Tapping the Unexpected Potential of Joint Ventures

The value of joint ventures is growing at twice the rate of M&A. Here's the formula for winning deals.

By Arnaud Leroi and Philip Leung

BAIN & COMPANY

Arnaud Leroi is a Bain & Company partner based in Paris who leads the firm's Mergers & Acquisitions practice in Europe, the Middle East and Africa. Philip Leung is a Bain partner in Shanghai who leads the firm's M&A practice in Asia-Pacific.

It may be time to reconsider joint ventures.

For years, many business leaders have viewed joint ventures as unpopular and not particularly successful tools for developing a business or optimizing costs. But new Bain & Company research has found surprising evidence to the contrary. Increasingly, companies are recognizing the value of taking inorganic approaches to complement their organic growth—and many are turning to joint ventures. In fact, overall, the value of joint ventures grew 20% annually from 1995 to 2015—that's twice the rate of M&A deals.

One important reason for the popularity: Joint ventures are the only means for accessing certain markets in some of the fastest-growing countries such as China, India, Russia and Brazil. Consider how CR Snow, SABMiller's joint venture with China Resources Beer, enabled the London-based brewer to grow in China, making Snow Lager the world's biggest-selling beer. After 22 years of a fruitful joint venture, SABMiller sold its stake to China Resources in preparation for its merger with AB InBev.

But in addition to market access, joint ventures are being used as a way to give companies much-needed flexibility. For example, scope deals, which comprise the lion's share of joint ventures, can enable a company to quickly add new customers, products, markets or channels. They also can give a company quick access to critical technology or capabilities. Meanwhile, scale deals enable joint venture partners to combine business units, assets or capabilities to generate economies of scale. The 2011 Deutsche Telekom and Orange joint venture BuyIn was aimed at generating procurement synergies, for example.

Joint ventures have become a standard practice in such industries as construction, where shared capabilities can lessen the significant risk of large infrastructure projects. In oil and gas, joint ventures are commonly used for exploration and production. And in the aerospace and defense industry, joint venture projects with a limited duration help solve the cost and sovereignty issues of large military and aircraft programs. Or they can be structured with the intent of helping both companies flourish for decades. Safran and General Electric Co. have enjoyed a partnership that's lasted for more than 42 years. It's a scale deal in R&D and a scope deal for aircraft markets.

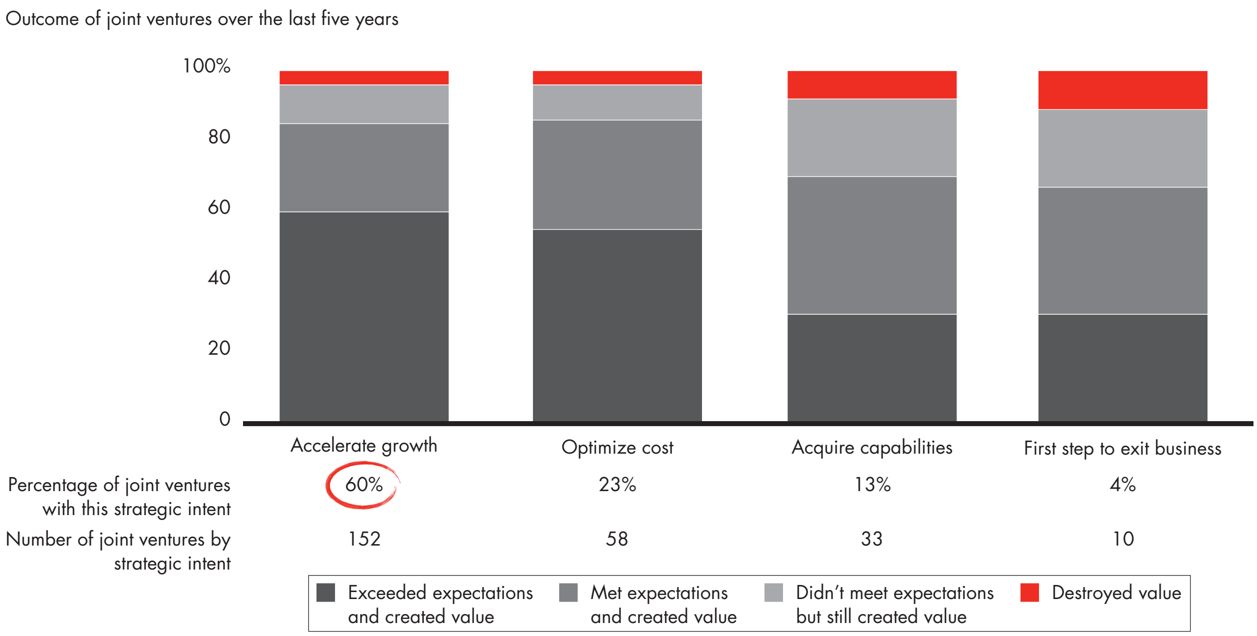
Research on US deals found that joint ventures yield a 17% return on investment, compared with an industry average of 11%. Meanwhile, in our global survey of 253 companies that used joint ventures to spur growth or optimize their product mix, more than 80% of the participants told us that the deals met or exceeded expectations *(see Figure 1)*.

What do these companies do right? Joint ventures can be a complex exercise, but these companies have developed the talents and routines to make them successful (see the sidebar "Building the capabilities for strong joint ventures"). They create a repeatable model that enables them to rely on joint ventures as a key ingredient in their inorganic growth strategy. Indeed, they understand the fundamental difference between joint ventures and M&A. If an acquisition goes off course, the acquirer has the power to take all the steps required to shift direction; they have the keys to the car. But with a joint venture, you can't start over again. You need to have the right foundation in place before the deal is signed, with solid agreement both on strategy and ways of working—as well as on how to end the deal when the time is right.

Said one CEO we interviewed: "If I had to do one thing differently, I would have agreed on the target company's operating model before signing." It makes sense. When a joint venture partner doesn't agree on operating model principles up front, it needs to be in concord after the partnership is in place—and that could be difficult.

Working with companies on more than 450 joint ventures, we've learned that successful joint venture partners establish a sound strategic foundation, with clear deal objectives. They operate with an aligned joint venture architecture, and with deal structures that prepare the partners for evolving scenarios. Also, these deals are set up for healthy integration or solid ongoing management. They also carefully manage leadership transitions to retain the Founder's Mentality®. As a result, the partners prevent a host of potential chal-

Figure 1: Over the past five years, joint ventures intended to accelerate growth were most successful



Source: Joint Ventures Survey, August 2016, The Economist Intelligence Unit / Bain & Company (n=253)

lenges, such as ineffective leadership, unclear roles, slow decisions, complex processes and an inability to resolve disputes.

Winners conduct careful evaluations before jumping in. They operate under the assumption that joint ventures work only when everybody wins, when there's a clear value-creation potential and business rationale for each partner—but they focus on growing the pie before dividing it up. In successful joint ventures, top management is involved from the start, and stays involved. Winners also overinvest in governance and partner-fit assessment up front, explicitly identifying possible future challenges and anticipating ways to change the joint venture model to accommodate a new market or environment. That involves dedicating time with the parent companies and the joint venture management team for regular strategic refreshes according to market evolutions. They tailor the specifics based on the type of deal—scope or scale. For example, in scope joint ventures, they adopt a "start-up" approach and focus on growing the pie. In scale deals, they adopt a "merger integration" approach and emphasize cost sharing.

Setting up a joint venture for success

From our research and experience working with companies on hundreds of deals, we've identified the four critical elements that must be mastered to boost the odds of success—elements that span the setup and lifetime of a joint venture.

Strategic foundation and partnership options

Most companies now recognize the importance of inorganic growth to balance their organic efforts. Joint ventures are just one option. Companies need to tie their joint venture objectives to corporate growth strategy, assessing whether a joint venture is indeed the best growth option to seize a business opportunity when compared with organic growth or acquisitions. Winners conduct detailed market and competitor analysis and business planning to ensure there is a clear value-creation potential for each partner. Next, they assess partner fit based on a comprehensive set of predefined criteria, such as strategic intent, decision-making style, risk approach and culture. They develop "what-if" scenarios up front to anticipate potential partner misalignment and related response strategies. And they define a joint venture business plan, perimeter and structure, as well as the key principles for a future operating model, from both a parent and joint venture perspective.

Joint venture design and deal negotiation

Having decided that a joint venture is the right approach and after assessing partner options, the next step is to design the joint venture and negotiate the deal. That involves answering a host of questions: What should the joint venture look like, and what operating model will be most effective? How should a company interact with shareholders and anticipate issues as the joint venture evolves? What's the best way to align interests and structure the deal?

In our experience, the best companies build a sustainable joint venture organization and governance structure designed as much for flexibility as for effectiveness. A key reason that companies overinvest on governance structure and organization design up front: It's harder to change either once a deal is signed. Also, they identify additional mechanisms that will ease the day-to-day operations and preserve the strategic intent and balance of power. They define a joint business plan based on the parent companies' initial objectives, identifying potential upsides and downside risks they're likely to encounter as the venture evolves. They focus negotiation strategy on issues instrumental to the success of the joint venture, taking advantage of those negotiations to assess the organizational fit.

In terms of process, it's important to focus on a target operating model—evaluating several possibilities and settling on the best one—before shaping the governance structure. Again, it's difficult to negotiate operating model decisions after the fact. Thoughtful governance design is a key ingredient for any successful joint venture. For example, an oil company joint venture established a governance and rotating management arrangement aimed at ensuring the joint venture was sustainable over time. For the first three years, one partner appointed the managing director while the other partner appointed the head of operations. For the

Building the capabilities for strong joint ventures

Companies increase their odds of successful joint ventures if they invest to build and maintain a strong joint venture capability. The model they deploy should depend on the level of contribution joint ventures will deliver to the company.

For example, companies that anticipate few deals or low-value deals or expect to have a relatively small percentage of their overall activity under joint ventures can rely on a joint venture knowledge-management program. That means maintaining a joint venture expertise team within the M&A team or business unit, codifying guidelines and routines to set up and manage joint ventures, and developing knowledge-management processes to capture experience gained through joint ventures.

At the other extreme, companies that intend to make joint ventures a key part of their growth strategy should establish an exclusive joint venture team to provide proactive support and supervise all joint ventures at the business unit or central level. They build the integrated joint venture portfolio strategy and tailor guidelines to the type of joint venture—operated vs. nonoperated, for example.

following three years, the head of operations became the managing director, and the first partner appointed a new head of operations. In negotiations, IP protection is also critical. To skillfully mitigate IP risks, a defense company defined clear IP protection terms with its Chinese partner. Among the moves aimed at helping it avoid technology leakage: The company set up separate office space and a separate IT network from the Chinese partner divisions.

Joint venture creation and ramp-up

Once a deal has been designed and negotiated, it's time to create the joint venture itself and take the steps needed to deliver the desired results.

Success can depend on the partners' ability to focus the organization on the most critical decisions that will maximize the joint venture's value while ruthlessly prioritizing the initiatives that will deliver the most value. It's important to resolve people issues early, getting the leadership in place to start building a new culture as soon as possible.

Companies should tailor the approach based on the type of deal. For scope deals, that means building an equity story around potential revenue growth and market share gains. Next, focus on combining the unique capabilities each partner will deliver—everything from client relationships to technology differentiation—into a new business model. Companies need to select talent for the joint venture based on initial competencies and capabilities, and create a plan for harmonizing ways of working, embedding the joint venture with the flexibility of a start-up.

Scale deals, by contrast, require companies to establish an integration thesis that spells out the intended economies of scale and related cost objectives. It's important to carve out existing activities and adopt the best practices from both sides, selecting talent based on a balance of powers between partners. Integration is key for scale deals. That's why successful scale joint ventures pay rigorous attention to culture integration and flawlessly execute integration initiatives.

Joint venture lifetime management

The best companies fully anticipate that conditions will change. In order for a joint venture to survive, it must adapt to those changes—everything from shifts in market conditions to fluctuating capital requirements to changes in management at a parent company. It's a challenge to keep the spirit and intent of the founders alive, even after four or five rotations of management. Fortunately, there are mechanisms companies can put in place to ensure successful lifetime management. For example, monitoring systems can enable continuous assessment of changing performance and conditions, helping companies determine when it's time to refresh or refocus a joint venture's strategic foundation to capture its full potential.

Ideally, the parent companies and management will arrange for two types of meetings during a deal's lifetime. They will establish a monthly or quarterly schedule of performance-management meetings to review short-term progress. It's a way to ensure the joint venture is on track to achieve its full potential. The partners will also set up a series of less frequent meetings—every two or three years, for example—with the goal of reviewing the strategy and refreshing it, if required. This meeting should include a different cast of characters than those participating in performance-management meetings, such as strategy leaders who can take a long-term view of the joint venture and recommend possible ways of moving the deal in a new direction to adapt to changing conditions. Indeed, when joint ventures fail, it's often because partners haven't set up a process for tracking and adapting to changes.

Another big requirement for success: knowing from the very beginning of a joint venture how to handle disputes and how the venture should end for both partners. For example, when a dispute or litigation arises, partners need to proactively manage the arbitration with a dedicated team to support the process. And exit strategies must be clearly determined in advance. Sometimes even the best marriages don't last, and parties need to agree on the mechanisms to manage a separation the right way—or to renegotiate the deal.

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Key contacts in Bain's Mergers & Acquisitions practice

Arnaud Leroi in Paris *(arnaud.leroi@bain.com)*
Philip Leung in Shanghai *(philip.leung@bain.com)*

For more information, visit www.bain.com