

Managing Joint Ventures in Emerging Markets



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The advantages and risks of joint ventures as an entry route into emerging markets

Whilst looking to take advantage of the significant opportunities presented by engagement in emerging markets, companies must navigate their way through a host of problems, including unfamiliar regulatory regimes, political and market risk, and cultural barriers. To minimise the risk whilst maintaining the potential upside, the choice of entry strategy is of vital importance. Get it right, and the business strategy has a far greater likelihood of running smoothly; get it wrong and problems can become so acute that the investment ultimately fails.

There are many different corporate structures that companies can use as part of their entry strategy, including wholly-owned subsidiaries, joint ventures, minority investments, distribution agreements and franchises. In this article, we look more closely at the advantages and disadvantages of joint venturing with a local company when operating in emerging markets.

Historically, joint ventures have been far more commonly employed by companies that are investing in emerging markets than by those building operations in more developed economies. An important reason for this has been that, in some markets, joint ventures have been the only strategy available to companies, due to restrictions on ownership by foreign investors. Above and beyond these legislative and regulatory constraints, joint ventures can also be the most attractive option for more positive reasons. If properly handled, they can offer relatively easy access to local know-how, established distribution networks, local contacts and relationships. Why build a new distribution network, for example, when you can simply tap into an existing one?

But while the application of joint ventures is well-established, they can be complex to manage and limit strategic flexibility to respond to changing circumstances. As a result, clear planning and forward thinking around the rationale and operation of a joint venture is essential.

Joint ventures offer numerous advantages

A number of academic studies have sought to pinpoint exactly why some investors plump for the joint venture route, including one recent example that considered the various dynamics lying behind the choice of joint venture versus greenfield development or full acquisition. Using published data and CEO questionnaires, it focused on companies investing in four countries: Egypt; India; South Africa; and Vietnam.

The study reached some interesting conclusions. It confirmed that the higher the level of institutional development in the host country, the less likely companies are to opt for joint ventures. The study went on to propose, perhaps more unexpectedly, that joint ventures can also be preferred over outright acquisition as a means to secure access to intangible assets, such as individual labour skills. One possibility for this preference is, as the study puts it, that “for certain assets embedded in individuals, an acquisition of a firm may not secure control because individuals may not want to work for the new owners and thus quit their job”. By extension, it is also arguable that contact networks are sometimes more likely to be preserved by a joint venture than in the case of an acquisition. Although these networks might not seem to be affected directly by the method of investment, staff retention and commitment will be essential to keep them functioning.

Joint ventures also have the advantage of flexibility, which is particularly useful in markets where attitudes to foreign investment may shift. Consider, for example, the recent decision by the Indian government to allow 51% foreign ownership by single brands of retail joint ventures. Those firms that have already built up a presence in the market (and an understanding of it) through joint ventures may find it easier to capitalise on the opportunities that majority ownership brings. But joint ventures can also act as a form of insurance if countries move in the opposite direction. If, for example, the current increase in global protectionist

sentiment translates into greater restrictions on foreign investment, joint ventures could provide a more effective way of working within restrictive regimes.

Many businesses continue to use joint ventures as a fundamental tool for entry into new markets. But the question is – should they?

The three Ws – being aware of the risks

Joint ventures, whilst offering a wide range of advantages to an investor, are not an easy form of investment for many companies. To be a successful investment vehicle, a joint venture needs to have been selected for the right reasons – and to have been a positive selection, rather than one made in the absence of any alternatives.

Before deciding whether the joint venture is the correct approach, companies need to consider the “three Ws”: “Why?”; “What?”; and “Who?”.

Answering the “why” question (that is, why a joint venture is more appropriate than any other form of corporate structure) can sometimes be straightforward – for example, if the joint venture is a short-term collaboration on a specific construction project or where legislation necessitates a local partner. But for many other projects, the drivers behind the selection of a joint venture structure may be less clear-cut and collaborating companies will need to be very clear about exactly what those objectives and drivers are. It is also important to realise that both partners’ motivation is likely to change over time and may not remain congruent, so companies should put in place a plan for how to respond to this. Some joint ventures are deliberately set up to be of short duration because of this issue; others have regular review points, and pre-agreed exit strategies that come into force should the interests of the partners diverge. Failure of both partners to be clear and honest about their aims and objectives going

into a joint venture agreement is a notable cause of joint venture failure.

The difficulty of undertaking more traditional due diligence which often occurs in a joint venture situation for a wide variety of reasons generates the next two “W’s”...

“What?” refers to what precise assets and capabilities each side is bringing to the party. For example, a UK company investing in a developing market would typically bring capital, technology and a brand; while the partner from the developing market would bring contacts, local market knowledge and distribution routes. This can raise a thorny issue when it comes to valuing the shares of a joint venture on exit: as one is often a tangible input and the other an intangible input, how do you value them? Intangibles such as brand can have a value placed on them but, once highly judgemental areas are introduced, the prospects of disagreement increase significantly. One source of irritation for companies operating joint ventures in emerging markets has been that local companies can be tempted to overvalue such intangible assets.

Answering the “Who?” question (that is, who really is our prospective joint venture partner?) can also be tricky. Whereas it may be relatively easy to get information on a potential business partner in a developed market, it can be much more difficult to do so in many parts of the developing world. Over time, this situation is likely to improve, particularly as credit ratings agencies and established investigators develop more precise information on these markets. Formal and informal contact networks can also make it easier to size up potential partners but, especially for small companies, information is likely to remain imprecise. However, at the current time, companies are well advised to undertake extensive due diligence on their prospective partners by making enquiries as broadly as possible in their chosen market – in many markets there is as yet little substitute for good, local intelligence from reliable sources.

Managing joint ventures effectively

While verifiable information on potential business partners will improve over time, there are a variety of other obstacles to overcome. Even basic decision-making becomes more complex in the context of a joint venture. For companies used to being in complete control, the sharing of decision making that comes with a joint venture can be culturally difficult to embrace. Such problems will vary in importance from one venture to another, although they are likely to be more acute if local management has day-to-day control, which is usually the case. A common way around this problem, however, can be to recruit new

external, non-aligned management specifically for the venture.

Other areas which need specific upfront focus include:

- Differing management styles and approaches – not just at a corporate level, but also relating to personality clashes between individuals;
- The control environment, whilst perfectly acceptable by local standards, may fall short of corporate governance standards in more developed economies;
- Local attitudes to business practices which in a UK context would be regarded as bribery, corruption and misuse of assets;
- Protection of intellectual property, which will continue to cause concern even though some developing markets, such as China, appear to be making cautious moves to address this problem; and
- A wide range of other risks, such as a partner using extra shifts in the plant to produce goods to their own account (the infamous “3rd shift”) or even setting up competing operations using assets from the original partnership.

As well as paying attention to the “three W’s” above, companies can reduce the risk they face by putting in place clear management mechanisms before the joint venture is established. For example, through management and control contracts, the partners should agree on a timetable for review meetings, reporting requirements and processes to manage conflict. In addition, they should determine clear exit routes in terms of notice periods, non-compete clauses and valuation mechanisms for buyouts.

There needs to be an agreement at the outset to refer serious disputes to international arbitration rather than local courts, which may be prejudiced against the foreign investor.

Even assuming everything goes well, joint ventures can pose another – often less expected – risk to companies, particularly smaller ones, simply in terms of the amount of management time and resources that they consume. Executives can find themselves constantly on the road to meetings in far-flung places and these commitments may stretch already tight management resources to the limit. Managing a joint venture is a very different experience to managing a subsidiary and many companies do not ask themselves what additional skills they may require to do so successfully. Even larger companies need to work out exactly how they will incorporate the joint venture into pre-existing structures.

Key points

Joint ventures remain relevant, despite more relaxed global attitudes towards foreign ownership, and continue to offer some specific advantages to outright acquisition in certain situations.

Companies need to be clear about exactly why they choose a joint venture structure, and what each side is contributing. Clear review and exit strategies are essential in this regard.

Managing joint ventures is generally difficult and time-consuming and may stretch smaller companies, in particular. Companies need to be realistic about whether they have the internal resources to manage a joint venture – particularly when it is geographically remote.

Companies need to be prepared for more stringent future reporting and disclosure standards for their joint ventures – whether they keep them at arm’s length or not.

Corporate Governance

For UK companies, particularly listed companies, consideration has to be given to appropriate corporate governance over the joint ventures – this can be challenging where day to day management is under the control of a joint venture partner. Companies need to have a clear idea how they will satisfy themselves that their corporate governance standards are being applied. It is important to remember that corporate governance is not only a financial requirement, but includes such areas as health and safety and environmental policies.

It is also important to remember that rules on the reporting of joint ventures in company accounts can vary considerably from country to country and may change in the future. The UK,

Canada and US have in the past been moving in different directions on this issue, however, we may now be beginning to see some convergence of views.

Conclusion

Joint ventures continue to be widely used, especially by companies seeking to pursue emerging market strategies. From a strategic perspective, joint ventures offer companies some degree of security against growing protectionist instincts, while also giving them a foothold in markets where the trend is towards greater liberalisation. In addition, trends such as the development of communications technology and the harmonisation of some reporting standards are also making joint ventures easier to manage.

But, as we have shown, those advantages do not come without risk. It can be difficult to ensure that the objectives of partners remain aligned, and there may be cultural differences that can be a powerful barrier to efficient decision-making.

Many of the risks can be mitigated, however, by ensuring that both partners are explicit about intentions and strategy from the outset. Clear mechanisms and reporting lines should be agreed, as well as processes to manage conflict or a divergence in objectives. While these approaches may not entirely remove the risks of joint ventures, they can help companies to understand more clearly what is involved before they sign on the dotted line.

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