Success in joint ventures

Joint ventures are an effective way to create platforms for growth and increase optionality—and to share costs and risks with a partner. They are also complex to stand up and, therefore, underutilized. The key to successful joint ventures lies in the upfront design. Read about how to set up JVs for success.

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Introduction

Across industries, M&A activity has fallen sharply from the recent peak in Q4'21 and generally remains below pre-pandemic levels. With higher cost of capital, strategic and financial buyers are being far more selective. Many are holding back, waiting for valuations to fall and more clarity on the future of their markets.

But the business drivers of M&A are still in force—the need to expand into new markets, the need to build scale, the need to acquire new capabilities for growth. This is why acquirers are turning increasingly to joint ventures. In fact, top executives in KPMG's annual CEO survey rank joint ventures on equal footing with traditional M&A as a growth strategy for growth in the next three years.[1] In 2018, CEOs ranked JVs far below M&A.[2]

In 2020, as the pandemic recession hit and M&A activity dropped by 12 percent (on average), the number of JVs announced rose by 6 percent (Exhibit 1).[3] Conversely, when the economy recovered and dealmaking took off, JV announcements fell by 12 percent.

Overall, we believe that JVs are an underutilized tool that could help companies in any economic environment and under all kinds of market conditions. There are good reasons to avoid JVs. They can be complex, and it is difficult to resolve questions of control and jointly run an asset or business to the satisfaction of all parties. There are many stories of JVs that have failed or broken up over diverging needs of partners.

But JVs are also a proven way to accelerate innovation, share costs and risks, and quickly achieve scale. For example, as the auto industry pivots to electric propulsion, automakers are using joint ventures to quickly build capacity for batteries, charging stations, and other essential components.

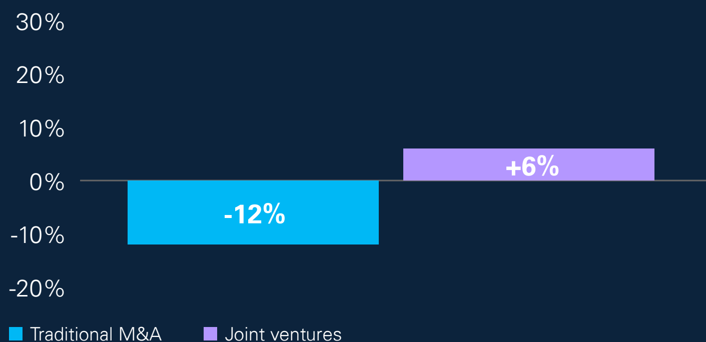
Success in launching and operating joint ventures requires clear definition of key elements in the early stages of dealmaking to secure alignment with the partner. This paper explores the common challenges in JV formation and leading practices to enable the effective launch and operation of a joint venture.

Exhibit 1. When M&A volumes drop, JV volumes rise, and vice-versa

Historically, joint venture volume has risen when M&A volume decreases. In 2020, the pandemic dramatically lowered risk appetite and fueled a shift toward JV s. Then, in 2021, the economy rebounded and the momentum shifted back towards traditional M&A.

2020 Pandemic | JVs vs. M&A

Change in volume from prior year



2021 Rebound | JVs vs. M&A

Change in volume from prior year

[1] Source: KPMG CEO Survey 2022

[2] Source: KPMG CEO Survey 2018

[3] Source: KPMG analysis

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Why JVs are attractive transactions

Joint ventures provide clear advantages when compared to traditional M&A, though these advantages are often overshadowed by the complexity of setting up JVs. While formation is complex, JVs are an effective tool to minimize transaction risk and upfront cash, create optionality, and establish a platform for growth.

Reduce exposure through risk-sharing

JVs allow partners to dial into the right mix of risk and expected reward in a way that optimizes their expected return on contributed assets. This goes beyond financial exposure—partnering via a JV can reduce risk through resource sharing, business diversification, supplier & customer bargaining power, and much more.

A platform for growth

Joint ventures can create a substantial avenue for growth —partners can benefit from access to not only new customers, but entirely new markets and geographies that were previously unavailable. JVs also provide access to increased financial capacity, which the business can deploy for new projects, market expansions, or even to fund further acquisitions. The operating model flexibility inherent to JVs can allow the business to pivot more quickly than would be possible with a traditional acquisition, letting partners react to changing market conditions and continue driving growth.

Flexibility to calibrate up-front cash

Joint ventures can provide an opportunity for parties to combine existing non-cash assets (e.g., fixed assets, personnel, contracts, IP) into a structure that allows them to calibrate or outright minimize upfront cash investment. Regardless of cash upfront, partners seeking outsized JV growth should commit to a phased investment schedule to fuel the JV's growth ambitions.

Optionality over the long-term

JVs provide more optionality over the long term than their traditional M&A counterparts. Unlike traditional M&A transactions, JVs can allow for various scenarios of exit all while sharing risk and reward with a partner. These options can include selling one's stake to the partner or third party, selling both parties' stake in the entire NewCo, taking the NewCo public (IPO), buying out the partner's stake, and more. While some of these options are available to a buyer in a traditional acquisition setting, the buyer bears the entirety of the risk. Furthermore, JVs can serve as a means of testing the success of a new venture or combination prior to acquiring full ownership.

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Common strategic rationales for JVs

Access to international or challenging local markets

JVs are often used to provide access to specific regions—both near and far—that one of the partners would be challenged to enter organically

Co-develop, combine, or access capabilities

JVs allow partners to selectively access each other's skills or capabilities to combine or co-develop an advantage without permanently giving away valuable rights

Access new products and services

By strategically partnering with counterparts that have access to desired customers, partners can drive new revenue streams

Drive a staged exit and buyout

JVs can serve as an intermediary "test" of fit between two organizations, and allow one of the parties to eventually sell their stake in the JV and exit a non-core business

Satisfy regulatory requirements

In certain markets, regulations may require or be more amenable to JVs—specifically when partnering with a local partner, unlocking industry-specific incentives

Build scale

Consolidation JVs offer partners the opportunity to combine like-for-like resources and gain efficiencies while creating further scale advantages

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But JVs are still underutilized due to complexity

Over the years, JV volume has averaged about 20 percent of M&A volume.[4] While there is no ideal ratio of JVs to acquisitions, we believe that JVs would be a more widely used if companies knew how to deal with the real and perceived barriers. These include lack of experience and strategic focus—companies too often look for the "right" partner, rather than defining a partner-agnostic strategy, then looking for partners that fit the profile.

Experience

Lack of JV formation expertise

Corporate Development teams tend to have more experience in traditional M&A transactions when compared to joint ventures. One of the key reasons for lack of repeatability is that the to-be JV leadership team involved in the upfront planning ends up transitioning with the NewCo itself, leaving behind little muscle memory in RemainCo to replicate the model.

Strategy

Partner-focus tendencies

A common and elusive pitfall to JV success is having a partner focus instead of anchoring to a partner-agnostic strategic objective. Partnership formation efforts that originate with partner selection instead of strategy definition are more prone to ignoring red flags, committing to sub-optimal terms, or stalling out before signing and scrambling for another partner without a north star to follow.

[4] Source: KPMG analysis

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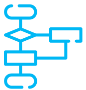
Governance

Balancing ParentCo control

A joint venture's board allows ParentCos to control key JV NewCo decisions. So, ParentCos tend to maneuver for the majority of appointments to the JV board to secure maximum control. This creates friction and a sense of disparate interests in the formative stages. Instead, there should be an equitable split that reflects the share ratio. What's more, ParentCos may use the secondment method when staffing a JV, raising questions from the other side on where loyalties truly lie.



Operating structure

Two-sided carve-outs and integrations

Operating structure design for a JV is often more complex than in a traditional acquisition, especially as it relates to deals where both ParentCos must carve out assets that then require integration into a newly formed entity to achieve expected returns. In this highly complex scenario, both parent companies must align on the level of ParentCo TSAs/LTAs, the associated costs, the right mix of "best of both" people, systems, contract terms, IP, etc., and must integrate the components in alignment with the expected synergies or growth schedule.

Financials

Profit-sharing and cost allocation

A few factors drive the complexity of JV structuring financials. For one, a NewCo is often sustained by service agreements from parent companies, which require negotiation to determine to what extent the NewCo will be burdened by a ParentCo's support costs. Perhaps most contentious, though, is defining the share ratio and profit-sharing mechanics between the NewCo and ParentCos. Lastly, partners should anticipate accounting gains and losses that can occur upon deconsolidation of existing businesses.

Exit

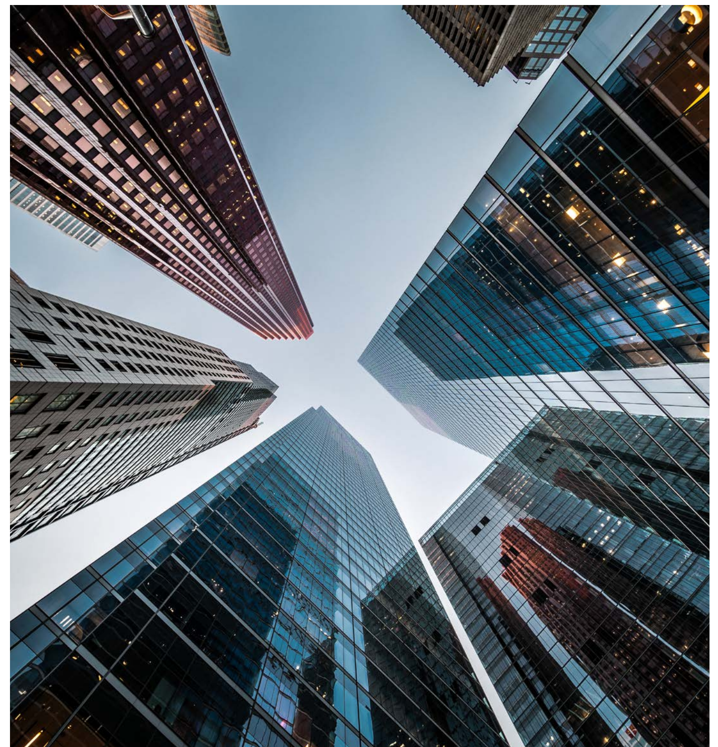
Alignment on the breakup terms

The key to defining equitable exit terms before signing is focusing on the true non-negotiables that each party should be reasonably entitled to take away in the event of a breakup. Deal-focused strategists will aim for a finite set of reasonable breakup take-aways based on a combination of initial and ongoing partner contributions.

Culture

Unintentional JV culture

Unless deliberately defined, joint venture cultures often end up being a haphazard combination of the two parent company cultures. If the parent companies are not intentional about shaping the NewCo culture, it will develop on its own, often out of dominant norms, rather than being defined specifically to realize the JV's strategy.



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Successful JVs start with careful design

JV setup requires clarity on a few key interlocking components. It is essential to start with the strategy rather than the partner. Then align on governance and economics, while working through operating structure, exit terms, and cultural alignment.

1 Be strategy-centric vs. partner-focused

Rather than starting with the decision to partner with a specific company due to familiarity, fit, or other reasons, successful deal makers start with the strategic objective and business case before proceeding into partner selection. As an example: Despite growing demand in a developing region, a client of ours was experiencing production and supply-chain constraints in their economy product line. In response, they set an objective to capitalize on growth for economy-line products in developing markets and evaluated strategies to reach the objective. What followed was a careful selection of JV as the optimal partnership structure, and partner selection to narrow down a short list of candidates.

2 Keep governance nimble and empower JV management

A joint venture's NewCo traditionally requires a board with representation from ParentCos, supported by sub-committees that serve more focused purposes. The focus of governance often intensifies around number of appointments for board seats. While this is a crucial factor, successful JV boards instead concentrate on delegating most decisions to the NewCo's management team while retaining voting rights in key decision such as material ongoing investments.

Case study

A leading industrial equipment manufacturer uses a JV to grow in a new category

A leading industrial equipment manufacturer sought to grow in a competitive new market with a line of economy products, but it faced constraints. After a strategic review, the company decided to pursue a joint venture combining its production operations with a partner's IP and supply chain. The goal of the JV was to accelerate production while lowering cost. KPMG assisted the client with defining the NewCo governance structure, defining the perimeter of contributions, valuation of contributions, operating structure design, and a roadmap for reaching the NewCo's growth targets.

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3 Design a JV operating structure with the "best-of-both parents"

At the broadest level, the JV's operating structure should be designed to optimize the JV's operations in a way that maximizes its ability to achieve the NewCo's strategic goal and return on the ParentCo's contributed assets. Each individual design choice that goes into the JV's overall operating structure should answer the question: "Which party is most advantaged in this specific capability or function (e.g., engineering), considering key factors such as cost, scale, sophistication, etc.?" to achieve the best-fit balance of people, systems, facilities, and other resources.

4 Create equitable NewCo economics and profit-sharing

When we say "equitable" in this case, we mean a state where contributions, share ratio, and profit-sharing are congruent — a feat that is easier said than done. The key to balancing this equation is 1) define the asset perimeter, 2) establish the forecast, and 3) calibrate to a share ratio reflective of contributions, and finally aligning on a profit sharing mechanism. Too often, we have seen parties get to signing while taking these steps out of sequence. We have seen more success when parties directionally agree on these financial principles in early talks and only renegotiating ahead of signing if the equation gets materially out of balance as the finer details of the models comes together. Lastly, Partners should keep a watchful eye towards downstream accounting implications, especially as the primary beneficiary, and how to financially consolidate the JV if not truly 50-50.

5 It's never too soon to discuss exit terms

Defining when and how each partner can trigger an exit from the JV can promote a more stable operation of the JV itself. Typically, exits entail one partner buying the other one out, unwinding of the JV, dissolution, taking the JV public, or selling the JV to a third party. While discussing the terms of an exit with a partner signing can seem like a deal breaker itself, we find that unresolved questions about exit terms can push the parties apart at the eleventh hour.

Our experience suggests two factors are key to navigating this delicate topic: first, confine the exit terms to a finite set of scenarios to avoid venturing into the obscure/unknowable. Secondly and most importantly, define a set of terms that would reasonably be agreed to by the other side—especially in case of an unwinding and who walks away with which key assets (e.g., intellectual property).

6 Proactively define the JV's culture

JVs provide an exceptional opportunity to intentionally establish new behaviors and norms. They are often defined to accomplish an objective that a single partner cannot easily achieve on its own. It is critical to understand the differences between both parties' ways of working early on—and define what elements are required for the JV's success. Knowledge of the parent companies' cultural differences and NewCo's cultural direction arms both partners with a better baseline of understanding during negotiations and establishes the winning behaviors to establish during formation.

Case study

Automaker aims to cut $1 billion in costs through a JV

A major automaker calculated that it could realize $1 billion in synergies by combining production operations of two of its operating brands in a new jointly owned company. Prior to deciding on the joint venture concept, KPMG assisted with the synergy assessment and selection of the best-fit structure among various partnership alternatives for both operating brands and the ParentCo to realize the expected synergies. KPMG further assisted the client with defining the NewCo governance structure, defining the perimeter of contributions, operating structure design, and a roadmap for reaching the NewCo's synergy targets.

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Four structural archetypes for JVs

There are four basic JV types, which range in degree of integration required and in difficulty of separation. A new business that does not depend on assets from the partners requires the least integration and is easiest to separate. A two-sided carve-out is the most challenging, involving the integration of assets from both parents.

Integration: High

Standalone consolidation

Each partner has a standalone business in the market, and the objective is to consolidate the two under the JV structure

Advantages:

- Minimal operational entanglements; already established in the market
- Potential for synergy opportunities

Complexity drivers:

- Extensive integration effort is required to operationalize the JV
- May require challenging decisions around rationalizing assets, people, and products

Two-sided carve-out integration

Both partners have operating assets that need to be separated from the parent company, and subsequently integrated to form the JV

Advantages:

- Larger pool of resources to contribute to the JV
- Combines "best practices" of each partner

Complexity drivers:

- Extensive separation exercise before partners put assets into a JV
- Requires highly coordinated planning between the partners to contribute or build necessary assets, people, contracts, etc.

Separation: Low — Separation: High

New business

Neither partner contributes operating assets to the JV. Instead, each partner brings a combination of funding, IP, management experience, etc.

Advantages:

- Optimal flexibility in defining new business and operating structure
- Minimal to zero effort required in traditional integration or separation activities

Complexity drivers:

- Increased risk stemming from standing up a new business and entering a new market
- Requires extensive effort in hiring, procuring assets, and establishing the operating structure

Carve-out and intangibles

One of the partners brings operating assets, the other contributes intangibles such as customer relationships, IP, and industry expertise

Advantages:

- Ability to select optimal suite of tangible and intangible assets for the JV
- Reduced integration effort and cost when compared to two-sided carve-out

Complexity drivers:

- Perceived inequity between the partners' contributions to the JV
- Partner separating physical assets may be exposed to a higher level of effort and associated separation cost

Integration: Low

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How KPMG can help

Defining the strategy

Assisting in defining and pressure testing the strategic objective, expected synergies, transaction options (e.g., alliance vs. JV vs. M&A), and JV partner evaluation.

NewCo financial modeling & contribution valuation

Developing valuation models to assess the value of partner contributions.

Financial due diligence of contributions and carve-out financials

Analyzing normalized run-rate earnings, net working capital, and debt of ParentCo contributions, as well as carve-out financials and technical accounting.

Structuring NewCo governance

Identifying functional leadership for the JV, supported by a management office and steering committee, to drive accountability and stand up the new business.

Designing the NewCo operating structure

Designing the NewCo's operating structure for Day 1 and its fully standalone-state, facilitating alignment with the partner company to design a best-of-both model.

Standing up the JV, separating assets and integrating into NewCo

Executing on detailed separation and integration project plans to implement the NewCo operating structure, manage workforce transitions, and enable value capture.

Defining the joint venture's culture

Assessing existing parent company cultures and defining the JV culture that will serve to drive the broader strategy, operating model, and org structure.

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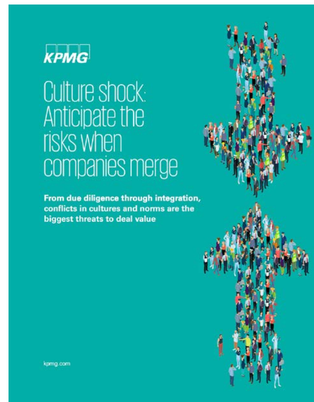

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