Joint Venture Advisory Practice

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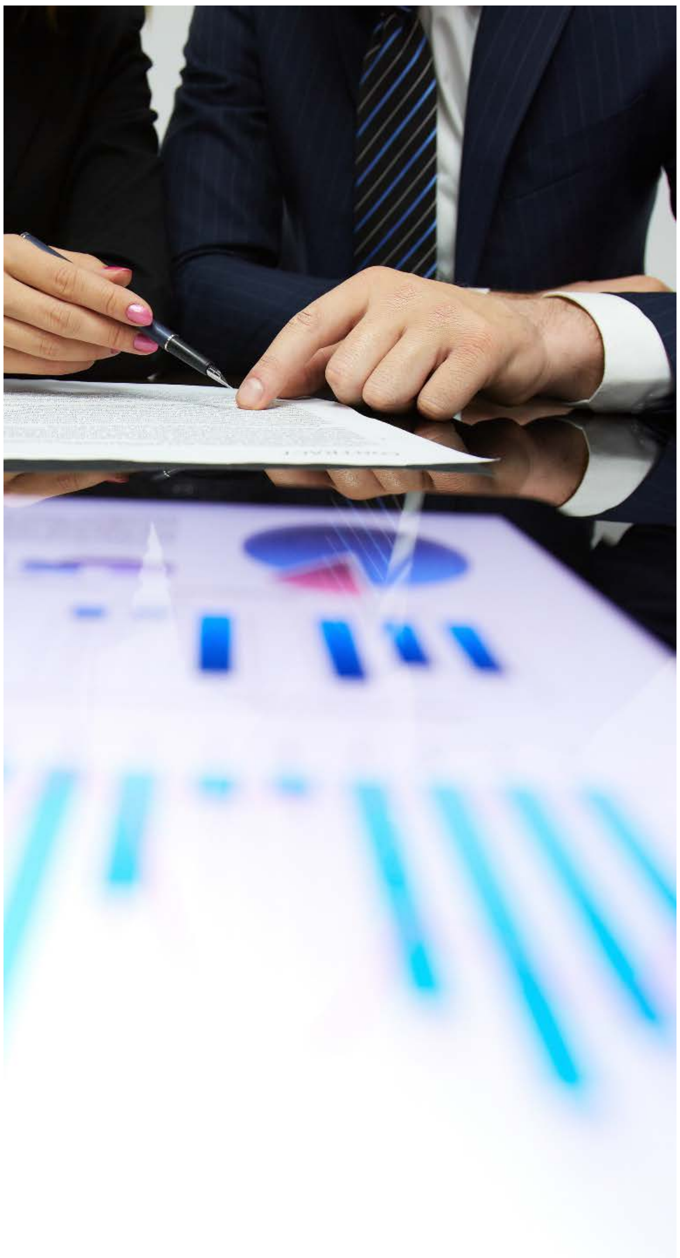
Why do a joint venture?

Why do businesses form joint ventures and how do they justify their existence? In this issue we consider the motivation for forming a joint venture or alliance, and consider three commonly used supporting theories: *Transaction Cost Theory, Strategic Management Theory,* and *Economic Theory.*



Joint ventures and alliances, as a way of doing business, are rationalised, chosen and justified through a range of theoretical tools. These tools have been the focus of many academic studies, but most of the research is quantitative and United States based. When reading across studies, academics consistently observe that it is difficult to identify trends or predict joint venture activity due principally to the fact that the definition of a joint venture is not agreed internationally, to the extent that some studies capture supply agreements in their data set. In practice, we observe that the reason for joint ventures is usually reflective of the motivation of the initiator.

Motivations for forming a joint venture or alliance

Motivation could be the reason a joint venture or alliance succeeds, or not. It is the trust, design and execution which decides this. However, understanding the motivation of the parties is critical if trust, design and execution are to be properly addressed. Here are three key motivations we've observed:

Transaction Cost

In our experience, Transactional Cost Motivations (based on the Transaction Cost Theory) tend to be common with people within organisations whose job is to optimise cost and efficiency to improve margins. Departments such as production, logistics, finance, R&D or procurement often justify joint ventures with the transactional cost rationale.

Motivations might be to improve production costs of two or more companies, by optimising scale of operations, learning opportunities, distribution locations, each other's partnerships and proprietary knowledge. Motivations might also be purely transactional, to maximise efficiency through joint ownership and control of rights, or mutual commitment of resources.

The issue with joint ventures set up to this effect is that when the joint venture is operating, partners often start to bargain. This is natural given the functions within a business that often design and operate this type of joint venture. For example, multi-jurisdictional or multi-partner joint ventures more easily create ambiguity of 'who is getting the better deal', amplified if the parent organisation has a crossed matrix of operations and if in country leadership are incentivised to achieve different goals.

In another instance, an independent joint venture becomes financially or operationally opaque over time as it is designed that way to optimise efficiencies. However it may open it up to additional scrutiny and monitoring from one or both partners as they manage the loss of control, which may result in increasing costs outside of the joint venture. When viewed in totality, the benefits are thus eroded.

When applying *Transaction Cost Theory* to rationalise a joint venture, it is wise to stress the perceived benefits under different scenarios, and ensure that there is a significant buffer should things not go exactly accordingly to the perfectly modelled business plan.

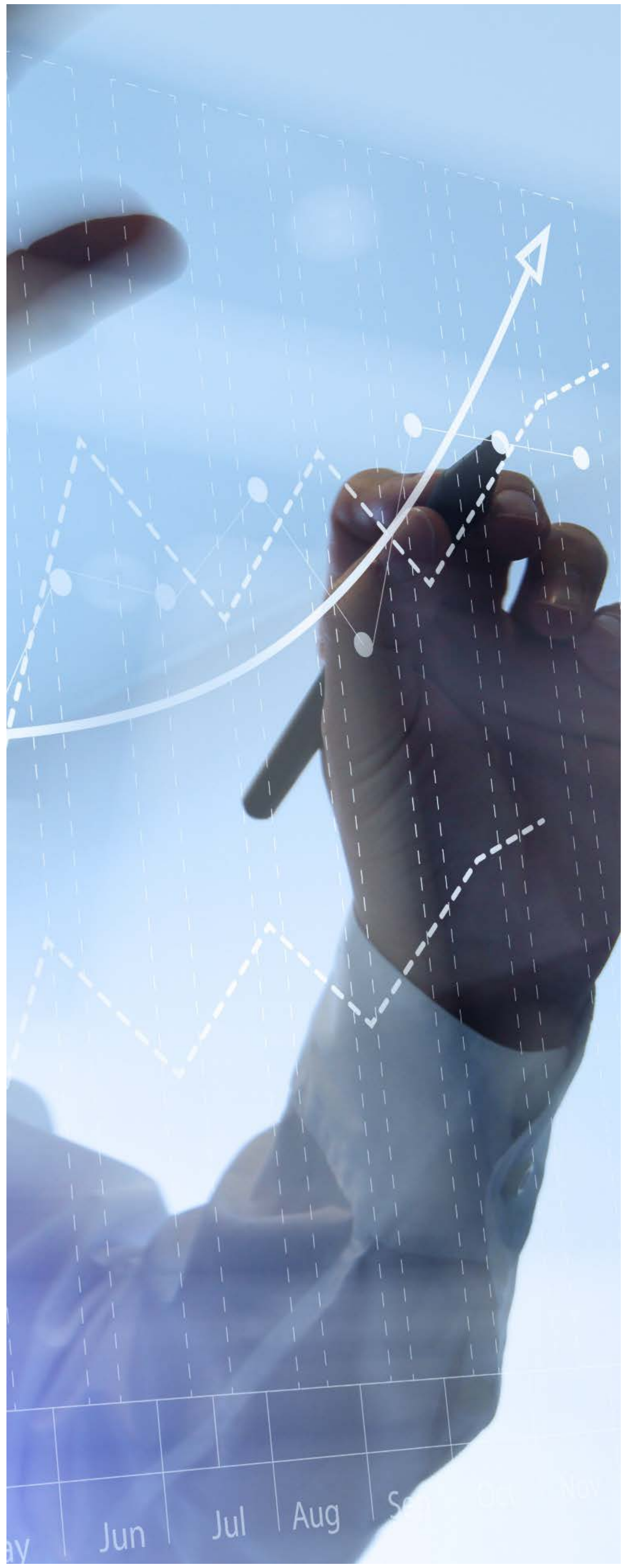
Strategic

Strategic Motivations tend to be more common with revenue generating operations such as strategy, sales, and business development, where profitable top line growth is how people are incentivised.

Strategic Management Theory draws attention to the strategic rationale for forming the joint venture, specifically the strategies of the two parties and how the joint venture might make a positive contribution to those strategies[1]. This cooperative strategy assessment is based on primarily: the motives for forming the joint venture, the selection of partners so as to achieve compatibility of their goals, and the need to achieve integration between partners' cultures and systems.

Well formed *Strategic Management Theory* also illustrates the underlying fundamentals of cooperative theory throughout operations. It considers, among other things: the resources contributed by the partners and the returns generated from those contributions, the impact of these contributions to both the joint venture and the contributing business, management structure of the joint venture and alignment of processes within and outside of the enterprise, issues of control (economic and operational), autonomy of the parties and impact on organisational design, networks within and outside of the joint venture, and inter-organisational learning.

Too often we see joint ventures and alliances which address the positive contribution elements, but do not go deep enough into the underlying fundamentals, usually for fear of upsetting or scaring away new found partners and being perceived as unable to close the now internally visible deal. Leadership should acknowledge this common flaw and be supportive of potentially upsetting the new partner in favour of detail, as it is often less destructive and easier to design up front than renegotiate it later. Underdeveloped strategic rationale that does not consider the operational impacts often leads to operational failure.



[1] Child, Faulkner and Tallman (2005) Cooperative Strategy; Managing Alliances, Networks and Joint Ventures (second edition), Oxford University Press.

Economic

Economic Motivations are more holistic and considered, adopting aspects from both *Transactional Cost* and *Strategic Management* theories, and are usually supported by executive functions.

While there are many views as to how to economically rationalise joint venture formation, we find the 'Seven Rationales for Cooperation'[2] as a robust approach which covers nearly all instances:

Risk reduction	a) Perfect portfolio diversification b) Dispersion and/or reduction of fixed costs c) Lower total capital investment d) Faster entry and payback
Economies of scale and/or rationalisation	a) Lower average cost from larger volume b) Lower cost by using comparative advantage of each partner
Complementary technologies and patents	a) Technology synergy b) Exchange of patents and territories
Co-opting or blocking competition	a) Defensive joint ventures to reduce competition b) Offensive joint ventures to increase costs and/or lower market share for a third party
Overcoming government-mandated investment or trade barriers	a) Receiving permit to operate as a 'local' entity because of local partner b) Satisfying local content requirements
Initial international expansion	a) Benefit from local partner's know-how
Vertical quasi-integration	a) Access to materials b) Access to technology c) Access to labour d) Access to capital e) Regulatory permits f) Access to distribution channels g) Benefits from brand recognition h) Establishing links with major buyers i) Drawing on existing fixed marketing establishment

In our view, economic rationalisation should always be assessed against possible future situations. For example, what limitations does the joint venture impose on the strategic direction of other parts of the business, or the partner? What happens if the joint venture becomes a competitor itself? What is the real impact to the remaining business if part is carved out to contribute to the joint venture? Shareholder value ought to be the guiding principle at the centre of any balanced view.

Summary

Whilst 'why do a JV?' might seem a simple question, it is often interesting to hear the differing responses. They are not always aligned, and often are supported by a theory which reflects the situation, training, background and incentivisation of the respondent. Unclear motivation can cause issues with joint venture performance, and can be difficult to fix once operational. Misaligned motivations can lead to governance issues. Aligned motivations give a joint venture the best chance of success.

Joint ventures and partnerships have a role to play in strategy, but must be used when appropriate and when the data is sufficient enough to support their rationalisation.

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[2] Contractor, F.J. and Lorange, P (eds.) (1988). Cooperative Strategies in International Business. New York: Lexington Books, pp.3-28.

Contact us

Brad Johnson
Director
Deal Advisory, Joint Ventures
T: +65 6213 3800
E: bradjohnson@kpmg.com.sg

KPMG
16 Raffles Quay
#22-00 Hong Leong Building
Singapore 048581
T: +65 6213 3388
F: +65 6227 1297

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