint business plan — they agreed to part ways if they failed to achieve these results (with PDC having an exit strategy and HCE able to proceed independently with no further obligation to PDC). If the collaboration proved successful, Zoeller, as majority shareholder, would reap the benefits of accelerated growth in the form of HCE's significantly increased valuation. PDC, meanwhile, would acquire a profitable company with substantial additional growth potential.

STEP 4 Partnership Execution

The joint business plan and pre-negotiation discussions set the stage for the finalization of an agreement and the launch of the partnership.

Negotiation

PDC's SVP of sales and marketing (assisted by PDC's CFO and legal counsel) led negotiations. The HCE team consisted of its CEO, CFO, and attorney. Having agreed upon most contractual details and core issues in principle, the parties proceeded to reduce those core issues to contractual language.

The result was agreement that:

- PDC would purchase a 20 percent interest in HCE for US \$1 million with a provision that this cash injection would fund operations rather than be distributed to shareholders.
- PDC would have two positions on HCE's seven-member board of directors.
- For a period of up to six months after the third fiscal year of the contract, PDC would have the option to purchase all remaining shares for the greater of US \$12 million or four times the previous year's EBITDA.
- If PDC chose not to execute its option, HCE may repurchase all of PDC's shares for the nominal amount of \$1 per share.

Launch

Upon execution of the agreement, PDC announced the alliance internally and to the industry through various media. The internal messaging took the form of a jointly issued memo from the two CEOs to all PDC and HCE employees. PDC supplemented this announcement by convening employee meetings at regional sales offices where managers explained the nature of the alliance, the role sales representatives would play, and how and when representatives would be trained to sell this new service.

Similarly, HCE assembled staff at its headquarters to announce the formation of the partnership and to field employee questions. HCE got the message out externally by issuing a press release to media outlets and sending print and electronic communications directly to customers. In addition, both organizations displayed the announcement prominently on their web sites.

Within a month after the announcement, HCE rotated staff through PDC's regional offices to train sales reps, while PDC launched an aggressive promotional campaign to its existing customers.

STEP 5 Partnership Governance

PDC and HCE maintained the momentum generated by the launch of the partnership by establishing strategic and operational links between the two organizations. PDC's SVP of sales and marketing and its director of North American sales filled the two PDC seats on HCE's board. This enabled PDC to influence and monitor HCE at the strategic level. The inclusion of PDC's director on the board established a direct connection between strategy and operations, since he had responsibility for operational management of the ISS sales effort. This also helped ensure that PDC's sales force was properly trained and motivated to sell the service. PDC's director of North American sales also developed detailed monthly reports on sales activities and quarterly reports analyzing progress toward targets and planned activity. HCE's board used these reports at its quarterly meetings to monitor the sales initiative. Regular informal contact between PDC's director and HCE's CEO and his staff supplemented formal reporting.

STEP 6 Termination Considerations

Strategic partnerships are generally a bridge to the future. When successful, they take on another form. In this case, that would be an acquisition. However, even when a partnership is grounded in detailed planning and disciplined execution as was the PDC/HCE relationship, other factors can undermine its success. When this occurs, it is frequently the result of change — change in the market, change in one party's strategy, and/or change in key personnel at one or both of the partnering organizations. The scenarios presented below describe two different outcomes that illustrate these points.

Scenario 1

Three years into the relationship, sales ramped up significantly. However, the partnership did not meet the targets established in the joint three-year plan. Revenue, at US \$19.5 million, was about 20 percent below projections. This shortfall was attributed to a much longer than expected sales cycle — the result of the need to overcome initial pockets of resistance to highlighting errors by hospital personnel. Profitability, on a percentage basis, did approximate projections, with EBITDA margins of 18 percent. With a solid pipeline of prospective sales and confirmation that the service had significant growth potential, PDC management decided to exercise its option. One month before its option expired, in accordance

with the governing agreement, it acquired the additional shares of HCE for a purchase price of about US \$14 million.

Scenario 2

A year into the partnership, PDC's CEO left the company. The new CEO believed that future growth should be driven by the development and acquisition of additional medical databases, rather than services. This strategic shift marginalized ISS at PDC and sales representatives became frustrated by the extended sales cycle required to sell the service. Acquisitions of several new database products aggravated this situation: sales representatives found it easier to sell these new products than to sell ISS.

To further damage ISS's allure, a competitor introduced a comparable product to the market a year after the partnership had been formed. As a result, ISS sales lagged substantially behind projections. HCE management bitterly attributed the lack of sales to insufficient effort and the inability of PDC's sales representatives to sell sophisticated products.

PDC sales management ascribed the anemic sales to product weakness. These conflicting views deteriorated the relationship. By the end of the third year of the partnership, ISS revenue had grown from US \$5 million to US \$9 million, less than 40 percent of original projections. As a result, PDC chose not to exercise its option and HCE re-acquired PDC's outstanding shares, thereby ending the relationship.

Case Study 2: Academy for Scientific Research

Background

The Academy for Scientific Research (ASR) is a for-profit organization headquartered in Toronto. ASR's flagship product, the Science Research Index (SRI) is an extensive database of scientific literature from the world's 5,000 most prestigious scientific journals. The database consists of summary information from the articles appearing in these journals for the last 50 years. The summaries are linked by the articles' citations, which enables researchers to easily navigate the database and dramatically facilitate their research efforts.

ASR was a small, niche information company prior to 1999 when ASR migrated its multi-volume, paper-based products to the Internet. Since then, SRI has become a standard search tool for virtually every major research institution (i.e., large university and governmental research centre) in Canada and the U.S. It is premium-priced (C\$40,000 per year per institution) and sold on a subscription basis by field sales representatives. Driven primarily by the success of the SRI, annual revenue had grown to C\$200 million by 2011.

After opening sales offices in Brussels in 2005 and Berlin in 2006, ASR has seen a surge in European sales. It presently generates 25 percent of its revenue from that market and the company projects more than 10 percent revenue growth in this market for the next several years. However, for logistical reasons, ASR has had difficulty penetrating Asian markets, which account for less than five percent of its annual revenue. ASR does believe, however, that there is significant pent-up demand for its products in the region. During its annual strategic planning sessions, discussions focused on penetration of these markets.

Discussions around the approach to penetrating these markets demonstrated the need to consider how ASR would remain resilient, adaptive, innovative and sustainable given the confluence of internal and external forces.

STEP 1 Strategic Assessment

During ASR's annual strategic planning exercise, the planning team considered a number of options to penetrate Asian markets, including:

- Opening sales offices in Tokyo and Hong Kong or Singapore.
- Acquiring a data distribution company that services the Asian markets.
- Partnering with a data distribution company in the region.

Although establishing sales offices in the major national markets was ASR's ultimate goal, it became apparent that the ramp-up time and resources necessary to do so would be significant and would actually delay the launch of an aggressive sales effort. ASR realized that acquiring a data distributor was impractical and unattractive, since the successful distributors in the region sell a range of information products many of which serve markets of no interest to ASR.

The planners concluded that finding a strong partner with distribution capability was the most attractive alternative because it would enable ASR to penetrate the market quicker and it would initially require minimal internal resources.

The planning team drafted a recommendation to pursue this alternative, indicating that this approach could potentially increase the company's regional revenue by 20-25 percent per year over a four-year period. The leaders of the planning team — the senior vice president (SVP) of strategic planning and the SVP of sales and marketing — presented the recommendation to ASR's CEO, who approved it and arranged for a presentation of the initiative at her next executive staff meeting.

STEP 2 Partnership Planning

At the subsequent executive staff meeting, ASR's CEO had the SVP of sales and marketing present the initiative, making it clear that she endorsed it. She then appointed a team (the SVP of strategic planning, the CFO, the vice-president (VP) of operations, and the SVP of sales and marketing) to develop a plan to execute the initiative.

Partner identification

The team proceeded to identify potential partners and assessed them based on the following criteria:

- Sales strength in key geographic markets (specifically, Japan, China, South Korea).
- Ability to market and sell sophisticated, English language data products.
- A portfolio of products that don't compete with ASR's products.
- A reputation for quality service and integrity.

The team narrowed the field to two firms, with one—Eastern Data, Ltd (EDL) — appearing to measure up best. The group determined that ASR's SVP of sales and marketing would initiate contact with EDL's CEO, requesting a meeting at EDL's Hong Kong headquarters to discuss possible collaboration opportunities. In the event that EDL rebuffed ASR or if negotiations broke down, the team planned to approach the other firm it identified.

Preliminary plan development

The team developed a plan for various aspects of the distribution initiative, specifically identifying:

- Which national markets were the highest priority (China and Japan).
- How the prospective relationship would be managed (by an in-country director-level ASR employee stationed in Hong Kong).
- How distributor personnel would be trained (a one-week session at ASR headquarters).
- The timing of the launch subsequent to engagement of a partner (three to four months).
- The formula for distributor compensation (roughly 20 percent commission).
- Where the relationship would ultimately lead (ASR would migrate to an employee sales force in four to six years).

The team then developed a three-year projection of revenue and gross profit. Lastly, they considered potential risks associated with the initiative along with mitigation strategies. The major risks included the potential premature breakdown of partnership and/or poor performance of the distributor. To minimize these risks, the team agreed that ASR would exercise close, in-market management of the distributor and consciously establish a non-adversarial relationship from the outset that would hopefully carry through contract negotiations and implementation. The team presented the plan to ASR's CEO who subsequently approved it.

STEP 3 Partner Engagement

Three weeks after approval, the ASR executive traveled to Hong Kong and met with EDL's CEO. EDL was enthusiastic about the prospect of partnering with ASR—EDL was familiar with ASR's offerings and thought they would be an excellent addition to its product portfolio. After extensive informal discussions, the parties agreed to convene a working session of ASR and EDL managers a month later to assess the opportunity in detail and craft a plan to maximize market penetration over a three to five-year period. In addition, the parties agreed to execute non-disclosure agreements (NDAs) and EDL's CEO agreed to provide ASR with:

- three years of audited financial statements to confirm the company's economic viability.
- access to several long-standing EDL clients to confirm the company's commitment to quality service and partnership collaboration.

Joint partnership plan

Having executed the NDAs and satisfied ASR's due diligence objectives, the partners convened a joint planning session to refine the sales projections developed by the ASR planners. EDL identified the richest opportunities — by national market and largest institutions (research centres) in those markets. In addition, EDL committed to revenue targets by market. ASR, in turn, agreed to underwrite a training program for EDL sales reps at ASR's Toronto headquarters a month before the launch of the initiative.

The joint distribution plan projected revenue of C\$25 million by the end of the third year of the plan. In addition, the companies' representatives identified major contractual and operational issues to be addressed in subsequent discussions. These issues included: exclusivity, pricing, commission rates on new and renewal sales, coordination of fulfillment and customer service, and inter-company communication and reporting.

STEP 4 Partnership Execution

The engagement process sets the stage for negotiations.

Negotiations

ASR's SVP of sales and marketing, assisted by the CFO and legal counsel, led the negotiations. The EDL team consisted of its CEO, its director of sales and marketing, and its attorney. The previously developed joint business plan served as the basis for a multi-year agreement. ASR approached contractual and operational issues with a keen interest in creating a win/win relationship. The company's short-term objective was rapid market penetration — ASR believed it was capable of replicating the subscription renewal rates it boasted in established markets (over 95 percent) and building a sales infrastructure in the region during the agreement term.

Negotiations resulted in an agreement with the following major elements:

- Territorial coverage to include Japan, China, South Korea, Taiwan, Thailand, Singapore, and Malaysia;
- A four-year term with exclusive distribution rights for EDL and cancellation notice at least six months prior to the end of the term;
- A relatively generous performance threshold (ASR had the right to terminate the contract if sales were less than 60 percent of projections for the entire region two years in a row);
- A 20 percent commission on new sales and renewals.

The issue of dispute resolution remained a sticking point between the partners. EDL expressed concern about having the contract governed by Canadian law because of the cost and inconvenience of having disputes litigated in Canada. Through mutual agreement, the partners decided to resolve all contractual disputes through arbitration.

Launch

Upon agreement, EDL announced the partnership via a press release along with articles about SRI in local influential academic publications. EDL sales representatives attended a week of training at ASR's headquarters in Toronto and, two months later, EDL and ASR sent managers and sales personnel on a conference tour, which the partners promoted heavily through social media. The tour, a series of product presentations to researchers and head librarians in target markets, successfully generated market and sales force enthusiasm.

STEP 5 Partnership Governance

After a successful launch, ASR maintained the initiative's momentum by focusing on management of the partnership. A newly established position, director of Asian sales, stationed in Hong Kong and reporting directly to ASR's SVP sales and marketing, oversaw management and governance of the initiative. The director of Asian sales traveled throughout the region, visiting prospective customers with and without EDL sales representatives, establishing relationships, and gaining market knowledge. In addition to regular and informal contact with ASR and EDL personnel, the director's organizational, analytical, and reporting responsibilities included:

- Monitoring the monthly sales and trip reports of EDL representatives via sales management software.
- Analyzing and reporting on sales to the SVP sales and marketing on a monthly basis.

- Meeting with EDL sales management quarterly to review activity and milestones.
- Organizing and hosting an annual meeting of EDL sales representatives and ASR product specialists, as well as EDL and ASR executives, for training, budgeting, team building, and recognizing accomplishments and the critiquing of the performance of the prior year.
- Building a small staff to help manage the partnership and establish an employee presence in market.

These activities enabled ASR to accumulate market knowledge, monitor distributor performance, and ensure a strong working relationship between the two organizations. It also positioned ASR to take a more active role in regional sales activity in the future.

STEP 6 Termination Considerations

After three years, Asian sales exceeded expectations, accounting for more than 10 percent of ASR's worldwide sales. During that period, ASR planned a phased approach to modifying the relationship and shared its vision of that process with EDL at the beginning of year four. At the end of that year, ASR's Asian region sales force (soon to be seven employees) would assume sales responsibility for the Chinese, Japanese and South Korean markets. To ease the transition, ASR planned to commission EDL on renewal sales in these territories for one year even though EDL would not have to dedicate resources to that effort. Under this plan, for the next four years EDL would retain responsibility for the Southeast Asian territories it presently serviced and it would also have exclusive distribution rights to previously under-serviced markets (e.g., Indonesia, the Philippines, and Vietnam).

Postscript

ASR's transition process ultimately led to the development of an in-house Asian sales force, which made EDL's representation in northern and southeast Asian markets unnecessary. Moreover, this approach served as a model for ASR's distribution initiatives in other under-exploited markets such as South Asia and Latin America.

Taken together, the drivers fulfilled both the resilient and adaptability drivers in the RAISE philosophy as they are meant to be strategic and long-lasting, able to withstand and adapt to the disruptive and ever-evolving demands of the marketplace.



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