Deloitte M&A Views podcast:
The rise of joint ventures: Elements of success (part two)

Transcript

Greg: Welcome to Deloitte M&A Views, a Deloitte podcast series exploring the latest trends and topics in mergers and acquisitions (M&A). I'm Greg Jarrett. Today we tackle part two of a two part series on joint ventures (JVs). JVs and alternative structures have become more popular within the marketplace because they enable companies to access resources and markets otherwise unavailable, while limiting risk and upfront financial investment. However, when Deloitte surveyed companies for the success rates of JVs, only 50 percent of JVs were viewed as successful and over 50 percent of JVs end within three years while less than 20 percent last six years or beyond.[1]

In today's session, we talk with Deloitte's Chris Ruggeri, Mike Armstrong, and Sejal Gala about how experienced M&A leaders are utilizing JVs to engage in business transactions and how to setup and plan the JVs to operate and exit successfully.

Chris, let me start with you today on the importance of making sure the financials are completely in order, applying a financial lens to the process. Is there any guidance on just how each partner should value their contributions to the JV?

Chris: This is a really important question, and in any joint venture there are three key opportunities to either create or destroy value and that is in negotiating the economics of the deal up front. What each party is contributing to the venture, and or what financial benefit during the operations of the venture, and then upon exit. In establishing the venture, one of the things we see all too often is parties to a venture immediately jump into, they dive into negotiations of the value of their contributions to the venture without laying out the ground rules. And one of the things that we think is incredibly important is, first of all determining the contributions to the venture that each party is going to make, the approach that will be taken in ascribing economic value to the contributions being made to the venture by each party, and then ensuring that the approach is appropriate. Establishing those ground rules can save you a whole lot of time in the negotiation process because it's not uncommon for negotiations to become somewhat intractable if the parties are negotiating every single detail.

[1] *Deloitte Consulting CFO Survey and "A study of Joint Ventures: The challenging world of alliances" Deloitte Financial Advisory, July 2010"*

An example of that would be its common in ventures that, contribution made by parties will include both physical assets or tangible assets, like cash or real estate, as well as intangible or in-kind contributions. Valuing in-kind contributions such as intellectual property, or business processes, or services that will be contributed and do have a demonstrable value, determining what those are, and how they will be valued up front can be critical in making sure that the negotiations proceed smoothly.

For an example of a transaction that I was involved in was, we had a couple of clients that were pursuing a global alliance in the chemical space. We spent more time actually negotiating the approach that would be taken to valuing the contributions to the venture and what the rules of the road were—we spent more time doing that than in actually the time it took to value the contributions. I can't emphasize enough how important it is to lay out a roadmap, if you will, of what will be contributed to the venture, by which party, and how those contributions will be valued. Doing that and spending that time up front will save you a lot of time downstream and also increase the probability that you'll get to a successful conclusion.

Greg: And this leads me on to what I think is a related question. Sejal, you can help me here. Given that the right partner is selected, what would you advise companies to do so that JVs are managed effectively on a day to day basis?

Sejal: The main thing is not to get into deal fever and take your time in that upfront piece. JV partners should make structuring and operating decisions upfront rather than during the execution phase, to make sure they have the right management structure in place to manage the JV. This includes a target operating model, the key dates, financial commitments, the nuances of managing this relationship, as much as possible, need to be put into the partnership agreement itself. Otherwise, if it's done in the execution phase, it's often done after the problems start coming up. And that's not when you want to be dealing with these issues. I would say, don't get into deal fever, take your time during the partnership agreement phase, set the right model upfront even if it takes a little longer to set it up and then it'll pay off huge dividends on the backend by having done it properly when you started.

Greg: I have a follow up question for Chris. What are some of the things that companies can do to insure that JVs still perform according to their objectives?

Chris: Sure. Well certainly it's incumbent upon each party to the venture to regularly reevaluate how the business is doing and whether the venture is achieving the results and the strategic objectives that each party has set out. But then there are other elements that should be considered. For example just regular reporting of business performance, operating performance. How's the business doing? How is capital being deployed? Are the objectives of the business itself, are they being met? That should be part of the regular process as well. And then there needs to be a governance structure in place that provides each party with the appropriate level of oversight and governance so that in the event the venture is starting to drift away from its intended objectives, each party to the venture has the ability to either get it back on track or, in extreme circumstances or if the two parties find that they're moving in different directions, there needs to be a mechanism by which one party could exit the venture in an orderly way.

Greg: Let me circle back to the start and the theme of this entire conversation. Sejal, let me ask you, since most JVs will dissolve eventually, we have the numbers on that, how can partners define when to exit and end the relationship appropriately?

Sejal: Yes. As you correctly recall, JVs do dissolve in the short term, with about 80 percent of JVs dissolving within the first six years. And sometimes that's for good reason and sometimes it's because their initial objectives were not met. It goes back to having a clear exit strategy, and that includes how each partner is going to get out in different exit scenarios, what are the exit triggers, what are the external or internal factors that trigger them getting out of the JV agreement, what's the valuation going to be when both parties dissolve the JV agreement, and what are the process and steps to take in order to exit. As long as all that is figured out, it's not to say, it's not going to be a tough process, but at least the framework is in place for that to happen.

For example, I'll give you, we're working with two alternative energy companies at the moment actually, who went into a joint venture really to integrate their supply chains and leverage their joint brand. Over time, what's happened is, there's been a lot of external competition and both parties have come to the conclusion that it is unprofitable to continue the JV relationship. In this particular case, they had done the upfront work to say what would happen if they got to this situation at certain financial benchmarks, like Chris said. And once that point was triggered, it was clear that the strategy was for the bigger partner to actually buy out the smaller energy company. And that's the process that we helped them through. And that's what was set out from the beginning as what they would do in that path. Call it a prenup, call it an exit strategy, basically plan ahead, is the main point of what we're trying to say.

Greg: There's a lot of information here. We have gone through a lot of stuff. And Mike, I'm wondering if there's an, an outline that we could just stick in front of ourselves and look at it, go through one or two points, and then circle back to the details if we have to. Is there something, let me just call it quick and dirty, that we could follow and realize that we're on the right path?

Mike: Yeah. Let me give that a stab. I think the one thing we want to reiterate is that the upfront design and planning of a JV is absolutely critical to its success. You simply can't push that upfront design off to the implementation stage. There are a number of things that you should be focusing on at that upfront stage. You should identify a clear strategy for the JV. You should find the right partner fit. You should establish the appropriate operating structure for the JV. You should figure out how you're going to monitor performance. And you also should plan for change and for exit from the JV. I think if you can keep your focus on these tasks, you should have far greater success in launching and running your JVs.

Greg: I'm Greg Jarrett and thanks for listening to Deloitte M&A Views, sponsored by Deloitte's M&A Institute. We release new podcasts regularly, and if you subscribe, you won't miss a single one. To stay connected and receive more information on Deloitte M&A service offerings, visit www.deloitte.com/us/masubscribe and follow us on Twitter @DeloitteMnA. Until next time!