Modernizing The Board's Oversight Of Joint Ventures

By Neetin Gulati, James Bamford, and Geoff Walker

Monitoring the management, operations and risks of your company is difficult enough for any board. What happens when those oversight duties are shared with another company? Joint ventures are an increasingly popular tool that allows corporations to share synergies and risks with an outside partner in a separate entity. Yet these benefits must be balanced with joint venture governance that protects both sides.

If you serve on a corporate board, chances are your company is actively considering entry into a new joint venture (JV). JVs and non-equity partnerships have exploded in the last few years, and that trend is not abating. Your company may also have existing JVs that could be underperforming or exposing the company to risks.

Increasingly, companies use JVs to address critical environmental and societal challenges, as well as stay competitive in the face of disruptive innovation. Some sustainability JVs have, for example, included partnerships between General Motors and LG Energy Solutions to manufacture battery cells for electric vehicles; Unilever and food-tech company Enough to bring plant-based meat products to market; and ExxonMobil and Agilyx to develop ways to process waste plastic to prepare it for recycling.

This trend is not surprising. JVs allow companies to access capabilities, enter new markets, share risk, and achieve both revenue and cost synergies. While some JVs have been extremely successful and performance has been improving over the last decade, they are also prone to underperformance and dysfunction. Our research on joint venture performance found that half still fail to meet their shareholders' strategic and financial expectations. In addition, we have found that most corporate directors are unable to answer the most basic questions about their company's joint venture portfolio.

Considering the stakes, boards can play a valuable role in helping executive teams pursue, negotiate, govern, and manage JVs in ways that create more value. Two such opportunities are forming new JVs and governing existing ones.

A JV should be pursued only if it is a better structure than other strategic options. JVs consume significant management time and expense in its launch and ongoing governance.

☐ ***1. Forming new joint ventures.*** While the executive team is responsible for driving a new JV transaction to close and launch, boards have an important role to play in oversight and guidance at the onset. Three areas corporate directors should focus on are: deal rationale; voting and control rights; and evolution and exit.

▫ ***A. Deal rationale.*** *Is a JV the right structure, and what are the strategic and financial objectives?*

An obvious but tricky question is whether this JV is the right deal. This is really a two-part question. Is this the right choice compared to other transaction structures, and how will this JV help the company achieve its strategic and financial goals? If done well, directors can bring a valuable perspective informed by their experiences and separated from the pressures on management to do a deal, while at the same time challenging optimistic assumptions, risk analyses, and the business environment.

On the first point, a JV should only be pursued if it is a better structure than other strategic options, or is

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the only viable way to pursue an attractive business opportunity. Directors should push on whether a simpler contractual arrangement (such as a licensing, marketing, or supply agreement) could accomplish similar strategic objectives with similar results. A JV will consume a significant amount of management time and expense in its launch and ongoing governance. Similarly, an acquisition should be preferred when possible, and the synergies are large enough to cover the expected control premium.

As for the second point, the strategic and financial rationale for a JV should be clear and crisp. For example, Ultium Cells, the battery cells joint venture of General Motors and LG, aims to create a battery that will cost less than $100/kWh, as well as provide 60 percent more capacity, and reduce the cobalt content by 70 percent compared to other EV batteries. GlaxoSmithKline and Pfizer's consumer healthcare JV aimed for annual cost synergies of $650 million, and eventual separation and public listing of the JV.

For both JVs, clearly defined success metrics provide quantifiable measures that the board can look to for evaluating how effectively the venture is achieving its objectives. Directors should also be well equipped to analyze and question the JV's feasibility, and the financial projections of management.

It is important to monitor due diligence to ensure it appropriately covers ESG risks. The poor ESG reputation of a JV partner can infect both the venture and its owners.

As part of its strategic assessment, the board should also assess how the JV fits with the company's mission, vision, and values, as well as the increasing importance of environmental, social, and governance (ESG) factors. As long-term stewards of the company, directors have an important role to play in both areas.

Because the company will not be in complete control of the JV, it is important to monitor the due diligence process to ensure it appropriately covers ESG risks. The poor ESG reputation of a JV partner can infect both the venture and its owners. Separated from the pressures of doing a deal, directors should ask tough questions about how deeply management has investigated potential environmental and human rights issues, and make sure the company is willing to walk away based on what they find.

□ ***B. Voting and control.*** *Has a workable decision-making and oversight structure been included in the JV agreement?*

A second topic the board should examine is whether the company's interests are properly safeguarded through the JV's governance structure. This is important particularly for non-controlled JVs, with a non-controlling partner's leverage greatest at the time of entry.

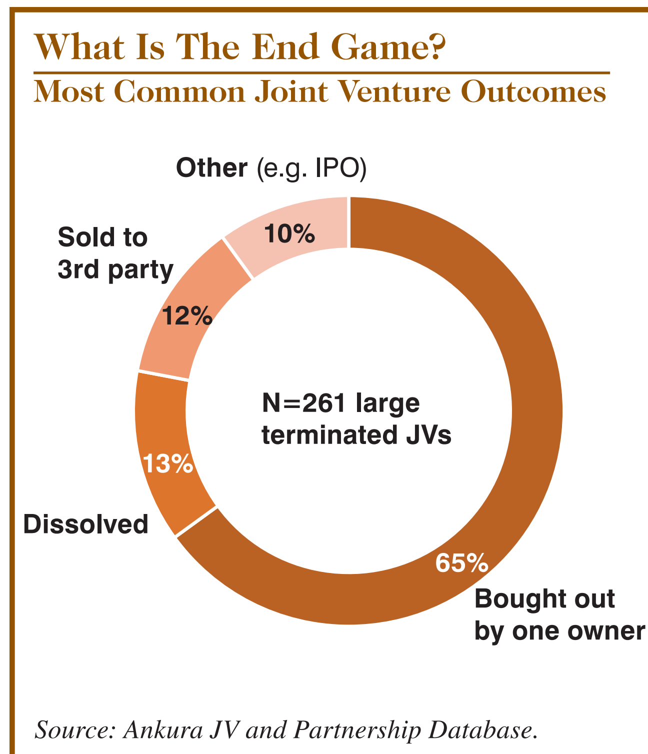
The great challenge of JVs—control—comes in many more gradations than "I control," "you control," or "we share control." For starters, control need not flow directly from ownership percentage. Many JVs have been formed over the years (including MillerCoors and the Solae JV between DuPont and Bunge) with unequal ownership, but are still governed as 50/50 ventures.

Ankura's analysis revealed that most minority partners in JVs have more negotiating leverage than they realize, and that a firm's ownership stake does not dictate, nor even correlate with, its voting rights. What voting and control rights a company secures is a function of its negotiating prowess and leverage—not its contributions or ownership interest. With distance from deal negotiations, directors are well-positioned to examine the governance terms included in the agreement.

The standard voting- and control-related terms in a JV agreement usually do a good job spelling out where the most fundamental decisions will be made (shareholders vs. JV board), and defining the voting thresholds needed to carry a decision (unanimous, supermajority, simple majority). Typically, these relate to topics like liquidating the company, changing the capital structure, amending the legal agreements, and appointing the top officers.

We have found that there is another level of operational decisions that are rarely defined in the JV agreement, but such decisions are critical for the venture to function. Board oversight of a JV agreement should include ensuring that defining and agreeing on these

What Is The End Game?
Most Common Joint Venture Outcomes



Source: Ankura JV and Partnership Database.

next-level decisions (including authority delegated to the JV CEO and management, and whether board and non-board committees will have any approval or vetting rights) are not punted to another day. These decisions are essential to ensuring strategic alignment and getting the JV off to a good start.

□ ***C. Evolution and exit.*** *Will the JV be adaptable to changing market conditions and parent company needs? What are the strategic considerations affecting exit?*

The future is impossible to predict, and even the best-laid plans sometimes go awry. Virtually every JV gets "stuck" at critical inflection points, unable to evolve or respond when necessary. When entering into a JV, it is important to build the capacity and flexibility to evolve when these inflection points arise.

Boards have a duty to look out for the company's long-term interests, and should ensure a new JV has built-in flexibility to evolve as market conditions and the company's ambitions change. This flexibility could include, for example, "opt-out" provisions that allow one partner to proceed with investments if the other cannot contribute additional capital, provisions for adjusting service and offtake agreements, and so on.

More importantly, the board should assess a new JV facing the reality that all JVs eventually come to an end. The median lifespan of a joint venture is 10 years, a figure which has remained largely unchanged for decades. Some 65 percent of JVs end with the venture being bought out by one partner. The other 35 percent end in other ways (such as being unwound, dissolved, sold to a third party, or taken public).

What is the desired end game of the venture? Is the JV intended as a long-term partnership, or a staged exit? Are you the "natural" buyer or sell of the JV?

There are questions the board should discuss with management prior to entering into a new JV. First, what is the desired end game of the venture? Is the JV intended as a long-term partnership, a staged exit, or a stepping-stone to a bring in additional partners, or to an IPO? For example, when Pfizer and Glaxo-SmithKline formed a consumer healthcare JV in 2018, the parties announced that they intended to separate the JV as an independent company. They included provisions on which party could trigger the separation process.

A second and related question is whether you are the "natural" buyer or seller of the JV. In our experience, one partner is likely to be better positioned to buy out the venture from its partner, for instance, because the venture is co-located on its site, is more core to its business, or receives critical technology or services from that partner. There may also be legal or regulatory reasons, such as rules on majority local ownership, that prevent one partner from taking over the JV.

Once the most likely eventual exit is established, the board should confirm that these considerations are reflected in specific contractual terms. Most JV agreements contain four to eight exit triggers, which are the events that allow a partner to exit the JV. The majority of JV agreements also include at "at-will" exit clause.

Consider whether such a clause should be paired with a "lockup" provision, during which time no

partner can exit, to allow the JV time to get off the ground. Each exit trigger may have one or more exit mechanisms, such as a "put" or "call" right to force a buyout of one or more partners, or an IPO trigger. Finally, the board should ensure that the agreement addresses the post-exit relationship between the JV and the exiting partner to ensure a smooth withdrawal or wind-down.

Corporate directors may have first-hand experience in how tricky JV exits can be, and how it can distract from business operations. With that perspective, directors should be well-positioned to provide oversight and test the exit triggers and mechanisms so the exit process is smoother for all sides.

Few corporate boards have an adequate understanding of their company's joint venture portfolio or its performance.

☐ ***2. Governing existing joint ventures.*** Corporate boards should also ensure they have visibility into and oversight of current JVs that are material to their company. The materiality and importance of a company's joint venture portfolio will depend on both company size and industry. Within the natural resources industry, JVs are very common and material to core business operations. For example, major oil companies like Shell, ExxonMobil, and TotalEnergies have ownership stakes in hundreds of JVs, while in the mining industry, BHP, Rio Tinto, and other mining companies are invested in dozens.

JVs are increasingly common in other industries as well. GM's operations in China and Korea, as well as its electric vehicle battery manufacturing operations, are carried out by joint ventures. Such operations are material to GM's bottom line and future as a company.

For companies where JVs are materially important to business operations, they are also important to shareholders and boards. Unfortunately, few corporate boards have an adequate understanding of their company's joint venture portfolio or its performance.

While directors do not have the time nor the responsibility to understand and review each JV in a company's portfolio, they still have a duty to provide oversight and strategic guidance. To start, directors should understand JV financial and operational performance and fit with the company's strategy; how JVs impact risk management and ESG performance: and how JV directors are selected and trained.

□ ***A. JV performance and strategy.*** *How effective is the financial and operational performance of our JVs? Do they continue to fit into our corporate strategy? Are there JVs that need to evolve, restructured, or be exited?*

JVs are often outside of senior management's day-to-day supervision, and their financial and operational performance is aggregated with wholly owned assets within a business unit. This can make it difficult for boards to have visibility into the how they are performing. As part of the board's oversight responsibilities, it should have access to and review the financial and operational performance. An annual performance and strategic review that summarizes the financial and operational performance of the company's JVs by key characteristics (such as business unit, geography, and level of control), as well as how JVs fit into the company's overall strategy can provide useful insights for the board.

By calling attention to joint ventures, directors can prompt management to pay greater attention to the company's JV assets. For JVs that are not meeting their strategic and financial rationales, this should lead management to consider what changes need be made, or if the JV should be exited.

Our research suggests that JVs that evolve their scope, structure, and governance are more than twice as successful as those that do not. Such changes should not be made reactively. There are also times a JV reaches an inflection point or deadlock, and the best move may be for a partner to exit or the JV to unwind.

As with any divestiture, your board should assess whether it is the opportune time to exit the JV or buy out the other partners in light of market factors, the company's long-term strategic plans, and the best interests of shareholders.

□ ***B. Risk management and ESG.*** *How do we manage risks associated with our JVs, and do we*

have sufficient information to adequately assess such risks? How will ESG considerations from our JVs impact our corporate ESG scores or disclosure, as well as possible future financial performance?

An important responsibility of a company's board is to ensure that the company's risk management and controls are appropriate and robust. This responsibility needs to extend to the company's JVs, including those not controlled or operated by the company.

For example, at a leading chemical company, the audit committee annually reviews corporate policies, controls, and performance across the company's joint venture portfolio. This review can reveal areas where JV policies, controls, or performance are not up to company standards, or where there are gaps in the information received from JVs.

Most public companies publish codes of conduct and corporate policies that define their operating principles. In many cases, the published policies also cover the company's JVs, and require the company's suppliers and business partners to abide by similar standards and policies. As part of their oversight responsibilities, directors should ask management how they are engaging with their JVs and partners to ensure sustainable and responsible practices on the environment, human rights, health and safety, and community impact.

Boards should understand how JV ESG performance flows up and impacts the company's ESG performance and ratings.

Institutional investors, asset managers, financial institutions, and other stakeholders increasingly look at non-financial data on ESG performance. This data may be included in security filings and public disclosures, as well as gathered and aggregated by independent ESG rating agencies.

In the next couple of years, the amount of non-financial ESG data that needs to flow up from JVs to their parent companies will only increase. For example, both U.S. and European regulators are on track to requiring greenhouse gas emissions data disclosure in financial reports. Material value chain emissions (also known as Scope 3 emissions) from a JV will likely need to be disclosed. Directors should take action to understand how this increased disclosure will impact the company and the anticipated reaction from shareholders and stakeholders.

□ ***C. JV director selection and training.*** *What policy guides the selection of executives serving as JV directors? Is training provided, and expectations communicated? Are JV directors adequate for the demands and responsibilities of the role?*

To start, corporate directors should be more involved in establishing the policies and guidelines used when selecting JV directors. In most companies, identifying executives to serve as JV directors is less thoughtful than it should be. The process itself is typically reactive, a fire drill triggered by a looming vacancy on the JV board.

Too often, the job of finding a new director lands on the desk of a senior company executive, or human resources or legal as an added task in their busy schedules. Rather than a structured process, the easiest and quickest path is to replace a departing JV director with the executive filling the internal role being vacated. In many cases, director selection is a process that the corporate board has no role in and, most likely, no insight into.

Directors are well positioned to challenge the biases that can impact job assignments and promotions. The leadership and professional development opportunities provided by serving as a JV director should feed into a company's broader strategic talent development plan.

A diverse set of JV directors will lead to a diverse pool of potential future senior executives of the company.

JV directors often come from finance and operating backgrounds, leading to underrepresentation of executives with other functional backgrounds, like external affairs and sustainability. Women are also significantly underrepresented—in one specific example, only six percent of all directors on mining industry JVs are women.

A diverse set of JV directors will lead to a diverse pool of potential future senior executives of the company. Prioritizing this is consistent with the board's responsibility for guiding the long-term vision of the company, and nurturing future talent and leaders.

While selecting actual JV directors may encroach on the line that separates governance from management, boards should advocate for a director selection policy that defines the expertise, competencies, attributes, and other factors that would be valuable on a JV board. In addition, such a policy would ensure that the selection of JV directors is consistent across business units and geographies.

Finally, transition and onboarding policies should lay out how to transfer responsibilities and knowledge from the outgoing JV director to the incoming director, as well as the required training. This includes conflicts of interest and how to effectively represent the company's interests.

In conclusion, as companies increasingly incorporate JVs into their long-term business strategy, corporate directors need to ensure that their oversight and governance do not gloss over the opportunities and risks that a portfolio of JVs can provide. Many directors, wary of crossing the line between governance and management, do not ask necessary questions on how the company's JV portfolio is performing.

We think those fears are overblown. Board members should recognize that they are well-positioned to take a long-term view on how a well-run portfolio of JVs can complement and round out the company's strategy, values, and risk tolerance. ■

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