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In This Issue: Real Options and Corporate Strategy

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The Decline and Fall of Joint Ventures: How JVs Became Unpopular and Why That Could Change

by Dieter Turowski, Morgan Stanley & Co. Limited

Joint ventures were supposed to be an essential tool for managers seeking a competitive advantage through collaboration. The powerful forces of globalization and technology were expected to stimulate strategic partnerships of all kinds. Yet many corporate managers seem to have concluded that joint ventures are just not worth the time and expense it takes to arrange them.

"We don't like joint ventures and try to avoid them wherever possible." This statement was made by a business development executive at one of the world's largest industrial conglomerates, a company with billions of dollars of assets tied up in joint ventures. At another firm, a global player in the technology industry, the head of M&A has stated that his organization needs to improve its ability to negotiate and manage joint ventures. This company also has many joint ventures, but several have failed to live up to expectations and disenchantment with such ventures is rising.

Statistics on the number of new joint ventures reinforce the anecdotal evidence of the declining popularity of joint ventures. The peak year for joint venture formation activity was 1995, which saw almost 5,700 new ventures. Since then, however, JV activity has gone into a sharp decline, with 2004 setting a new ten-year low of just over 700 new deals (see Figure 1). By contrast, the number of M&A transactions announced each year continues to run well above levels of the mid-1990s. Consistent with these two observations, joint ventures in 2004 represented just 2% of all corporate combinations (defined to include mergers, acquisitions, and joint ventures), down from a peak of almost 20% in 1995.

Part of the decline in joint ventures can be explained by changes in the external environment. Many joint ventures during the 1980s and 1990s were driven by regulatory barriers that restricted foreign ownership. To invest in some emerging markets, it was often necessary to have a local partner. Even in developed markets, restrictions on foreign ownership in certain industries encouraged joint ventures or strategic alliances instead of cross-border mergers and acquisitions. And as many of these barriers have been relaxed or eliminated, the corporate demand for joint ventures has diminished.

But if liberalization has reduced the need for JVs in certain countries and circumstances, other changes in the global business environment over the same period might have been expected to encourage their formation. For example, most of the major developments providing the impetus for M&A activity over the last decade, particularly globalization and the corporate search for new markets, should have had similar effects on joint ventures. My sense is that managerial failure and frustration, rather than changes in the external environment, are at the root of the decline.

Why Executives Don't Like Joint Ventures

I have had many conversations with executives about how to start new ventures and how to rework or put an end to those that run into trouble. Most of the discussions end up focusing on three major concerns: lack of control, lack of trust, and uncertainty about exit.

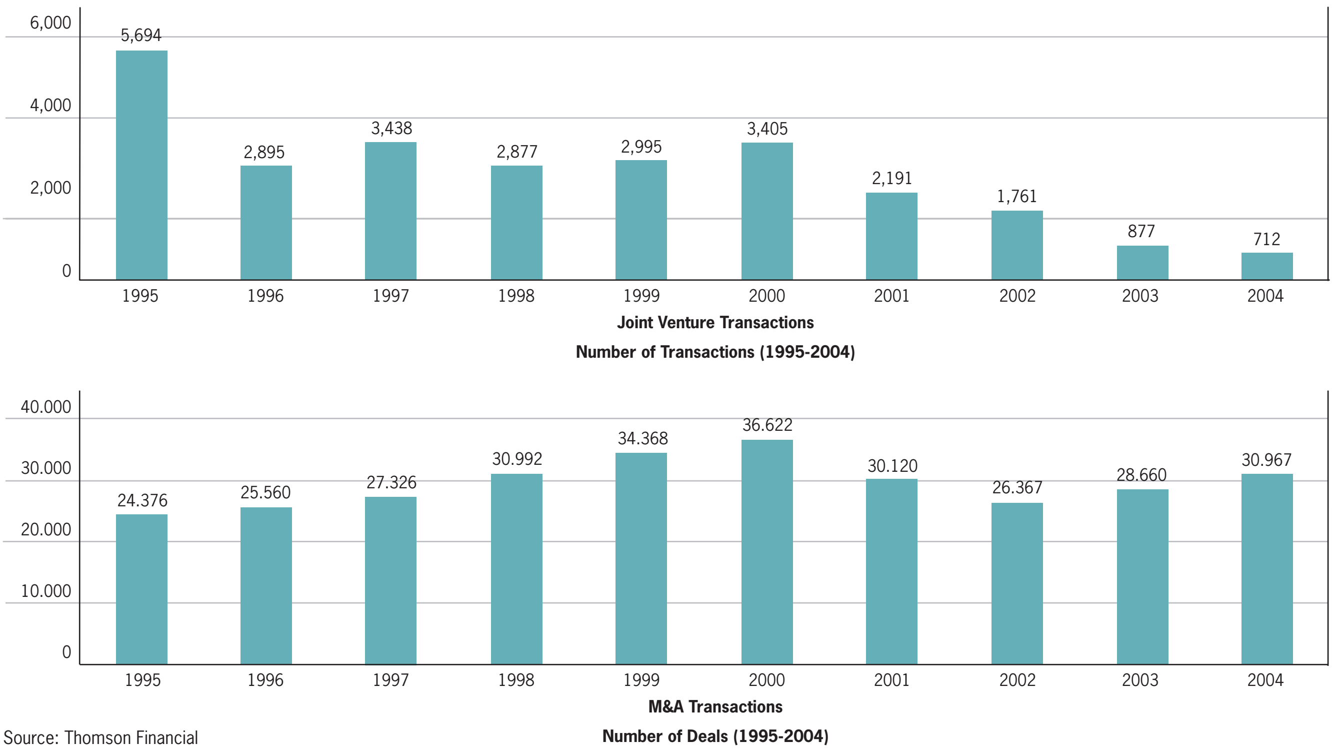
When first contemplating a joint venture, most managements are nervous about the idea that complete control over decision-making will be replaced by shared control. This is especially troubling for managers when the assets contributed to the JV will continue to have strategic linkage to the rest of the firm. In some cases, the effect on strategic flexibility can extend beyond just the venture itself—for example, when the JV agreement includes a difficult change-of-control provision. In one instance, a merger of two very large pharmaceutical companies was delayed by several years due to such a problem.

Complaints about lack of trust are surprisingly common. When problems and tensions between parties do surface, managements often spend large amounts of time and money in resolving the issues. In extreme cases, the parties end up invoking dispute resolution clauses that result in the use of lawyers and arbitrators. Such a process may allow the JV to move beyond the particular issue, but often does further damage to the longer-term relationship.

Third and last, the decision whether to have a termination provision, and how to structure it, is often a very difficult one. Many executives prefer to have some exit mechanism if circumstances change. But deciding what is fair and reasonable at the beginning of a venture, when the relevant clauses are being written, is never easy. Many valuations that seemed sensible during the stock market boom of the late '90s have since caused considerable embarrassment to those who agreed to them.

It is thus not surprising that many executives have completely dismissed joint ventures as a vehicle for growth. But is this the right conclusion? Perhaps for some companies. But for most, the answer may well be to use the lessons

Figure 1 **JV Activity vs. M&A Activity (Last Ten Years)**



Source: Thomson Financial

from past failures (both positive and negative) to improve their ability to negotiate and manage joint ventures. By so doing, they will be less likely to fall into some of the common pitfalls—some of which are well concealed, even from managers who have been down the path before.

Problems with Joint Ventures—And How to Avoid Them

It is not easy to make useful generalizations about joint ventures. To a far greater extent than acquisitions or divestitures, one joint venture is likely to be very different from the next, and JVs thus tend to be highly customized. Nevertheless, there are some conclusions that can be drawn from a review of mistakes made in past transactions. Below are five relatively common ones, together with some thoughts on how to avoid them.

Don't rely too much on experience from negotiating acquisitions—JVs require a more balanced negotiating style. Negotiating a joint venture has many similarities to negotiating to buy or sell a business. In a typical JV where both parties contribute operating assets, you need to do due diligence and value the other party's assets, while at the same time ensuring that you are getting fair value for the assets you are contributing to the JV. So it is not surprising that an M&A-type approach is often adopted, and this is where problems often begin.

Success in M&A often requires adopting an aggressive negotiating style. Many issues are "win-lose" issues in which success for one party on a certain issue—say, price—comes at the expense of the other party. Negotiators will use various techniques to extract a good outcome that can cause friction between the parties. But that is typically not a problem in M&A since once the deal is done, there is unlikely to be much significant ongoing contact between the parties.

My favorite example of this problem involved a joint venture negotiation in the media industry between two savvy and highly regarded players. One of them, a media "mogul" involved in many aspects of the industry, was well known for litigiousness and for taking a very tough approach to negotiations. Both parties to the negotiation wanted to buy the other's business, but neither wanted to sell. Thus, a joint venture was the solution. The strategic logic was compelling, the synergies were great, and a deal should have been struck quickly. Instead, the negotiations dragged on for nine months, with the talks close to collapsing on many occasions. Finally, with a deal arranged and the signing four days away, the mogul demanded a revision of the economics of the deal. This demand reflected the release of the latest quarterly numbers for both businesses, which supported the mogul's position. At this point, the other party decided to walk away, and the JV never happened. The reason cited was uncertainty about the possibility of achieving a good working relationship.

The media mogul was, by all accounts, an effective and successful M&A negotiator. Over his career, he had created

Table 1 **A Menu of Exit/Termination Mechanisms**

Possible Trigger Events	Restrictions on Exit or Transfer	Mechanisms	Determination of Price
A decision by one partner, at its sole discretion, to trigger a termination event	Prohibition on any exit or sale for a certain period of time, or indefinitely, without consent	Sale from one partner to another (through put or call arrangement)	Fixed price put or call
A unanimous decision by both parties (or all parties if more than two) to trigger a termination event	Right of first refusal by the non-selling shareholder if the other shareholder sells	Sale of JV interest to a third party	Formula price
A change in control of one of the partners	The right of the non-selling shareholder to block a sale to a competitor	Sale of entire JV to a third party	Fair market value appraisal
A deadlock over fundamental strategic issues	Tag-along rights (the ability for Partner A to force a purchaser of Partner B's interest to purchase Partner A's interest on the same terms)	IPO	One party determines price, and the other party chooses to buy or sell at that price
A material breach of the JV agreement		Restructuring of JV whereby both parties stay involved, but the economics are changed	Third party buyer sets price based on negotiation (in the case of a sale to a third party)
		Unwinding of JV with return of contributed assets back to original owners	Public market price (in the case of an IPO)

billions of dollars of value in his various portfolio companies, much of it through deal-making. But when it came to joint ventures, he was unable to adjust his negotiating style to reflect the need for a more cooperative, "win-win" approach. As a result, there were almost no successful joint venture relationships in his empire.

Don't let the contract dominate the relationship—procedural trust is no substitute for the real thing. Although a less competitive negotiating style can help set the tone for a good relationship, the philosophy or spirit in which a JV contract is drafted and interpreted can be equally important in encouraging effective collaboration. When you don't know the counterparty you are negotiating with, it is human nature to take a prudent or cautious approach, the more so when dealing with parties from different countries or cultures.

The result of excessive caution is a contract that is very long and incredibly detailed—one designed to deal with every imaginable contingency. I can think of one example of a joint venture in the pharmaceutical industry where the agreement filled 13 large notebooks. The JV's management had virtually no decision-making autonomy; all decisions of any importance rested with the corporate parents. Whenever conflicts arose, the first response of both parties was a legalistic rush to understand complex contractual provisions and how they could be used to their own advantage. But if JV agreements are crafted more with the aim of achieving a shared understanding than designing explicit provisions for all contingencies, the parties will have stronger incentives to seek business solutions instead of legal remedies.

Ideally, then, the parties to a joint venture should look for ways to establish trust outside of the contract. This can be done in several ways. First, it is important to ensure that the vision and objectives of the parties are truly aligned. Second, the surest means of establishing trust is by starting during the negotiation phase. Face-to-face meetings, although more time-consuming, are essential and cannot be replaced by e-mails and conference calls. The key individuals from each company involved in the JV must make a real effort to establish a relationship with their counterparts. Finally, assuming that the negotiations have gone well on the business issues and final approvals are being sought, the parties need to ask themselves if there is a sound basis for a long-term relationship. If the answer is no, they should question whether a joint venture really makes sense. They might still decide to move forward with the transaction, but with the clear understanding that it is likely to be a short- to medium-term venture. In such a case, the likely endgame and exit mechanisms should be clearly understood by both parties from the start.

Consider the importance of commitment versus flexibility—option value may not always be a positive in the context of joint ventures. Executives have very different views about whether it is good to have the ability to readily terminate a joint venture. A very senior executive at one of the largest oil majors once told me that he prefers to have *no* termination clauses in his firm's joint ventures. In support of his point, he pointed to one of his most successful JVs that had survived for over 20 years. Had there been a termination option, it would probably have been exercised, given problems that had arisen over the years—and, in his view, the termination would have been a mistake. The absence of such a provision meant that the parties were committed to one another, for better or for worse. As a result, they took a far-sighted approach to running the business and the governance relationship worked well.

But another senior executive, this one at a very large food retailer, takes the opposite position. It is absolutely clear to him that every joint venture needs to have not just one exit route, but several. The business environment changes very rapidly and strategic flexibility is essential. Today's partner could turn out to be tomorrow's main competitor. Mergers and acquisitions add to this uncertainty by creating the possibility that your partner will be *acquired* by a competitor.

My discussions with executives suggest a decided preference for flexibility over commitment. Part of this preference reflects the growing appreciation of the "option value" of maintaining strategic flexibility. But much of it also undoubtedly comes, as suggested, from recent experience: If you have been stuck in a bad JV without a termination clause, your thinking is likely to be biased. At the same time, there may be a tendency at the senior levels of most organizations to exaggerate the benefits of flexibility, which can be easily articulated, as opposed to the less tangible benefits of commitment. Indeed, I know of one instance where a fully negotiated joint venture was presented for final approval to the CEO, a process that was viewed as a formality by the various executives involved. To their surprise, they were sent back to rework the termination provisions to provide more flexibility.

The right answer to this question, then, depends on the circumstances; every situation is different and requires a tailored approach. When deciding where they want to be on the spectrum of commitment versus flexibility, executives should be asking themselves a number of questions:

- Is the joint venture important to my long-term strategy, or is this simply the first step in an eventual exit?
- How comfortable am I with my partner?
- Are the strategic contributions of the partners to the JV likely to change over time?
- How important is stability for the development of the JV?
- Are there a large number of commercial relationships between the JV and the parent companies?

Once these questions have been considered, the parties involved will then need to consider how to structure the termination provisions. Table 1 gives some idea of the range of options available for terminating or restructuring a joint venture. Decisions will need to be made with respect to the trigger event for termination, restrictions on termination, the mechanism itself, and how value should be determined. Although making these decisions is clearly a complicated exercise, the important message is that it should be done based not on some general view that flexibility is good or bad per se, but rather on the basis of what makes sense in a particular situation.

Resist the urge for certainty in termination clauses—a "process oriented" approach will usually be more equitable than an "outcome oriented" approach. Many executives who insist on flexibility also want certainty about the price that would be paid if the JV were terminated. Thus, there are a large number of joint ventures that have a built-in formula for calculating the transfer value in a future termination or restructuring transaction. A typical formula would calculate a value based on some multiple of earnings or operating profit. In some cases, attempts are made to normalize the earnings or operating profit by taking an average of several years, or perhaps looking into the future and including budget numbers.

One has to be cautious in using such a formula-based approach because of the possibility of an unfair outcome. For example, any formula that was agreed upon in a contract written during the 1999-2001 market boom would almost certainly result in a completely inappropriate value today. The greater the length of time between the signing and the exit, the greater is the likelihood that a formula may not reflect market reality when it is invoked. Thus, although a formula-based approach would make sense when both parties to a JV are clear that one will sell to the other in a few years, it is likely to be inappropriate when there is no clear idea when an exit will take place.

A more prudent approach in such circumstances would involve establishing a value based on valuation advice at the time of the termination event. It is important that the parties agree on a clearly defined process for arriving at a value. One possible approach, for example, is "baseball-style arbitration," where each party hires an independent expert to perform valuations. If the resulting valuations differ by more than a certain percentage, a third expert is brought in to mediate between the first two, thereby creating an incentive for all parties to take a reasonable stance in the first place.

Recognize when a joint venture has outlived its useful life, and do something about it before value is ultimately destroyed. No matter how well thought out a joint venture is when created, circumstances can change and the partners' strategic interests may diverge. This can happen for various reasons. A company that needed a local partner to enter a market may find that it has outgrown the need for such a partner. Or sometimes competitors join together to reduce costs only to find that competitive tensions make it difficult to continue cooperation. In other cases, a merger of one of the parents makes the JV untenable. Finally, joint venture companies sometimes reach a point in their evolution where they need to become independent from their parent companies, and do so by selling shares to the public in an IPO.

What can happen when a joint venture continues for longer than it should? In some cases, tension and mistrust can increase between the parties to such a degree that there is a material impact on day-to-day operations. For example, the JV may be starved of capital to fund its full development because one parent is blocking actions to raise new capital, either from the parents themselves or through external sources. Or disputes on fundamental issues may begin to take up significant amounts of management time, especially if the dispute resolution clauses built into many JV agreements take effect and lawyers or arbitrators begin to get involved. In some cases, partners will use their veto rights to block important decisions in order to force a discussion about the future of the venture. Clearly, once the relationship has deteriorated to this level, the time for action may already have past.

Once the parties have recognized that the status quo is no longer an option, it is important that they look beyond the joint venture contract in thinking about possible solutions. Although the contract will sometimes contain the appropriate provisions to terminate a relationship, the best solutions tend to come from the parties' efforts to think creatively about what makes sense. There are some obvious approaches

When a Joint Venture Has Outlived its Current Form

Four Cases of Creative Approaches to Addressing the Issue

Case 1: Astra-Merck. Astra-Merck Inc., a 50-50 JV between Astra (now AstraZeneca) and Merck, focused on selling Astra's products in the U.S. market. Astra wanted full control over its most important market and the flexibility to pursue a merger transaction, but Merck had no desire to cash out from a successful JV that had the U.S. rights for the blockbuster drug Prilosec. The JV was restructured so that Astra had full control, but Merck would continue to have an economic interest in Astra's U.S. activities.

Case 2: Autolatina. Autolatina was a JV between Ford and Volkswagen to manufacture cars for the Latin American market. Originally set up to lower manufacturing costs, competitive tensions made it more and more difficult for the parties to work together. The parties agreed to unwind the JV, and the physical assets were split between the two parties, together with an equalization payment.

Case 3: Borealis. Borealis was a 50-50 chemicals JV between Norway's Statoil and Neste (now Fortum, the Finnish energy company). Neste wanted to exit the chemicals sector, but Statoil did not want to own 100% of the JV. Two new partners were found: ÖMV (the Austrian oil company) and IPIC (an Abu Dhabi-based investment company) to purchase the Neste stake while at the same time contributing operational assets and a commercial relationship.

Case 4: SITA. SITA is a consortium of airlines that own a communications network. The airlines recognized that they owned a potentially valuable asset that could be developed into a data communications provider for third parties, but did not believe it made sense for them to invest the capital on their own. The airlines created a new company and sold an equity interest to Morgan Stanley Capital Partners in order to raise capital. The new company, Equant, later went public, providing liquidity and a substantial return for the airlines.

to terminating a JV, such as one party buying out the other, or pursuing an IPO for the business. There will also be less obvious solutions that may involve a restructuring of the JV, or the bringing on of new partners to help facilitate an exit for one or more of the existing partners.

New Hope for Joint Ventures?

There is now some prospect that the decline we have seen in joint venture activity over the last decade will be reversed. As discussed above, many of the reasons why many executives have come to dislike JVs are not necessarily fundamental to the ventures themselves. They are instead the result of bad execution and perhaps lack of experience.

In fact, a recent study suggests that there may be a strong positive correlation between the amount of experience that corporations have with joint ventures and the returns they realize on them. On the basis of the results of a Booz-Allen survey, researchers from Booz-Allen concluded that corporations with nine or more alliances earned an average return on investment (ROI) in the range of 20%, as compared to just 10% for companies with just one or two JVs.

Recent anecdotal evidence also suggests that some sophisticated corporations with joint venture expertise have had very positive experiences with JVs. For example, last year Philips and LG Electronics took public their joint venture in LCD screens, LG.Philips LCD Co., putting a value on the business at the time of writing in the range of $14 billion. Sony Ericsson, which initially had some problems, is now taking market share and has become profitable in an industry that is extremely competitive. And Airbus, which started life as a consortium in 1970, and did not become an integrated company until 2001, now represents a formidable rival to Boeing, an outcome that would have been difficult to imagine 10 or 15 years ago.

Thus, it appears that experience is driving better financial performance in joint ventures. But there is another factor contributing to the potential of JVs as vehicles for achieving profitable corporate growth. The prices paid in joint ventures tend to be more reasonable than those paid in acquisitions, since JVs are usually based on the principle of shared control and thus neither party pays a control premium. And since joint venture discussions tend to take longer than M&A negotiations, there is more time for planning with JVs and less chance of being rushed into a bad deal.

In summary, there is hope that joint ventures and other forms of strategic partnership will flourish again in the future. But their ultimate success as a corporate tool will depend, at least to some extent, on the ability of companies to improve their capabilities to create and manage these partnerships.

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