Governing joint ventures

Better oversight isn't just for wholly owned businesses.

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Corporate governance has become a top priority for executives of public companies. Yet too few of them have raised the bar for governing joint ventures, whose financial-management systems, most executives tell us, just aren't as good as those of wholly owned businesses. Such systems, we hear, don't regularly incorporate joint ventures into the standard corporate-planning and review process, and parent companies don't pay enough attention to them. Where standards exist at all, they are informal and vary quite widely.

This neglect is risky. Most large companies today have ten or more sizable joint ventures accounting for 10 to 20 percent of their annual revenues, income, or assets. And in our experience, the effects of weak governance—chronic underperformance, a failure to adapt and evolve, and excessive managerial costs—help sink many such partnerships.

More than a decade ago, the California Public Employees' Retirement System (Calpers), hoping to improve the performance of corporate boards, established a set of corporate-governance guidelines. Applying them to joint ventures, of course, calls for adjustments. Nonetheless, we believe that such guidelines will not only help companies (and perhaps their public shareholders) to assess the governance of their existing joint ventures more clearly but also make their executives better informed when they enter into new joint ventures.

Indeed, guidelines such as these can make the difference between good and bad governance—between governance that is fast, accountable, and transparent, on the one hand, and prone to gridlock, weak performance management, mistrust, and stagnation, on the other. Our experience with many large joint ventures suggests that improving their governance can help their corporate parents to change their strategy, scope, financial arrangements, and operations and to identify and reduce the risks they face. Those risks can be considerable: in a recent case, an industrial conglomerate discovered, 18 months after the fact, that one of its joint ventures had exposed it to a $400 million liability.

Understand the challenge

Shareholders of public companies are typically united by a common desire to optimize returns—in the form, for example, of dividends and share price levels—and to manage risks. By contrast, the governance of joint ventures, which receive ongoing operational resources from a few large shareholders, is much more complicated (exhibit).

In joint ventures, for example, board members (and others involved in the governance system) must manage what may be the divergent strategic and economic interests of the parent companies, which often have very different constraints, views of the market, and means of profiting from the business. Likewise, the boards of joint ventures must secure and oversee the flow of operational resources (including technology, raw materials, and staff)

EXHIBIT

Anatomy of joint-venture governance

Governance in typical public company	Additional governance challenges for joint venture
Board composition	
Board members are not employed by shareholders; represent interests of all shareholders equally	Board members are typically employed by 1 of the shareholders, creating potential conflicts of interest
Board roles	
Board focuses on approval of major strategic decisions, CEO succession, risk management	Board must manage conflicts between shareholders, secure resources from shareholders, monitor transfer prices/ parent transactions, manage career path of management team
Decision making	
Investors unite in desire to maximize shareholder returns, manage risks	Key decisions (eg, strategy setting, capital planning) require agreement among a few large shareholders, which may have very different interests, financial constraints, view of market
Management team	
Management team members are accountable to CEO and board	Key members of venture's management team (eg, CEO, COO) are former employees of 1 parent; many likely to see future career tied to returning to that parent
Resource flows	
Venture does not depend on shareholders for any operational inputs	Venture depends (at times extensively) on 1 or both parents for key inputs, services, business functions (eg, raw materials, administrative support, sales force)

between them and their parent companies. These boards must also navigate through other operational problems, such as the creation of incentives for employees of the parent companies (such as engineers and sales reps) who interact with but aren't employed by the joint venture.

What's more, the members of the boards of joint ventures—almost always employees of their parent companies—have to overcome inherent conflicts between the specific interests of each of the parents and the overall interests and health of the venture. As one former board member of a large aerospace joint venture explained, "It was quite a dishonest system. You went into a meeting wearing two hats, as both supplier and owner. Each partner's prime motivation was to look after its own interests."

Toward a better model

Despite the differences between wholly owned businesses and joint ventures, many of the basic tenets of good corporate governance can—and should—be applied to both. The principles discussed here might be seen as the minimum needed to promote accountability, speed, transparency, and, ultimately, performance.[1]

Appoint at least one outside director

Outsiders are now extremely rare on the boards of joint ventures. Yet an outsider who is explicitly charged with promoting the interests of such a business and asking tough questions about its performance and long-term direction can dramatically improve its transparency, its bottom-line-performance orientation, and its overall returns. Such an outside director is also in a position to argue on behalf of its strategy when the parents have diverging interests. In the infrequent cases where joint ventures have appointed outside directors, the experience has been quite encouraging.

Consider, for example, the case of Aera Energy, a multibillion-dollar upstream oil joint venture that Mobil and Royal Dutch/Shell formed in 1996. The venture, initially a wholly owned spinout of Shell, was built on the premise that to compete in the mature and highly competitive heavy-crude business in California, Aera needed to operate in a manner very different from that of its major-oil-company parents. It therefore had to be quite independent. A key part of establishing this independence was the appointment of outsiders to the board. In 1996, when Shell created a 60–40 joint venture with Mobil's upstream California assets, the partners agreed to retain the outsiders on the joint venture's board and have them

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[1] These guidelines are a subset of McKinsey's draft joint-venture governance guidelines: more than 30 principles that companies should apply to their joint ventures. The guidelines have grown out of our client work with more than 500 alliances and, more directly, out of McKinsey's October 2004 roundtable for CEOs and directors.

continue to chair the audit and compensation committees.[2] Instead of choosing oil industry veterans, the parents sought out highly respected executives from other industries. Eugene Voiland, the CEO of Aera, believes that the outside directors brought a fresh perspective to the business, promoted transparency and frank discussion, and advanced the interests of the joint venture as a whole (rather than optimizing one parent's interests).

Designate lead directors or a strong chairperson

Partners in a joint venture typically approach the design of its board by picking three or four members each, without specifying their individual roles. Such board members thus act as generalists instead of contributing specific skills. Ideally, however, companies should adopt a highly specialized model of joint-venture governance by appointing board members with individual expertise who can provide real oversight and guidance in important areas such as finance, manufacturing, and regulatory affairs.

As a first step, each parent company should appoint a board member to function as its lead director. This makes at least one member a peer of the joint venture's CEO, with the power to challenge the management team and the responsibility for securing resources from the parents and for managing the relationship with them. One prominent global chemical company insists that in every major joint venture, each partner must appoint a lead director who spends at least 20 days a year on its affairs (the norm for nonlead directors is 5 days).

In some cases—especially multiparty joint ventures and consortia—a strong chair with oversight of strategy and budget issues can serve the same purpose. Consider Sematech, an 18-year-old research consortium formed by more than a dozen leading semiconductor companies. Its chairman, O. B. Bilous, devotes time to the consortium *between* board meetings by working with the CEO to review and challenge the content of all board presentations and by serving as a sounding board for the management team on key strategic and operational issues. The chair must bring real credibility to the role: Bilous assumed it after a career at IBM, where, as a general manager of a major division of IBM Microelectronics, he had structured

[2] When Exxon merged with Mobil in 1999, the new company installed a board composed entirely of internal directors.

and served on the boards of four very large semiconductor-manufacturing joint ventures. He is not, however, currently employed by Sematech or any of its investors, so he is an independent nonexecutive chairman.

Review and reward the performance of board members

Contrary to today's standard for corporate governance, few joint-venture board members are evaluated on their individual performance, and compensation is only obliquely, if at all, linked to the performance of the venture they oversee.

Companies should rethink the way they review and compensate the members of the boards of joint ventures. For starters, in annual reviews board members should be evaluated by such criteria as their impact in shaping the joint venture's strategy, their success in fulfilling their risk-management responsibilities, their track record in securing resources and attracting good people, and their ability to secure timely decisions from the corporate parents. Moreover, companies should consider linking the directors' compensation directly to the profit-and-loss statement or to other performance targets. To align the interests of the joint venture with those of the inside directors and to ensure that they have some skin in the game, at least 5 percent of their total compensation should be linked to a common metric for the performance of joint ventures. In fact, these businesses could steal a page from nonequity alliances that reward their board members and managers for exceptional performance by drawing down sums from a monetary fund whose size is linked to financial targets.

Sponsor an external audit

Large joint ventures do a fairly good job of generating basic financial and operating data—for instance, the cost of goods sold, plant utilization levels, and product defect rates. But they tend to be less effective at understanding their own economics (including transfer price profits) from the perspective of their corporate parents and at generating the second-level management data[3] so essential to grasping the real issues and prospects of a business.

The resulting lack of transparency about the economics and transfer prices can be startling. One industrial joint venture's parents extracted essentially all of their value through the sale of product subsystems to it—not through its dividends, which were negligible. At no time did its board understand whether it was truly profitable, because the governance system made the parents' actual costs in building these subsystems opaque. Indeed, the issue of transfer-pricing profits created deep tensions

[3] For example, information on the profitability of different customer or product segments, assessments of key business risks, and detailed comparisons with the performance of competitors.

in the relationship. The parents referred to the annual meeting on prices as "the poker game," and the parents' auditors called themselves "the liars' club" because they had to smoke out each other's pricing bluffs.

One US downstream oil industry joint venture that also depended extensively on its parents for key inputs, such as crude oil and administrative services, provides a contrast. Each year, its board hired a leading accounting firm to audit its books. The accountants were asked to pay particular attention to the parent companies' transactions, such as crude-oil supply and off-take agreements, thereby ensuring that materials and services were fairly priced and that the board understood the total economics of the business.

Create a real challenge process

Too often, and for many reasons, joint ventures are shielded from thorough performance scrutiny. For one thing, they exist on the corporate periphery, outside their parents' normal reporting processes. Likewise, their parents may be reluctant to invest scarce managerial resources in efforts to oversee them properly merely to capture, say, only half of the resulting benefit. Indeed, the returns not only seem lower but also may take more effort to secure: changing an underperforming joint venture in a significant way typically requires agreement by the parents, and that can be difficult—if not impossible—to achieve. Nonetheless, a company making a large investment in a joint venture should oversee it with the same level of intensity that would be devoted to other businesses of the same size.

One important consideration is how to create a rigorous reporting and review process that engages all of the corporate parents without subjecting the joint venture to "double jeopardy"—that is, to full and separate reporting to all of its corporate parents, forcing it to meet different data and format requirements and to report for different calendar years. Here, the experience of one consumer-product-financing joint venture is instructive. To avoid double jeopardy, it was linked directly into one parent company's corporate-review process and treated like one of that company's wholly owned business units. The key difference is that the board members from both parents participate in these meetings and challenge proposals from the parents' perspective. In the oil industry, the board of a multibillion-dollar joint venture established an independent review process, including a separate and very strong finance and audit committee as well as the aggressive use of outside auditors to benchmark the performance of the business.

Let the venture's CEO run the business

We recognize that the board of a joint venture may, from time to time, have to intervene in its operational affairs or strategy decisions—for example, during a major downturn in its performance or a fundamental change in its geographic or product scope. But we also believe that a board must empower a joint venture's CEO to operate as its true general manager, not only for the sake of fast and objective decisions, but also to attract and motivate strong leaders. All too often, CEOs of joint ventures lack the authority to run them, while board members act as quasi-operators who intervene haphazardly in tactical decisions.

One thing companies can do is to grant the CEO the power to hire and fire all employees, or at least a veto. Another is to give the CEO a reasonably high degree of sign-off authority on capital expenditures and to establish beforehand what percentage of the dividends the joint venture will retain to invest. In addition, the board should develop and endorse a performance contract for the CEO—essential not only to define the boundaries between the CEO and the board but also to make sure that the corporate parents have similar expectations about the joint venture's performance.

The experience of a four-partner joint venture in the electric utility industry is illustrative. Although the board had endorsed a strategic road map for the first two years, it was exceedingly general and hadn't been codified consistently or even formally approved by the board. Individual directors, trying to steer the business in one direction or another, made many back-channel requests to the CEO between board meetings, so that the original road map became less and less relevant. The joint venture lost its focus, missed a key customer window, and nearly drove one of its parents to exit.

To improve its business discipline, the board recruited an experienced general manager as CEO. Before accepting the job, he insisted that the board endorse a three-page memo identifying six objectives for his first year. Each objective came with three or four pinpoint deliverables and a relative weighting for evaluation. The result: the parents started to walk in lock-step during year three, and the joint venture became more disciplined in business and operational matters.

Few if any joint ventures now follow such guidelines. But those that do have an opportunity to improve their performance materially. Q

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