

A study of Joint Ventures
The challenging world of alliances



Executive summary

Especially in periods of market or operational uncertainty, joint ventures can be used effectively as an alternative to a merger, acquisition or even organic growth.

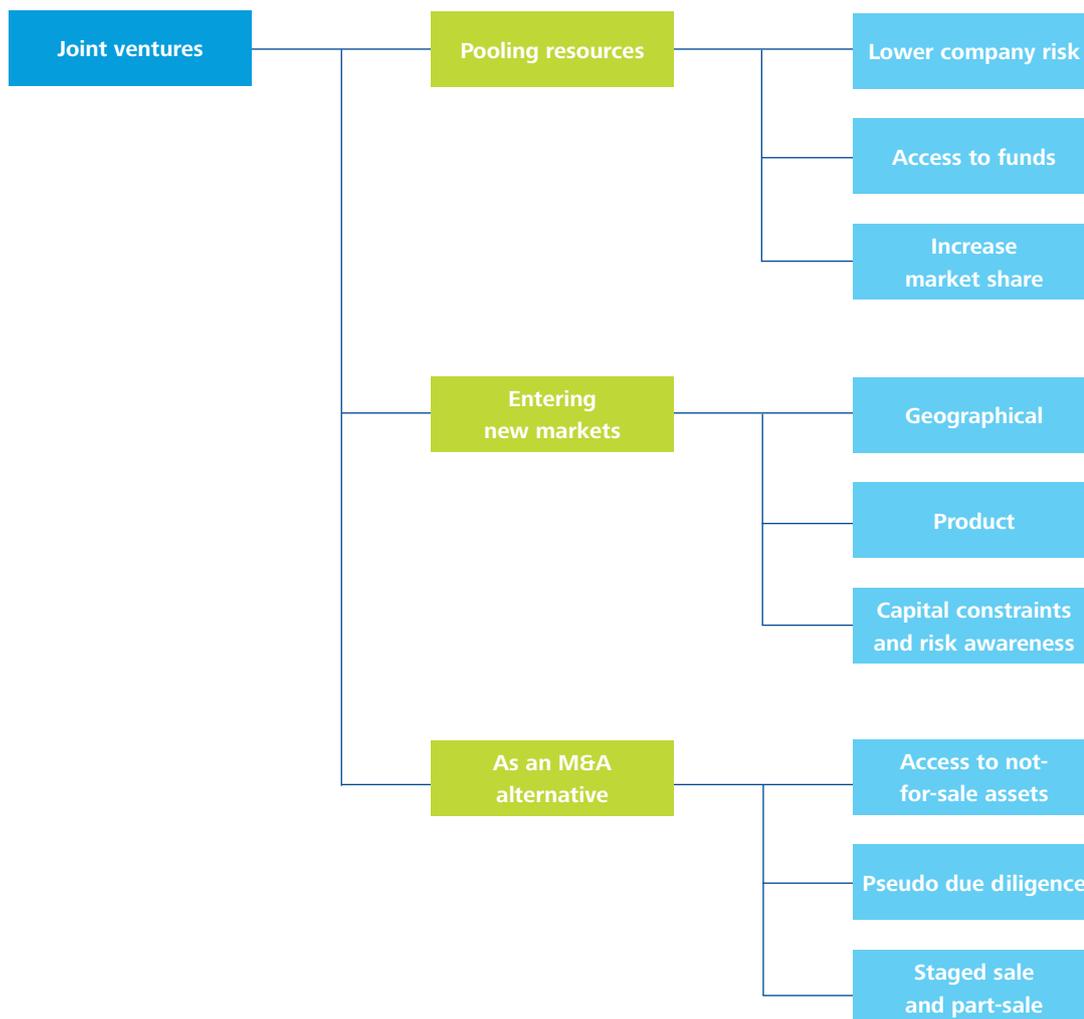


In the context of uncertain market and financial conditions, JVs can achieve growth while minimizing risk levels. This document summarizes some research findings and key issues when pursuing a JV project.

- **JV activity increases in the recovery period after a major economic downturn by over 20% above average levels**
JVs can be used to share the risk in new projects or as the first step of M&A strategy
- **JV deals are effective at decreasing company risk**
Increased RoE and decreased beta
- **Choosing a partner carefully is instrumental to the success of a JV**
Participants' cultural fit, deal experience and trust between participants emerging as critical factors
- **Successful JVs rely on the clarity of their purpose and control as well as strong management support**
The commitment of senior executives in the parent company on a consistent and continued basis can secure the delivery of the original vision
- **The average duration of a JV (3 years) is shorter than expected, which emphasizes the importance of an exit strategy**
Pressure should be put on participants to have a clear exit strategy in place from the very beginning of the collaboration. The preferred exit strategy is a sale of assets to one of the partners

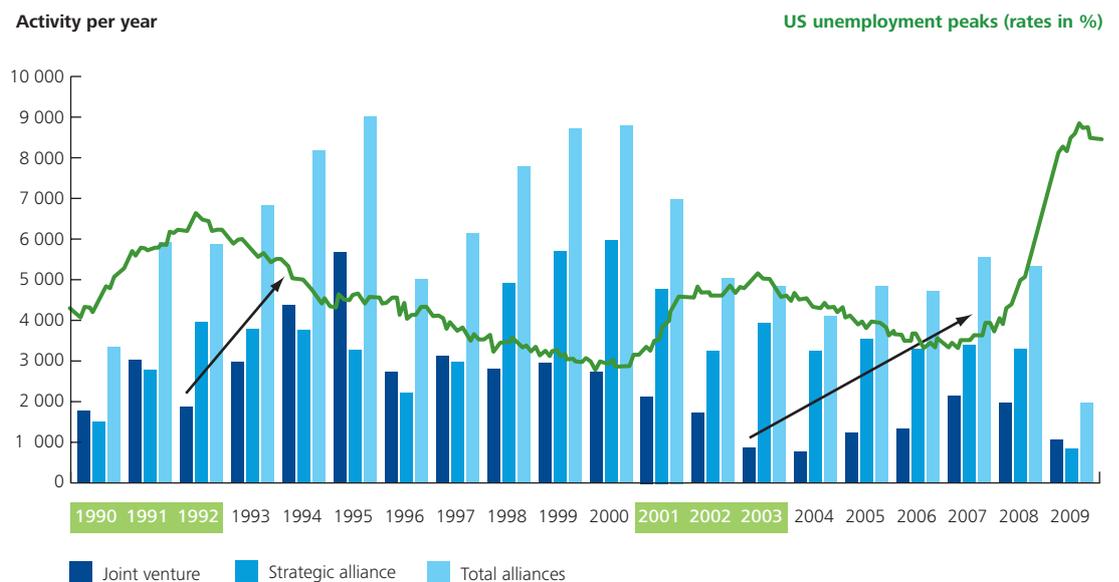
Why JVs?

In our recent research there were 3 main reasons why companies pursued JVs as part of their strategy



Following major economic downturns, JV activity comes to the fore

Increased activity reflects the switch from conserving cash to looking for growth, balanced by a need to share risk.



Source: CASS Business School - "Sharing Risk: A Study of Corporate Alliances" December 2009 - Sponsored by Deloitte

Credit scarcity in the wake of economic downturns also offers a powerful driver particularly for companies with high levels of:

- R&D intensity (R&D as a percentage of sales);
- Leverage (total liabilities over total assets);
- Capital intensity (total assets over total sales).

Industry research shows a cyclical nature to joint venture activity with recent relative growth in the Media & Entertainment sectors.

JV Activity Trends

- JV activity is highest in the recovery period following a major economic downturn
- JV activity increases both relative to M&A activity and in absolute terms following a major economic downturn
- JVs considered viable alternative to M&A in times of recovery due to capital constraints and risk minimisation

Point in time of economic cycle	Relative activity (JV/JV + M&A)	JV quarterly activity
After major peak	13%	561
Before major trough	8%	298
After major trough	16%	640
Before major peak	8%	420

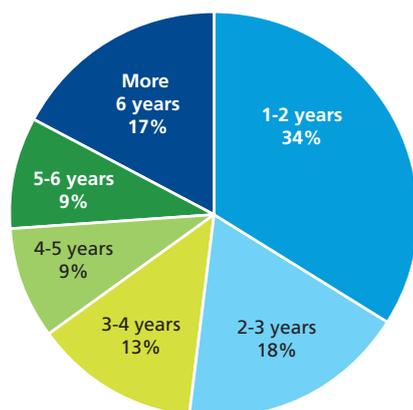
JV Duration

- Most JVs will end sooner than most managers expect
- Median duration is 3 years
- Having a proper exit strategy in place at the start of the JV is key

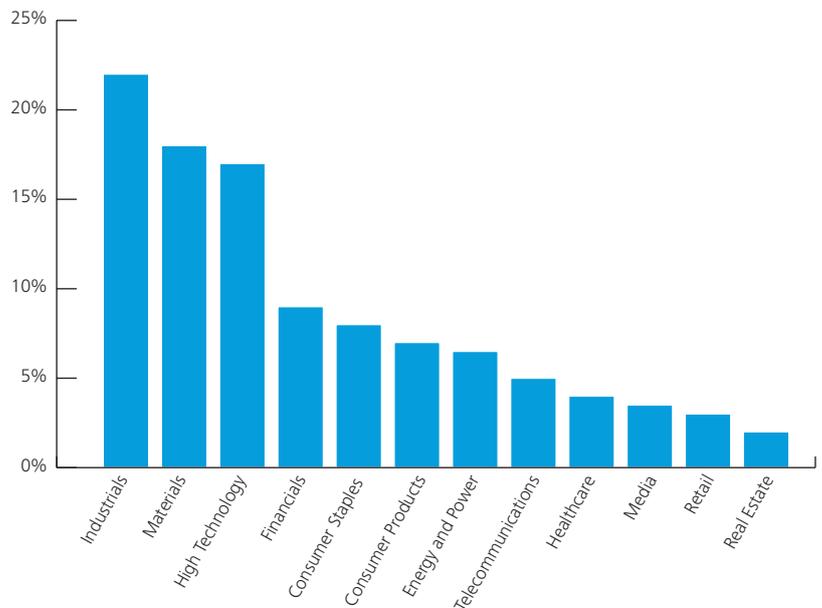
JV Sector Analysis

- Majority of JVs are in "Industrials", "Materials" and "High Tech" sectors driven by R&D intensity (over 50% of total JVs)

Medium duration: 3 years



Activity as % total

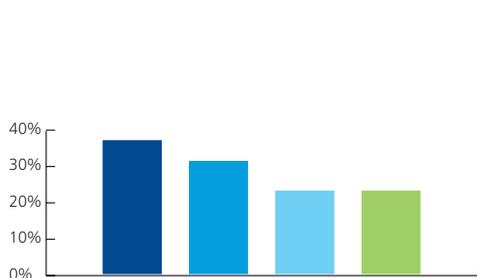


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Results of a Survey conducted between December 2009 to March 2010 with 20 French groups

Among the panel, 85% of interviewees have experienced successful JV projects and more than two thirds foresee current economic conditions as favorable for these alliances.

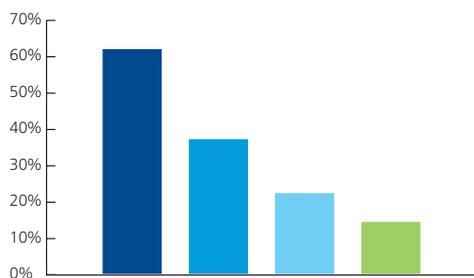
What have been the primary reasons of the Joint Venture ?



Top priorities

- Sharing of operating risks / Costs / Investments
- Access to other customers and markets
- Alternative to an acquisition in cash
- Access to additional capability or capacity

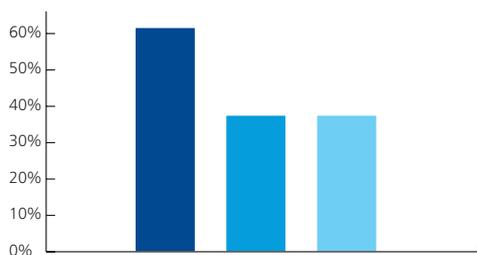
What have been the biggest issues to set up the Joint Venture ?



Top priorities

- Governance
- Cultural differences / Lack of trust
- Social / Human capital
- Regulatory / Deal structuring

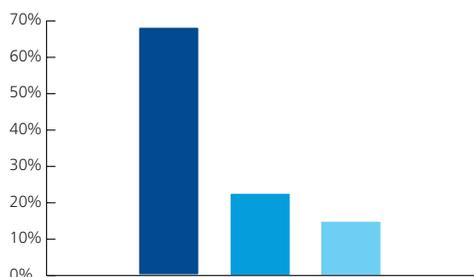
What have been the biggest issues during the Due Diligence phase?



Top priorities

- Financial due diligence
- Legal, Tax and regulatory
- Operational due diligence

What have been the biggest issues during the negotiation phase?

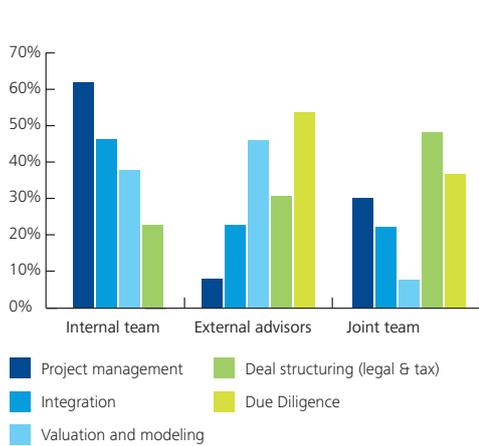


Top priorities

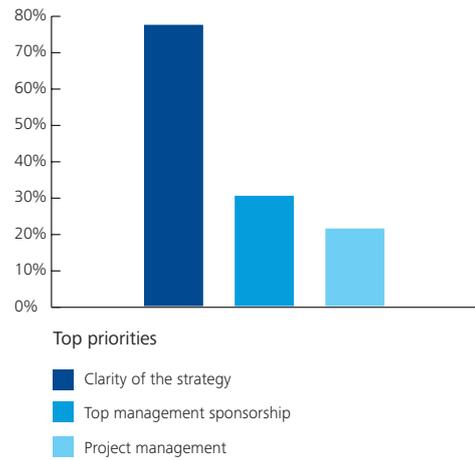
- Governance and conflict resolution
- Alliance agreements
- Exit scenarios

Clarity of the strategy, governance and management are the top 3 priorities of the interviewees.

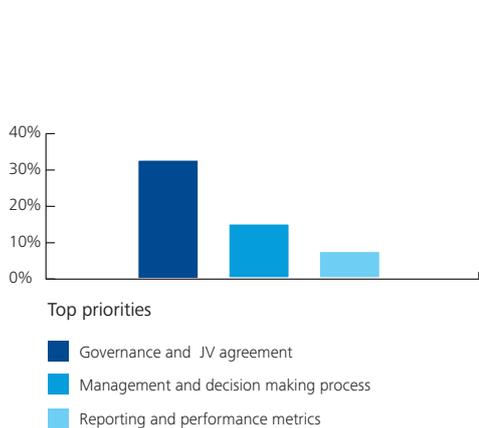
What is your experience and your recommended organization for a Joint Venture project?



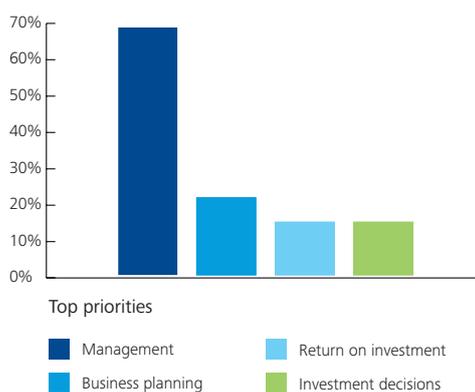
What would be your top 3/5 recommendations to improve the implementation of a Joint Venture project?



What would you change from your experience of the Joint Venture day to day operations?



What are the most critical points generating conflict situation between partners?



How have JVs fared (1985-2009)?

The average JV participants' RoE increased significantly, from 1% to 7% above industry average over a period of four to five years. Choice of JV partner significantly impacted JV performance.

A higher RoE is more likely if:

- JV partners are of a similar size: Significant negative correlation where partners were very different in size, size being a proxy for corporate culture
- Either of the JV partners have M&A experience: Significant positive correlation where at least one of the partners had previous experience in setting up a joint venture

RoE is adversely impacted if:

- JV partners are close competitors: Information-sharing versus protecting business intelligence impacted performance (JV partners which were not competitors had an increase in RoE from 3% to 9%)
- JV partnerships are domestic rather than cross-border: Cross-border partnerships outperformed the average partnership (cross-border JV partners had an increase in RoE from 2% to 10%)

Sample: The sample was restricted to deals where the average of the two-participants' relative size to the joint venture was above 5%. The final sample of 75 companies had a median market value of \$2bn.
Return on Equity: RoE is calculated as income available to common shareholders over common shareholders equity, from the year prior to the announcement to three to four years after. Values were adjusted by deducting corresponding industry median values from companies' actual RoE values (i.e. the average JV participant had a RoE one year prior to announcement of 1% above industry, increasing to 7% above industry three/four years later).

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Pros and cons of JVs and strategic alliances

Creating a joint venture can be viewed differently by the parties. One could see it as the first step in a staged sale and at the same time the other as a thorough due diligence and valuation process for an ultimate purchase.

Pros

- Opportunity to leverage the distinct strengths of both partner organisations
- Cuts investment or funding costs versus developing commercial opportunities in house
- Partner skill set should be complementary, making the value of the JV greater than the sum of its parts, as well as providing quick and low cost access to expertise in an area where you are weak
- Reduces downside risk should partnership not deliver the expected/ hoped for returns
- Increased power over the activities and principles guiding the JV's operations and objectives compared to a minority interest investment
- Allows a deal to be done when funding might otherwise preclude it, since you can contribute things other than cash, such as assets, IP or know-how

Cons

- Still no overall control. In the event of deadlock between the partners there has to be a mechanism for making decisions, and this will almost by definition not always deliver each partner's preferred outcome
- Whilst some services might be provided to the JV by each of the JV partners, there will clearly be some potential synergy opportunities that are undeliverable under this structure
- Rewards of success shared with the JV partner
- An exit plan needs to be worked out up front to avoid disagreement and deadlock between the partners that destroys value. In addition, the JV partner may simply use the knowledge gained through the JV to set up in competition themselves. Protect against this.
- Likely complex diligence process
- SPA and other contractual terms will need to be carefully drafted

It's finely balanced...

Top 10 challenges for every JV

A joint venture must have a clear definition of scope that permits and defines partners' freedom to compete outside that scope and equally prevents any competition within.

There are a number of challenges which will need to be addressed during the establishment of the JV

The Vision

The vision for the JV is critical. It needs to be properly communicated and translated into a practical series of deliverables for all to understand. If this is poorly defined, it will take longer to deliver, with increased cost, and erosion of profits.

The early development of a "Blueprint" is critical to set out the vision for the business, providing clarity of purpose and a basis for communications. Defining the operating model will enable Newco to be appropriately planned, setting a clear vision for Day 1 through to completion.

Organisational Governance

Establishing the JV's Board and its governance arrangements are especially challenging because each partner (and the JV's own management team) has different agendas, needs, ideas and priorities. Sensitivity to the interests of all can result in delays, unresolved issues and political difficulties.

Establishing the objectives of the JV early, the constitution of the Board and the governance structures, creates a framework for decision making and issue resolution. This will ensure management deliver both the requirements of the respective parent companies as well as the ongoing business of the JV.

Management team

Any new enterprise requires exceptional leadership to deliver the objectives of the stakeholders. The additional complexities associated with a JV means that without a rapid and clear allocation of roles and responsibilities the JV will suffer.

Appointing an effective and empowered Management team, responsible to the Board is critical for driving the JV's value.

Parent companies' senior executive sponsorship

Without visible and vocal commitment from appropriate senior executives with accountability in the Parent Company organisations, even the more strategically compelling JV will fail.

The commitment of senior executives at the parent companies on a consistent and continued basis will secure the delivery of the original vision

Identification of the challenges and preparing a well executed response to each one are critical to driving the potential success of a JV

Changing times

Establishing a series of guiding principles to deal with changing circumstances is likely to improve the likelihood of success. A narrowly defined set of rules and regulations is likely to result in delays and potential stalemate as Management teams struggle to respond to changing circumstances

Investing time up front in the JV's guiding principles will be time well spent. Overtly legal arrangements rarely work

Synergy Delivery

Often JVs are established to deliver synergies neither parent could achieve independently. They are likely to be critical to success. Delivery of synergies sooner than planned will drive the expectation of further success.

It is necessary to define the sources of benefits early and the plans to deliver them at lowest cost. Programmes require a robust financial tracking mechanism to report progress and alert any possible delays.

Integration vs Transformation

A rapidly delivered integrated business model is stage one.

The integration should bring the two organisations together working effectively as one as quickly as possible. Improving the JV with transformational change should be managed subsequently.

Managing People

JVs are rarely transacted speedily. A prolonged transaction timeline will be distracting for employees. As they consider their own positions as well as form views on what an integration with a competitor may mean for them, there is a risk of biased views delivering suboptimal solutions and a loss of focus on the current business.

It is essential to retain and motivate key talent, win the hearts and minds of all employees, and provide certainty where possible. This requires an effective communications programme.

Response of competitors and customers

The transaction announcement is a chance for competitors to aggressively seek to win market share by exploiting the distractions caused by the new JV. Mutual or new customers may become confused by the new direction, product offerings, brands and service levels.

A focus on customer retention will be required throughout the transaction and JV establishment period to minimise disruption. Competitor action and spoiling tactics need to be built into the strategy and scenario planning work should be performed.

Original businesses

The impact of a significant JV can be extensive on the parent organisations. Understanding and managing the multiple touch points and interfaces is critical to ensure that the existing business continues to operate effectively.

Early and comprehensive definition of the areas of interface and the plans to manage them are critical. Too many of these may bring in to question the likely success of the JV. These programmes, like those for the JV itself, require a robust financial tracking mechanism to report progress.

Exiting

Planning your exit is as important as planning for the JV. Look at the options. Discuss them openly with your partners and don't be too prescriptive.

By raising the topic early on, both parent companies and JV Management can articulate potential exit scenarios. Legal agreements are rarely effective at protecting the parties from changing circumstances.

In our experience there are some consistent themes in setting up successful Joint Ventures...

Successful Joint Ventures

Clarity of purpose

- Make sure that the rationale and objectives for the JV are set out clearly from the start for all parties
- Communicate clearly to ensure broad "buy-in" across the organisation
- Identify the sources of benefit and establish clear ownership and accountability
- Agree how value will be derived and shared with the JV partners
- Focus on a small number of critical initiatives
- Build the "blueprint" for the JV as early as possible.

Control

- Implement robust planning and programme management processes to underpin the JV objectives
- Give careful consideration to the appointment of the JV leaders and how they work as a team
- Allocate your best people to managing the implementation of the JV
- Make planning and reporting frameworks as practical as possible
- Tackle risks and issues quickly and take the tough decisions early
- Track benefits rigorously and ensure only one set of numbers

Managing people

- The successful management of the people dimensions of change is the principal difference between success and failure
- Recognise that major changes increase uncertainty and ambiguity
- Remove uncertainty as quickly as possible through open, honest and timely communications
- Involve and prepare the HR team early on, ensuring it is skilled and fully resourced
- Plan for change at all levels across the organisation and ensure effective support and training is available
- Realign objectives and rewards with the objectives of the JV

A joint venture is like a marriage; you need to put time and effort into the relationship with your partner.



Finding the perfect JV partner

A local partner can help us overcome language barriers, mitigate cultural issues and give us direct access to local customers. In exchange, we give them either funding or management and organisational know-how.

What makes for the perfect partner? – A practical checklist for your lead negotiator

- Do you trust your direct counter-part at the partner company?
- Are the beliefs and culture of the other party's organisation similar to yours?
- Do you describe the JV in similar terms and in complementary ways?
- A joint venture is a mirror exercise; will your business be able to cope with the commitment required to make a jointly run business a success? And theirs?
- Have you agreed on who's running the JV? Is there balance and logic to what's been agreed?
- Is the other party committed to a mutually beneficial relationship?
- Will the other party be able to meet the long-term obligations on both the financial and strategic fronts?
- Do they provide full and accurate information during the negotiations?
- Do they deliver on time?

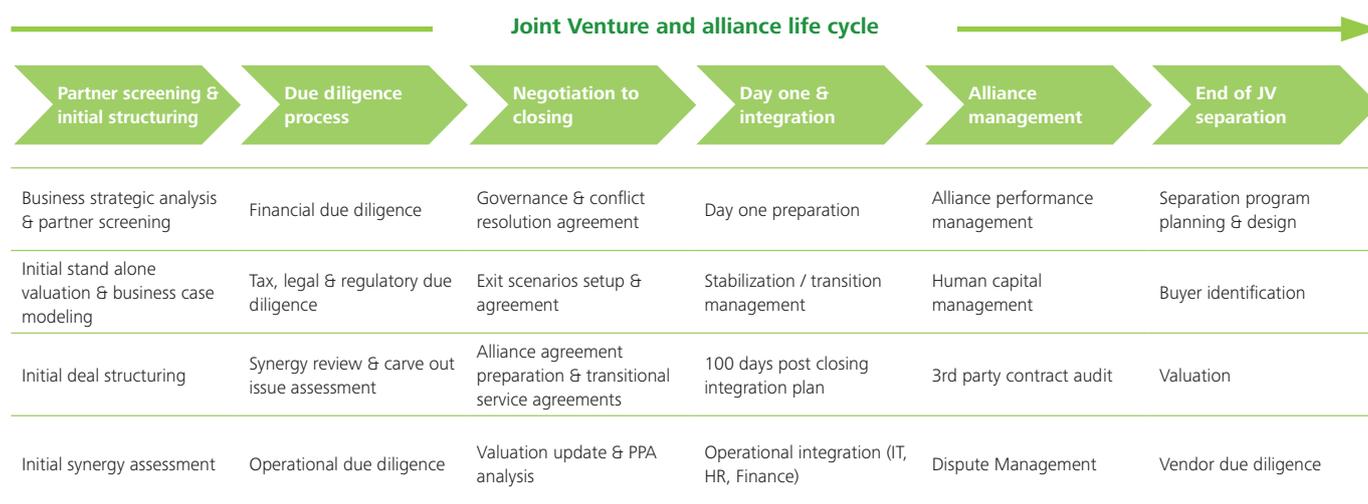
Establishing Governance arrangements

If the two partners are too different in size, the smaller partner runs the risk of getting lost in the corporate governance of the larger firm.

JVs have additional challenges around their governance that need to be addressed at an early stage

Aspect of Governance	Typical Public Company	Additional Challenges for Joint Venture
Board Composition	Board members are not employed by shareholders equally	Board members are typically employed by 1 of the shareholders, creating potential conflicts of interest
Board Roles	Board focuses on approval of major strategic decisions, CEO succession, risk management	Board must manage conflicts between shareholders, secure resources from shareholders, monitor transfer prices/parent transactions, manage career path of management team
Decision Making	Investors unite in desire to maximise shareholder returns, manage risks	Key decisions (e.g. Strategy setting, capital planning) require agreement among a few large shareholders, which may have very different interests, financial constraints, view of market
Management Team	Management team are accountable to CEO and board	Key members of venture's management team (e.g. CEO, COO) are former employees of 1 parent; many likely to see future career tied to returning to that parent
Resource Flows	Venture does not depend on shareholders for any operational inputs	Venture depends on 1 or both parents for key inputs, services, business functions (e.g. Raw materials, administrative support, sales force)

Taking you through a JV process



Source: Deloitte Financial Advisory

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