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Joint venture and alternative structure transactions:

Getting them right from the start

Introduction

Joint ventures (JVs)[1] and other alternative structures (such as alliances and consortiums) may be superior to mergers and acquisitions (M&A) and greenfield operations in many market entry situations. While full company or carve-out acquisition and divestitures are a critical tool in the strategic toolset of nearly every business, JVs typically offer the following advantages:

- Access to resources and markets that are otherwise unavailable
- Limited upfront investment
- Risk mitigation through partnership
- Expedited time to market
- New path to an exit, through IPO or sale of shares

It is critical to approach JVs with a clear strategy and careful planning. A JV's ultimate effectiveness in achieving strategic and operational objectives is typically determined in the up-front phases of the transaction. In our experience, there are seven core decisions that are critical factors in JV success.

[1] The term joint venture (JV) throughout this paper represents all alternative structure transaction types.

1. Define clear strategic objectives

Defining the desired end result of a transaction enables each partner to assess the feasibility and strategic fit of the JV. Joint ventures can be used to achieve the same wide range of strategic objectives as acquisitions and divestitures – from a path to shed non-core assets to a driver for innovation.

Most frequently observed drivers for JVs are:

Access to resources

- Additional funds
- Intellectual property
- New capabilities

Access to markets
Customer intimacy in foreign markets, regulatory approval to operate

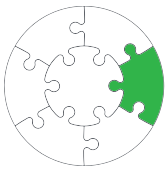
Risk mitigation
Maintain level of separation between JV and parents, limit investment

Case study*: Metal manufacturers partner for strategic risk mitigation

Two metal manufacturing companies formed a joint venture to build and operate an integrated mill together. Company A focused on converting ore and producing iron products, while Company B operated as an ore extractor. As a result of the JV, company A obtained a guaranteed 20-year supply of ore and mitigated the risk of volatile ore prices. Company B received a guaranteed market and price for its ore while receiving high quality, lower cost iron products from company A.

Takeaway: The JV was successful in large part because both partners defined, and were aligned on, complementary strategic objectives up front.

* Case studies are representative market scenarios.



2. Select the right partner(s)

Picking the ideal partner also plays a pivotal role in establishing a successful JV. Of course, partner selection criteria differ based on the strategic objectives. In some cases, the right partner is defined by their ownership of a critical asset such as presence in a market or intellectual capital. For example, if one partner is looking to carve out assets for an eventual IPO or sale, then a financial partner with the resources and successful track record may be the right choice.

Cultural fit should not be disregarded. Significant differences in decision making structures or risk appetite can dramatically increase complexity of the JV. A culture clash should not necessarily stop a deal; however, knowing that it exists informs the need for more detailed up-front negotiations and alignment on governance and performance monitoring.

Material components should be negotiated before the deal is signed – in our experience, delaying these decisions will require more time and resources and often leave both partners feeling as if they were misinformed.

Case study: Global fast food company and local business conglomerate partnership

A large, global fast food company entered into a JV with a local business conglomerate to expand its operations into China. The fast food chain brought industry leading practices and supply chain expertise and the local business conglomerate contributed its knowledge of the rapidly changing Chinese consumer and complex local regulations. As there was a clear delineation of each partner's role in forming the JV, the JV was able to establish more than 150 fast food stores in China.

Takeaway: The fast food company defined the JV strategy ahead of time (i.e., China market entry) and selected the right partner that had the critical capability (local market expertise) to execute the JV strategy.

3. Define the value of JV contributions

Partners need to independently assess, and then jointly negotiate, the value of initial contributions to the JV. Rather than starting with specific contributions, partners can save time and help increase probability of a successful negotiation if they can first agree on a conceptual framework for valuing the contributions that each party will make to the deal (e.g., intellectual property, services provided, market relationships.)

Various valuation methodologies are available depending on industry and market timing. For example, one technique may be to identify an income stream or a cost savings from a specific contribution.

The partners should align on ongoing value appropriation, such as the share of the value generated by the JV that will be attributable to each partner, and how this may change due to internal or external factors. As part of this step, it is important to consider country specific nuances such as restrictions on distributions and return of capital, charge for the use of trade name, and regulations.

Case study: Changing cash contributions of technology competitors JV

Two technology sector competitors formed a joint venture to combine their US businesses to achieve strategic synergies. Company A produced a leading, mature product facing increasing competition, while company B produced established products still in their growth phase. During the 5th year of the JV, the proportion of partner cash contributions changed and the partners could not negotiate an agreement on an updated ownership structure. That ultimately resulted in the dissolution of the JV.

Takeaway: The link between asset contributions and ownership stakes should have been defined up front.

4. Define the JV structure and operating model

JV partners should make structuring and operating model decisions up front – rather than during the execution phase. Part of this should be a plan to reach the target operating model, with target dates and financial commitments reflected in the partnership agreement. This serves as yet another check on the costs and expected value associated with the transaction.

Examples of key decisions are:

- Accounting treatment of the interest in the JV (consolidated or non-consolidated)
- Level of parent companies' involvement in strategic and operational decisions (i.e., active management vs. passive monitoring)
- Operational links to parent companies—sharing vendor purchasing and customer servicing agreements
- Level of financial support provided by parent companies

Case study: Telecom Providers JV Operating Model Failure

Two telecom providers formed a JV to serve the South Asia wireless telecommunications market. The JV allowed customers to roam freely between networks at no additional cost. As a result, the JV retained almost 40% of the market. The two companies continued to operate their own networks and many of their own functions, and the JV did not announce clear plans for consolidation. As a result, the CEO submitted his resignation amid concerns that the venture was not delivering cost savings quickly enough.

Takeaway: The JV's disintegrated operating model was the reason why the JV was unable to deliver expected value.

5. Appoint a strong, aligned executive team

The primary challenge faced by the JV executive team is lack of alignment around the goals of the JV. This occurs especially when the team members come from the parent organizations and maintain loyalties to their original organization rather than the newly created entity. This is often amplified by a lack of unified team identity – some JVs are formed very rapidly and the team is hastily assembled with little opportunity to define an effective interaction model.

Potential solutions to this challenge can be implemented in the initial phases of the JV:

Invest in team selection
Allow the CEO to select his direct reports from internal and external candidates.

Formalize communication channels
Explicitly bar communications outside formal governance channels.

Incentivize JV success
Link the executive team's compensation to the performance of the JV.

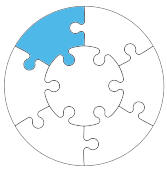
Invest in team building
Conduct formal change management and team building initiatives.

Define career path
Outline promotion opportunities for JV executives at all parent companies (not just their original company).

Case study: Consumer product competitors JV partnership exit

Two consumer product companies formed a JV to combat declining category sales due to increasing industry fragmentation. They wanted to capitalize on a shift in consumer trends towards sustainable products. The partnership combined almost all of their global operations and split leadership positions and board seats equally between parent companies. Unfortunately, primarily due to power struggles between the parent companies, the JV was not able to establish a strong, aligned executive management team. The joint venture faced a number of executive changes throughout its existence and was eventually terminated when one partner exited a geographic market.

Takeaway: The JV leadership team should be committed and should have aligned incentives designed to achieve the objectives of the newly formed entity.



6. Establish performance management structure

Prior to the launch of a JV, it is critical to define detailed performance metrics and targets and specify how they will be calculated and reported. The initial set of metrics may be defined in the strategic planning phase and can help with partner selection. For example, if one potential partner is looking to focus on growth while the other is focused on cash generation, this will be reflected in the metrics and can help identify the misalignment in objectives from the start.

Equally as important as defining the initial set of metrics, is establishing a mechanism for metrics to be modified in line with shifting strategic priorities and changes in the market. In most cases, changes will need to be negotiated and approved by the board (with representation from all partners). However, an established annual mechanism for proposing and aligning on changes can drive all partners to proactively consider the continuing effectiveness of the metrics and fast track the process.

While metrics are always highly customized to the industry, target market, and specific deal nuances, key components often include:

JV financial performance (total, trends, vs. plan):

- Revenue, OPEX, operating income
- PTI more accurate than EBITDA (manipulation of capital expenditures)
- Key initiatives (supplier negotiations, ROI of JV projects)

Partnership value:

- Growth of core business, as tied to JV (e.g., lead sharing)
- ROI – JV vs. acquisition
- Effect on core business (e.g., NPS, customer satisfaction, operations risk)

Separation progress (if carve out):

- Exit of TSAs (number of services, service value)
- Stand up costs

Case study: B2B financial services JV partnership metrics

A global B2B financial services company divested a partial ownership stake of a non-core business unit focused on retail services, creating a JV with several investors. In defining partnership performance metrics, the partners agreed to track and report, as well as tie compensation to net Income. They did not agree on the specific calculation methodology, however, which resulted to conflicts between the partners on the metric and resulting compensation. The investors declined to negotiate on updated metrics, leading to ongoing tension.

Takeaway: Define metrics at a detailed level, leveraging industry experts and case studies to avoid future pitfalls. Tie compensation to multiple metrics linked to prioritized strategic objectives to mitigate impacts of potential skewing due to a single metric.

7. Plan for change and exit

The most important factor that differentiates a JV from another M&A transaction is that the JV structure is designed to change. A small percentage of JVs continue successfully for decades, and in most cases, the JV evolves. For example, a partner sells their stake or dissolves the relationship completely, having successfully achieved (or not achieved) the strategic objectives.

To enable the JV and the partners to nimbly respond to changes in the market, an exit strategy should be defined in detail as part of the transaction agreements.

A robust exit strategy typically includes following components:

Exit triggers (e.g., milestone date, drop in performance metrics below target).

Exit scenarios (e.g., transfer or interest, forced sale or IPO, wind-down).

Valuation approach (e.g., use of a neutral third party to conduct valuation, approach to a defaulting partner).

Governance process to initiate and execute the exit.

Most successful JV partners will evaluate, on an annual basis, whether or not the JV is continuing to achieve its strategic objectives and is still an optimal use of the invested assets. As part of the initial valuation, JV partners should also value the residual value of their share in the JV – assessing various exit scenarios. This will provide the JV partners with initial information to assess potential exits when it is required.

Case study: Alternative energy companies end JV partnership

Two mid-size alternative energy companies partnered to form a joint venture to integrate supply chains and leverage brand equity. The JV faced high levels of external competition and soon become unprofitable. Primarily due to the lack of planning for marketplace shifts and a failure to establish a contingency plan, the JV was not able to recover and eventually ended in one partner buying out the other. The remaining JV partner then reorganized the company and shifted focus to a different strategy.

Takeaway: Define contingency plans and an exit strategy for each partner ahead of time to build in flexibility and the ability to restructure the JV if the original strategy does not materialize.

Conclusion

As JVs have continued to increase in popularity in recent years, the challenge of designing and sustaining an effective JV structure has remained consistent. However, through targeted and well-thought out decisions in the upfront structuring phase, companies can set themselves up to mitigate the downside risks. This can drive the value generated from JVs and fuel a company's growth.

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