Joint Ventures and Strategic Alliances
Examining the keys to success
Optimize deals

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Introduction
The globalization of business models and dramatic changes in the way that businesses operate and compete have resulted in a shift in mergers and acquisitions (M&A) strategy and execution. M&A or organic growth is not always feasible, nor is it always the fastest route to achieving desired objectives in a very competitive marketplace. Increasingly, corporations and investors are moving beyond the traditional acquisition/disposal model and using joint ventures (JVs) and strategic business alliances to achieve their business development objectives.

Much of the recent activity around alliances is being driven by the rapid pace of technological advances. Most companies cannot achieve their growth aspirations singlehandedly without harnessing the complementary capabilities of partners. US CEOs have said that the top drivers of alliances are access to new and emerging technologies and the need to strengthen innovation capabilities.

Even as partnerships and strategic business alliances are becoming more important to CEOs, the challenge of managing them is rising. Alliances are becoming more complex, and success rates, by some measures, can be low. The need for trust, collaboration, and equitable risk-sharing make these arrangements far more delicate to navigate than traditional M&A transactions.

In fact, relying on the formalized approaches companies have developed for M&A may lead to difficulties when it comes to negotiating a joint venture or strategic alliance. Rather, companies need to create specialized approaches to anticipate, manage, and monitor the challenges associated with these types of more collaborative transactions. Agile leaders in the future will develop enterprise-wide capabilities that enable them to be as adept at alliances as they are at traditional M&A. In the following pages, we discuss the current landscape for JVs and alliances, factors motivating their use, associated challenges, and leading practices for executing successful arrangements.
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Joint ventures and strategic alliances defined
A strategic alliance is an agreement between two or more organizations to share resources or knowledge to pursue mutually beneficial objectives while remaining independent organizations.

A strategic alliance is less involved and less permanent than a joint venture, in which two companies typically pool resources to create a separate business entity. In a strategic business alliance, each company maintains its autonomy while gaining a new opportunity to develop a more effective process, expand into a new market, or develop an advantage over a competitor, among other possibilities.

Both forms provide a way to supplement internal assets, capabilities, and activities, with access to needed resources or processes. Partners may provide the joint venture or strategic alliance with resources such as products, distribution channels, manufacturing capability, project funding, capital equipment, knowledge, expertise, or intellectual property.

Strategic alliance structural options vary based upon the desired characteristics. These structures range from a mix of contributions of assets and capital to primarily contractual. Structures that include the mix of assets and capital tend to be true JVs, partnerships, and minority equity investments. When assets or capital is not contributed, contractual alliances tend to be virtual joint ventures, long-term contracts, and seller financing. See Appendix A for a description of these types of alliances.

In this paper, any reference to “alliances” refers both to joint ventures and strategic alliances.
Alliances on the rise

Alliances play a key role in a corporate growth strategy. They are an alternative to the organic option of building a new business from the ground up, or the inorganic option of making an acquisition. Their importance was highlighted at the turn of the 21st century by scholar Peter Drucker, known as “the founder of modern management” who predicted some of the biggest economic and business trends of the last century. In 2001, Drucker stated, “The greatest change in the way business is being conducted is the accelerating growth of relationships based not on ownership but on partnership.”¹ This trend shows no signs of stopping today.

According to PwC’s 2016 Global CEO Survey, 49 percent of global CEOs are expecting to make a strategic alliance in 2016, down only slightly from 2015.² (See Figure 1). In the US, there has been a noticeable uptick in CEO interest, with 59 percent saying they are planning to initiate a strategic alliance in the next 12 months, a jump of 15 percent over 2015. The desire is global and across sectors: Among China CEOs, 63 percent want new strategic partners; 66 percent of CEOs in healthcare; 62 percent in pharmaceuticals and life sciences; and, 68 percent in entertainment and media plan to enter alliances this year.

With many industries facing mature and consolidated markets, executives are under pressure to find growth in emerging economies or in adjacent

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Figure 1: CEOs are focused on pursuing strategic alliances

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Enter into a new strategic alliance or joint venture</td>
<td>59%</td>
<td>51%</td>
<td>49%</td>
<td>46%</td>
</tr>
<tr>
<td>Complete a domestic M&amp;A</td>
<td>46%</td>
<td>44%</td>
<td>54%</td>
<td>49%</td>
</tr>
<tr>
<td>Complete a cross-border M&amp;A</td>
<td>29%</td>
<td>27%</td>
<td>27%</td>
<td>24%</td>
</tr>
<tr>
<td>Sell majority interest in a business or exit a significant market</td>
<td>18%</td>
<td>23%</td>
<td>13%</td>
<td>10%</td>
</tr>
</tbody>
</table>

Source: PwC’s 19th Annual Global CEO Survey

industry sectors. Many are finding that going it alone or pursuing an M&A transaction is either undesirable or not feasible. Instead, they are opting to join forces with a partner to gain access to new markets or complementary capabilities.

We’re seeing alliances forming across three predominant areas. The first includes companies interested in pursuing expansion into emerging markets such as China, Southeast Asia, Latin America, and Africa. The second includes the more capital intensive industries such as oil & gas, chemicals, manufacturing, automotive, power & utilities, and mining. Last, but certainly not least, are businesses seeking to strengthen innovation capabilities and access new technologies such as companies in financial services, technology or digital, telecommunications, media, pharma, biotech, and medical devices. In some of these cases, it can be more strategic for a company to share risk or leverage the partnership where a high barrier to entry may exist in a particular industry.

Traditional partnerships — with suppliers and customers — have certainly seen an increase. But US CEOs have been considering more alliances with rivals, firms in other industries, and start-ups (see Figure 2).

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**Figure 2: CEOs planning to broaden their pool of alliance partners**

![Bar chart showing current and future alliances]

Source: PwC’s 18th Annual Global CEO Survey
What is driving alliance activity in the US today?

More and more, companies are turning to alliances to step up growth and to benefit from a partner’s complementary skills and capabilities. Traditionally, companies have entered into JVs or alliances to gain access to new markets or expand their customer base. But, increasingly, new drivers are prompting the decision to partner (see Figure 3). For example, among the top reasons for forming alliances according to US respondents in the 18th Global CEO survey were access to new and emerging technologies and strengthening innovation capabilities.

These newer drivers are a result of the transformative impact that technology is having on many industries. In an era where many industries are converging, another emerging trend is the use of alliances to access new industries.

Figure 3: Access to technology and innovation are increasingly driving alliances

Source: PwC’s 18th Annual Global CEO Survey
These drivers are explored in more detail below, in order of importance to US CEOs.

**Access to new/emerging technologies and strengthening innovation**
The rapid pace of technological advances is driving much of the recent activity around strategic alliances. Companies often use alliances to secure new technology and strengthen innovation aptitude, which may include speed to market.

**Access to new geographic markets/entry point for emerging markets**
This traditional driver is still at the top of the list for US CEOs. The increasing difficulty of achieving a rapid, relevant, and meaningful presence in high-growth and emerging markets, coupled with escalating execution risk and regulatory/operational issues, has led to a dramatic rise in the use of alliances in those markets. These structures offer an effective means of entering strategically important markets. In fact, for some emerging markets — China in particular — the only way to gain entry is by partnering with a local company. Governments seeking alternate sources of capital or expertise to fund and operate large infrastructure projects or to help jump-start local businesses are increasingly willing to enter into JV or alliance arrangements, such as public private partnerships (PPPs) and sovereign wealth fund investments with established corporations. These relationships also act as a pipeline for established businesses to expand into emerging markets.

**Access to new customers**
Building and growing a loyal customer base is important to any business. But as competition intensifies, getting through to new customers can be a challenge. Strategic alliances provide partners with a ready-made and receptive audience — one reason CEOs consider these arrangements as an effective sales conduit to new customers.

**Access to talent**
As companies broaden out into new areas or develop new products and services, some of the skill sets they need may be in short supply. Rather than training internal personnel – or, worse yet, becoming bloodied in the war for talent – companies may opt to enter into an alliance with a partner rich in needed capabilities.

“Alliances are playing a significant role in the growth agenda for CEOs. We see this in the results of our 2016 Global CEO Survey and also in our discussions with clients.”
Greg McGahan, Partner, US Alliances Services Leader, PwC
Ability to strengthen brand or reputation
Joining forces with a partner with a significant reputation in a particular area is a good way to gain “brand equity by association.” One partner may contribute the name, while another may contribute particular expertise. When two brand-name companies in complementary areas form an alliance or joint venture, the resulting entity can create powerful buzz in the marketplace.

Sharing of risks and resources
Certain alliances are motivated by the need to share what are often significant upfront risks in developing new products and/or business models. They also provide a way for companies to share scarce functional expertise or resources.

The ability to share the upfront investment for development or exploitation of new intellectual property (“IP”) with a partner via a co-financing arrangement is a common motive for establishing a JV or business alliance. These arrangements are used in industries as diverse as aviation, pharmaceuticals, technology, automotive, and media. They are typically product or project specific and require significant upfront negotiation and investment of management time to complete.

A lack of available investment capital or a low appetite for M&A risk is another big motive behind JVs and alliances. Corporations have looked to partner with financiers such as private equity funds, hedge funds, and sovereign wealth funds to co-invest in their strategic targets. These arrangements are often extremely complex structures with put and call options and decision triggers that can result in a divergence of ownership interests in areas such as business strategy, the venture’s life-cycle, and exit strategies. It can be especially difficult to identify the right partner, arrive at mutually acceptable terms, and negotiate values and structure with these types of arrangements.

Access to new industries
Gaining access to new industries is a relatively new driver for US CEOs. As boundaries of industries blur and converge, CEOs expect cross-industry competition to accelerate. For example, 24 percent said their business entered or considered entering the tech sector within the past three years.¹ But jumping into a new industry can be risky. Joining forces with a partner is one way to test the waters and develop capabilities without having to build them from the ground up.

Portfolio optimization – step divestment of sub-scale and non-core businesses
Many companies are under shareholder pressure to cut costs, restructure, or realign their portfolios. Some companies are using JVs and alliances to effect a step divestment of a non-core business or function or to combine a sub-scale business with that of a supplier or competitor in order to increase scale and improve profitability. In addition, these arrangements can be structured so that the seller retains a minority interest or provides financing.

However, such structures may not provide an immediate or large infusion of cash, and they can complicate deconsolidation accounting.

Accounting and tax rule changes
In certain cases, accounting and tax rules are the motivating factors for an alliance. These include potential gain recognition, off-balance-sheet financing, and pass-through structures that may allow tax gain deferral and accelerate the use of tax attributes.

¹ PwC’s 18th Annual Global CEO Survey.
Alliances and M&A are both inorganic strategic growth alternatives and are generally used when the option of building a new business organically is not viable. Alliances have a number of commonalities with M&A and share many of the same drivers, from geographic expansion to access to new technologies. Nevertheless, there are some important differences that can render the customary playbook for conducting M&A transactions less effective (see Figure 4).

Unlike traditional M&A, in which the acquiring or majority party takes operational control, alliances call for a collaborative strategy and joint planning and execution. A failure to collaborate can destroy trust and lead to the dissolution of the alliance. In contrast to M&A, alliances share benefits and risks between the participants. Alliances are generally finite in nature and need to be reviewed regularly to help facilitate staying on track to meet each party’s objectives. Because they can evolve over time, they may benefit from flexible contractual agreements. The alliance may face additional challenges when its parents have different cultures and governance processes.

### Figure 4: Key differences between alliances and M&A

<table>
<thead>
<tr>
<th>Alliances</th>
<th>M&amp;A</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agreement negotiation</td>
<td>Unilateral planning</td>
</tr>
<tr>
<td>Flexibility due to same end game</td>
<td>Conflicting agendas opposing objectives (buyer/seller)</td>
</tr>
<tr>
<td>Finite</td>
<td>Infinite</td>
</tr>
<tr>
<td>Shared</td>
<td>Individual</td>
</tr>
<tr>
<td>Numerous management teams</td>
<td>One management team</td>
</tr>
<tr>
<td>Different cultures of partners</td>
<td>One prevailing culture</td>
</tr>
<tr>
<td>Regular review of alliance</td>
<td>Integrate acquisition</td>
</tr>
</tbody>
</table>

**Key nuances between Alliances and M&A**

- Can't shift gears easily - a lot must be planned up front
- Agreements must be flexible
- Upfront planning around the alliance will ultimately be exited
- Upfront agreement on how risks and rewards will be shared
- Need to collaborate in decision making
- Recognize the inherent difference in cultures, embrace and adapt
- Alliances must be reviewed regularly around specific milestones

Optimize deals
Increasing complexity in the structure of alliances

JVs and alliances take form through a variety of arrangements. These can range from a simple series of agreements, such as supplier agreements, to complicated structured arrangements using legal entities (see Figure 5). More often than not, as participants seek to build in flexibility, these arrangements take on greater complexity.

The terms and value protections included in these structures—such as the puts, calls, and collars that are often required by minority investors, sellers, governments, and financial sources—introduce additional forms of complexity. Often the complexity has unintended consequences that can impact operating decisions, performance, and, ultimately, the overall success of the arrangement. For more on the types of structures, see Appendix A.

Figure 5: Today’s alliances are increasingly complex
Common challenges that can derail alliances

Strategic alliances and joint ventures are difficult to execute and achieve. If an organization opts not to address challenges upfront, they may end up with higher than expected failure rates. Appropriate upfront planning will help mitigate some of the common challenges organizations can face and help increase chances of success. Experience has shown that addressing the following five common challenges can dramatically improve success rates.

Most alliances arise from the need for the different qualities that a partner brings. Yet those differences – in culture, objectives, and decision-making – can often cause friction and conflict and derail success. Alliances are often likened to marriages, where both parties need to be prepared to work together, to respect the other party, and to be willing to compromise. Both parties need to work collaboratively toward a common goal and grow the strength of their mutual relationship to deliver success. Misaligned strategic agendas and cultures, mismatched expectations, and inefficient decision-making can lead to a breakdown in trust and result in the dissolution of the alliance. As alliances are becoming more important to CEOs, they are also becoming more complex, and the challenges of managing the alliance is rising. Success rates, by some

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Figure 6: Common challenges that can derail alliances

- Establishing trust
- Cultural differences/Differences in approach
- Unanticipated events
- Lacking performance monitoring
- Exit issues
measures, are also low. The more common reasons why many alliances can fail to achieve some of their desired objectives include:

- flawed strategy
- execution of business plans
- poorly crafted legal and financial terms and conditions
- poor/damaged working relationships

There are differences between M&A and alliances that may be underestimated in the execution of alliances. The good news is that the appropriate level of upfront planning will circumvent many of the pitfalls that can derail alliances. Unlike traditional M&A, in which the acquiring or majority party takes operational control, alliances have shared control, and the partners share benefits and risks equitably, underscoring the need for collaborative strategy and planning upfront. For M&A, it isn’t imperative that all operational details are decided before day one of the merged entity. In contrast, a large percentage of operational details need to be planned, decided, and agreed to upfront with alliances. Upfront planning can help to establish mechanisms to address unanticipated events, performance issues, and the evolution of the alliance for the ultimate success of the venture.

**Establishing trust**

There needs to be a high degree of trust, transparency, and mutual understanding between the participants, and they must be nurtured and managed very carefully. Any breakdown of trust and understanding will impact everything from the speed of negotiation to the development and documentation of a strategy and operating plan. When all parties to an alliance understand one another’s strategic rationale for entering into the alliance, there is a far greater likelihood that they will be able to build a sense of mutual trust. Trust not only facilitates negotiations, it helps the participants establish a framework for how the alliance is going to operate, what the reporting structure will be, and how the alliance will be managed and monitored.

Having trust between partners also allows a certain level of flexibility, so that if changes need to be made, they can be made quickly. Without trust, the entire foundation of the alliance will be shaky. If trust starts to wane, there needs to be a means to rebuild it.

**Cultural differences**

Culture is a huge concern for M&A transactions, but the issue is perhaps even more critical when it comes to alliances. People from each organization will be working together on a daily basis toward a common goal. No one culture will necessarily “trump” the other, unless there is an upfront agreement that one organization’s way of working will dominate. This is always a difficult discussion and, in fact, one reason alliances can take anywhere from 6 to 18 months to come together is that partners need that amount of time to understand one another’s cultures and values. Cultural hurdles can be especially challenging when the alliance involves parties from different countries. Often when US companies seek a partner in an emerging market, they fail to appreciate the intangible value those partners can bring, from government relationships to customer and human resources knowledge. Yet this kind of cultural understanding may be one of the most valuable assets an emerging markets partner can offer.

**Unanticipated events**

A partnership is a collaboration, a sharing of activities. Yet all too often, when something unforeseen occurs — whether it’s a regulatory challenge, a change in the competitive landscape, or a change at one of the parent organizations that affects its attitude toward the venture – the event is effectively a nail in the venture’s coffin because the parties are unable to work together and adapt to the change.

**Lack of performance monitoring**

Understanding how performance will be evaluated and managed is critical, but often the basis for disagreement between alliance partners. They can
have widely divergent views on what constitutes good performance and what metrics should be used to track it. Performance metrics are ultimately a reflection of what each stakeholder considers most important about the alliance — in other words, they are fundamental to the success of the alliance and need to be agreed on at the outset, not cobbled together once the alliance is up and running.

**Exit issues**

Planning for the ultimate end of an alliance is sometimes uncomfortable. No one likes to think about the end when the marriage is just getting started, but failing to do so can spell trouble. Partners need to consider the conditions under which they would want to dissolve the arrangement and then hammer out the details, including such issues as the handling of jointly developed intellectual property and the incurring of liquidation costs. Most alliances are finite by nature. But creating a framework for exit can help prevent them from ending before their time.

“Forming alliances can be challenging, but with a sound strategy and thoughtful planning and execution, the opportunity to reap the benefits is huge.”

Greg McGahan, Partner, US Alliances Services Leader, PwC
Factors for achieving a successful strategic alliance

Optimize deals
Alliances, if done well, can lead to outperformance and competitive advantage. Nevertheless, these rewards can be accompanied by high risk. Constant vigilance and significant commitment from the senior leaders of each parent is necessary to maintain rigorous, professional end-to-end execution. Despite the fact that there is no “silver bullet” to help facilitate the success of an alliance, there are several factors that can help.

**Put strategy first.** Start with a strategy not a partner. A well-understood strategy underpins the path to a successful alliance, determining whether an alliance will be a more effective approach than either growing organically or pursuing traditional M&A. It will also determine the optimal type of alliance structure, which could range from an incorporated JV to a non-incorporated strategic alliance (see Appendix A for more information on types of alliances.) Strategy will also determine the optimal alliance partner. A sound strategy provides a framework and foundation for executing growth objectives.

**Invest in joint upfront planning and execution.** More time invested in planning can help create the foundation for establishing a successful execution process. Spending time on upfront planning helps reduce “surprises” and builds trust. Planning and execution can include developing term sheets and legal agreements, ironing out the details of governance and dispute resolution, building an exit strategy, tax structuring, establishing performance metrics, and planning for Day 1 and beyond.

**Build an enterprise-level commitment.** Organizations that use JVs and alliances as a significant part of their growth strategy, build the capability to form alliances - just as they would build any other capability. Many companies have formalized and institutionalized their M&A expertise. Commit the time and resources to doing something similar for forming alliances by implementing a dedicated corporate alliance management function.
### Seven factors for a successful strategic alliance or joint venture

<table>
<thead>
<tr>
<th>Factor</th>
<th>Description</th>
</tr>
</thead>
</table>
| **1. Put strategy first** | - Start with a strategy, not a partner, facilitate clarity around core capabilities, trade-offs, and strategic priorities  
- Be clear on why and how this alliance helps execute your strategy more effectively than organic growth  
- Consider the bigger picture and the alternatives - market trends, competitor actions, and whether the alliance would be better as a JV or an acquisition |
| **2. Invest in joint upfront planning** | - Invest the time upfront to plan collaboratively with your partner; get to know them, their track record, learnings from previous alliances, and their culture/way of working; identify and pursue common objectives  
- Jointly develop a compelling business case based on incremental sources of value, and how these will be delivered  
- Agree on desired culture and behaviors and appropriate incentives to drive these; choose the right people  
- Establish clear governance, responsibilities, and decision rights |
| **3. Plan the end** | - Consider the circumstances that might lead to dissolution, and agree on a formal process  
- Decide what will happen to any shared assets and people after the dissolution |
| **4. Create trust** | - Make and live up to small, ongoing commitments; facilitate equity (each party proportionately being rewarded based on what they put in); cooperate with one another; be open and transparent; be willing to adapt; celebrate successes  
- Adopt a ‘win-win’ mind-set; focus on growing the whole pie, not securing the biggest slice |
| **5. Start small** | - Begin with a narrow, achievable shared objective; manage expectations, focus, and aim for early success  
- Expand your joint ambitions as trust and confidence grows |
| **6. Keep track** | - Agree on the metrics that will reflect success at achieving the alliance’s objectives  
- Adjust metrics as the alliance evolves |
| **7. Build enterprise-wide capability** | - Establish a dedicated corporate alliance management function to oversee alliance activity  
- Use this function to codify and share leading practices, drive collaboration, provide expertise, coordinate relationships with key partners, and ultimately create an enterprise-wide ‘alliance culture’ |
Put strategy first

Alliances are an effective way to embrace new strategic opportunities and pursue different sources of growth, but each alliance can be complex and unique. A well understood strategy underpins each step in the critical path to success for an alliance. Start with a strategy not a partner – and help to establish clarity around core capabilities, trade-offs, and strategic priorities. Be clear on why and how this alliance contributes to your overall strategy more effectively than organic growth or M&A.

Also, consider the bigger picture and the alternatives – market trends, competitor dynamics, whether the alliance would be better as a JV or acquisition, and the potential partners. Due diligence on potential partners is essential to establish financial and operational background. An assessment of the partner’s historic alliance track record is also recommended.

The alliance’s business plan needs to reflect the input and agreement of each participant and should be clearly and thoroughly documented in a form that is monitored and revised over the life of the arrangement.

When all parties to an alliance understand the respective strategic rationale and objectives motivating the alliance, there is a far greater likelihood that the participants will be able to build a sense of mutual trust. This can then facilitate the negotiation of the transaction and means there is a greater likelihood the participants will be able to establish a framework for the ongoing monitoring and management of the alliance, benefiting everyone involved.

There may be structuring options available, ranging from incorporated JV to non-incorporated strategic alliance. These should be carefully considered as the commercial structure of an alliance may impact management of working capital and results of the organic businesses of the partners involved. The alliance can be structured to either absorb the asset base and results of the alliance in the partners’ businesses, or quarantine the asset base and performance of the alliance to avoid “clouding” of the working capital and the performance of the organic businesses (See Appendix A).
Steps for planning a seamless execution

Once the strategic rationale for the alliance has been established, a thorough planning and execution process (Figure 7) can help position the strategic alliance for success.

Figure 7: Steps for planning a seamless execution
Perform partner selection and diligence

Choosing the right partner is a complex process that begins with a well-understood strategy. Strategy should drive partner selection, not the other way around. Understanding the strategy and motivations of a prospective partner is also essential — whether it is access to capital, entry into a new market, or finding a complementary skill set — because this will determine whether there is an appropriate fit. Taking the time to get to know potential partners will also reveal whether the organizations’ cultures are compatible.

Thorough due diligence is important before entering into any form of relationship. It is imperative that both partners assess one another prior to signing any form of binding agreement.

The following are key considerations for due diligence:

Detailed assessment of partner contribution

- Revenue drivers and profitability of businesses, key products, and customers
- Quality of revenue and earnings
- Forecast sensitivities and basis of key assumptions
- Cash flow drivers and concerns
- Stand-alone cost assessment and level of parent allocations
- Balance sheet exposures and off-balance-sheet contingencies
- Working capital assessment and definitions to minimize post-closing disputes
- Accounting policy basis and consistency
- HR benefits, compensation philosophy and assumed/transferred assets or liabilities
- Leadership, key talent, and employment agreements
- Culture assessment, performance management philosophy and process
- Tax attributes and exposures
- Counterparty considerations (credit risk, funding)
- IT systems and requirements
- Transition services required

Detailed assessment of the business/asset to be contributed

- Assets vs. legal entities
- Co-mingled operations, assets, or liabilities
- Goodwill allocation
- Stand-alone, stranded, and one-time separation costs
- Carve-out considerations
- Normalized earnings
- Tax attributes
- HR-related matters (change of control, potential liabilities to transfer)
- Gain/loss calculation

Develop term sheets and legal agreements

Agreements and term sheets provide a foundation for the structure of the alliance, whether it is a collaboration, a partnership, or something else. The parties will need to draft thorough documentation of the investment agreement that includes defined terms and a framework for operating, monitoring, and exiting. They will also need to complete the slate of transition service agreements and shared long-term service arrangements. Term sheets should capture the key aspects of the due diligence process and lay out directives for handling potential future events. The partners should also address such issues as ownership and disposal of contributed or jointly developed intellectual property.

While these agreements are legal documents, they need to be grounded in a set of mutually agreed-on principles that form the basis of the partner negotiation.

Build governance and dispute resolution mechanisms

The governance structure determines how and when participants can exert influence over decisions of the alliance or joint venture management team. If the governance mechanisms put in place at the outset of the arrangement lack adequate flexibility or the means to adapt as the needs of the business or individual participants change, the viability of the arrangement can be undermined.
Joint ventures and strategic alliances

Build mechanisms upfront to manage through an exit

Most alliances are finite in nature. For example, the alliance may achieve its goals and no longer be necessary. There may be a change in circumstances for one of the partners or even a dispute that renders working together no longer viable. An important part of negotiating the details of the alliance is determining the parameters – or “exit triggers” – that will allow participants to unwind their involvement or divest their ownership or interest in the structure. The exit plan should cover situations of termination in the case of poor performance, changing environmental conditions, or any other predefined parameter. It should also outline the transition process.

Figure 8: Tax issues to consider throughout the alliance life cycle

<table>
<thead>
<tr>
<th>Creation/Formation</th>
<th>Ongoing</th>
<th>Divestiture/Termination/Exit</th>
</tr>
</thead>
<tbody>
<tr>
<td>• How the transfers (of tangible and intangible property and services) to the alliance vehicle will be taxed to the transferors</td>
<td>• How profits from operations will be taxed to the alliance vehicle or owners</td>
<td>• How unwinding or liquidating the JV vehicle will be taxed to owners</td>
</tr>
<tr>
<td>• Whether the structure triggers transfer or stamp taxes</td>
<td>• How distributions of profits will be taxed to the owners</td>
<td>• How the exit (ie., sale of interest) will be taxed at both the counterparty and alliance levels</td>
</tr>
<tr>
<td>• Valuation of assets and liabilities for tax purposes</td>
<td></td>
<td>• How the partial sale of an interest can lead to loss of tax benefits such as tax consolidation</td>
</tr>
</tbody>
</table>

Nevertheless, there is no one-size-fits-all solution. For example, the degree of risk to which the partnership is exposed will to some extent determine how complex and formalized the governance and dispute resolution mechanisms need to be.

In situations where the alliance involves joint control, establishing a governance structure that clearly delineates oversight of the operating environment is especially important. The structure should address:

• Operating and management protocols — level of participant support, oversight, integration for start-up and ongoing operations (including contingency plans)

• Selection of alliance leadership (board, CEO, and key management appointments), decision-making rights, dispute-resolution processes, and reporting protocols

• Communication protocol for participants, investors, regulators, etc.

• Procedures for protecting sensitive information — both operating and financial (whether that of the alliance or its participants)

• Compliance with country-specific laws and regulations

Build mechanisms upfront to manage through an exit

Most alliances are finite in nature. For example, the alliance may achieve its goals and no longer be necessary. There may be a change in circumstances for one of the partners or even a dispute that renders working together no longer viable. An important part of negotiating the details of the alliance is determining the parameters – or “exit triggers” – that will allow participants to unwind their involvement or divest their ownership or interest in the structure. The exit plan should cover situations of termination in the case of poor performance, changing environmental conditions, or any other predefined parameter. It should also outline the transition process.
and timeframe, asset valuation methodology, asset protections, and asset entitlements.

In some situations, particularly those that include cross-border agreements, negotiating what is essentially a prenuptial agreement may be considered offensive. In those circumstances, it may be easier to define a limited term for the venture that can then be renegotiated when that date is reached. Nevertheless, it is still important to address issues such as funding overruns and providing parent guarantees.

Establish an efficient tax structure

The stakeholders' tax and legal profiles are important considerations throughout the life of a joint business relationship. It is also important to address legal and commercial issues — including contract assignability and novation, workforce sharing or transfer, the transfer or licensing of IP, and the cross-sharing of IP — as well as the associated transfer pricing consequences.

The tax structure needs to meet the following primary goals:

- Does not involve substantial immediate tax costs as a result of the transaction
- Achieves a tax-efficient flow of earnings on an ongoing basis
- Limits potential taxes upon termination or exit
- Transfer pricing with regard to contractual arrangements to prevent US and foreign tax authorities from reallocating income
- Placement of debt to reduce the possibility of interest disallowance in various jurisdictions
- Tax rules and regulations that continue to evolve, driven by government spending deficits, changing political environments, level of employment, etc.

The choice of entity for the alliance (partnership vs. corporation) will impact tax exposures both initially and throughout the life of the alliance (see Figure 8).

Choice of jurisdiction is key when considering structure and counterparty choices. The goal is to lower the global tax rate on income and non-income taxes and withholding rates. Hybrid entities (for example, a partnership for US tax purposes and a corporation for foreign tax purposes) may also have advantages. Other considerations when identifying an appropriate jurisdiction include:

- Controlled foreign corporation (CFC) regimes for deferral of taxation on earnings in low-taxed jurisdictions and ability to “base erode” tax of holding-company jurisdiction
- Bilateral tax treaties that impact profit repatriation and remittances and exit strategies (for example, non-resident capital gains tax)
- Foreign exchange controls and restrictions, as well as regulatory hurdles that cause trapped cash issues (especially relevant in emerging markets)
Establish performance monitoring and goals

JVs and alliances are a challenge to structure, negotiate, and implement, but they are often most challenging once established and operating. Participants need a clearly defined and well-understood framework that tracks business performance and provides a roadmap for handling decision-making. An effective monitoring framework offers transparency into day-to-day activities for participants, as well as insight into financial performance. In addition, participants need a formal process for revisiting the details of the arrangement and making adjustments — including to the strategic direction — if necessary.

Budgeting, forecasting, and performance assessment require a constant focus. The alliance or JV needs a philosophy around budgeting and planning (for example, “must-hit” or guidance) that includes key performance indicators (KPIs) that are strategic, operational, and financial. Short-term cash forecasting will also need to be established.

In addition, the alliance needs to select performance measures that serve as the basis for employee incentives, assess employee contribution to the alliance, and enable fair distribution of rewards. Incentives should be aligned with goals and the timing of the business planning cycle. These metrics may need to change if there is a change in strategy.

Execute thorough Day One planning

Unlike M&A, with alliances there is usually no single entity assuming the helm: by definition these arrangements involve shared control. This is why it is essential to confirm as many elements as possible — and to agree on mechanisms for handling any issues that might come up — before Day One arrives.

Careful Day One planning will help facilitate the achievement of objectives of both parties and that they agree from the outset on governance and oversight, organizational structure and reporting hierarchy, funding mechanisms, the operational plan, metrics for measuring performance, financial reporting, accounting policies and procedures, tax planning, and contingencies for exit, including gain/loss recognition.

Other Day One issues that should be worked out include decisions about how to retain key talent, customers, vendors, and partners; communication plans for stakeholders (customers, vendors, workforce, shareholders etc.); and licenses and contract novation. Financing should also be in place and partner contributions ready to go.

HR policies

HR policies and procedures will need to be established at the outset of the JV or alliance. These can entail highly sensitive negotiation, and the importance of the potentially divergent cultures of the partner entities should not be underestimated, especially when cross-border issues are involved. The alliance needs to establish a governance structure around potentially significant HR spend or commitments. Staffing is an important consideration, particularly if immigration restrictions can affect the quality and availability of human resources.

The alliance partners should conduct a culture assessment to understand the degree of similarities and differences in ways of working. A shared awareness of respective cultures together with early agreement on desired ways of working should be embedded into the alliance’s communications and engagement strategies, governance, individual performance, and reward philosophies.

The alliance partner should develop policies and procedures to handle such issues as:

- Severance
- Employee retention and change in control
- Talent selection and performance management
- Trade unions and collective bargaining agreements
- Any required board representation
Management compensation plans can help maintain competitiveness in the local market. Important considerations in developing an effective compensation include:

- How will fixed and variable compensation and short term vs. long term compensation be determined?
- Will stock options and other deferred compensation plans be used to supplement cash compensation? Which stock will serve as the basis for the stock option plan?
- What vesting timeline will apply to incentive compensation awards?

Determining appropriate employee benefits—including pensions and medical coverage—should consider the following:

- Agreeing on pension funding policies (minimum contributions versus stable yearly amount) can be difficult given the potential for differing regulatory requirements and perspectives.
- Leveraging the participants’ scale when pricing the alliance benefit plans is an important tool in managing program costs.

Depending upon the ownership structure, counterparties may be required to reflect alliance employees in their IRS Controlled Group.
Treasury policy

Treasury policy will need to be agreed upon, including investment and funding activities of the JV or alliance. The following are important treasury policy considerations:

• Long- and short-term funding requirements
• Guarantees and related accounting impact on alliance participants’ financial reporting
• Timing and processes
• Intercompany cash management, settlement, and controls
• Priorities for excess cash and distributions
• Incorporation of currency, commodity, and other hedging approaches in the risk management protocols of the alliance

Risk management function and policies

Risk and compliance policies and minimum standards should be clearly defined before signing. Regulatory requirements will need to be identified and policies agreed upon for identifying, managing, and monitoring compliance. Regulatory bodies and laws that apply at the local, state, federal, and international level will need to be assessed, including:

• Foreign Corrupt Practices Act (FCPA)
• Industry practices
• Government treaties
• Anti-money laundering laws
• Export controls
• United Nations
• Office of Foreign Assets Control

The parties will also need to determine how they will monitor risks such as strategic risk, liquidity/funding risk, credit and counterparty risk, operational risk, compliance risk, and reputational risk. Part of this will involve establishing a disaster planning and recovery strategy.

Insurance requirements

The parties will need to agree on and plan for the insurance needs of the new business, and how existing relationships can be leveraged to reduce costs.

Accounting, finance, and tax policy

Establishing accounting policies and controls and applying them consistently is critical to protecting the participants’ investment. Policies must be aligned with respective US GAAP or international requirements, and the control environment for the alliance vehicles must comply with Sarbanes-Oxley and other regulatory requirements. Accounting policies and procedures should also be modified for new alliance activities, and compliance should be monitored continuously, including through use of independent annual audits.

Due to differing regulatory, compliance, and market-specific reporting requirements, the reporting needs of alliance participants may vary. It is therefore important to establish compatible financial systems and counterparty requirements (for general ledger, financial reporting, accounts payable, fixed asset, accounts receivable, etc.) and to align period-end close timing. The alliance team should also evaluate the impact of creating, mapping, and updating the structure’s chart of accounts for each of the participants. For timely settlement, it is important to price, monitor, and track chargebacks for services performed by either participant or by the alliance itself.

Clear governance and guidelines for financial reporting include the following:

• Establish operational processes to help facilitate transparent decision-making on critical matters such as budgets, financial leverage, compensation, and hiring/firing of management.
• Jointly agree on and establish operational reporting processes since requirements may vary.
• Evaluate the need to bring in external auditors or establish an internal audit function, particularly when a different structure is employed for the alliance.
• Establish communication protocols that enable alliance participants to receive the same information at the same time.

• Identify appropriate financial reporting and control resources (transaction processing, specialists, decision support) and either source them locally or through alliance investor contributions.

See Appendix B for additional information on accounting considerations.

Emerging markets considerations
Implementing a JV or alliance in an emerging market can be fraught with complexity. These markets can present cultural, regulatory, and economic challenges that must be anticipated early. Participants in JVs and business alliances in these markets will need to exercise considerable judgment that may entail difficult trade-offs. Because there are so many nuances to consider, participants must enter into these arrangements with their eyes open. See Figure 9 for factors that require careful evaluation.

Execute the 100-day plan
While alliances call for more things to be nailed down on Day One than M&A transactions, the first 100 days of the partnership are also critical. During this time, alliance management needs to address a host of issues, from moving to an integrated IT platform to protecting customer relationships while the alliance gets up and running.
Figure 9: Nuances of emerging markets

- Are foreign investment conditions for JVs at risk of changing (i.e., percent of domestic share, management composition requirements, and entry and exit conditions)?
- Are market access arrangements or similar commercial policies relevant to your business expected to change?
- How will sovereign risk be monitored, and which models will be used to assess, predict, and prepare for potential issues?
- How are government relations and lobbying efforts to be managed?
- What impact will the FCPA, anti-money laundering, and similar legislation have on the business model and competitiveness?
- Is security a concern?

- How will financing occur and how will capital be allocated?
- What is the structure and extent of financial entity regulation and supervisory oversight?
- Has the profit repatriation process been defined?

- Will local employees be available and skilled for the role?
- Are the partnership’s hiring practices in line with local labor laws and procedures?
- What are the partnership’s remuneration and benefit policies (e.g., expatriate cost sharing arrangements, compensation levels)?
- What are the safety precautions being taken for employees working in these emerging markets?

- Can your partner help you tailor your products or service offerings for local market needs and dynamics (such as buyer behavior, product design, brand, product specifications, pricing, quality, distribution channels, revenue, or fee restrictions)?
- Do local policies and commercial requirements (e.g., import and export duties) impact your business model and competitiveness?

- Are differences in working styles truly understood (e.g., process of decision making, hierarchy, attitude to time, expression of opinions, conflict management)?
- To what extent are deep business relationships required to be cultivated to do business?
- Is religion a significant factor of doing business in the region?

- What are the necessary legal frameworks, contractual and compliance requirements?
- Is the JV legal entity structure aligned to available tax benefits?
- Are there any differences in governance standards and business practices (e.g., legal, taxation, authorizations/permits) in the partnership that need to be reconciled?
- Will IP transfer and control occur between partners? How will it be handled?
Developing an enterprise-wide capability

Many companies that excel at establishing and operating alliances have implemented a dedicated corporate alliance management function. This function acts as a corporate center of expertise, helping to embed an alliance capability and culture across the organization. Specific responsibilities for a corporate alliance function can include:

- Sharing of leading practices/intellectual capital and lessons learned
- Internal coordination and initial evaluation
- Decision-making guidance on proposed alliances
- Serving as a sounding board for alliances that are facing problems
- Providing ongoing alliance governance and, if required, resolution of escalated issues
- Leveraging latest technologies to embed efficient and innovative ways of working
- Offering external visibility (for example, to the investor community)

The role and influence of such functions tend to evolve over time. Initially, the function assesses the rationale for alliances, evaluates potential partners based on strategic and organizational fit, and facilitates ongoing alliance performance assessment. In the medium-term, the function starts to codify key learnings, develop templates and tools for alliance assessment and decision-making, and provide specific expertise. In the long-term, it drives collaboration, identifies alliance target partners and opportunities, coordinates relationships with key partners, and ultimately creates an enterprise-wide alliance culture.

59% of US CEOs plan to initiate a strategic alliance in 2016, up 15% from 2015

Source: 19th Annual Global CEO Survey, PwC
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Conclusion
Are you ready?

Is your alliance strategy underpinned by a structured strategic plan – or did you start by considering a partner?

- *Do you and your alliance partner agree on how you complement each other, your distinct contributions and how you will share risks and benefits?*

- *Have you agreed on an initial set of objectives and commitments that you can both clearly deliver against?*

- *Does your alliance partner selection process and due diligence include a cultural assessment as well as financial measures?*

- *Have you jointly developed and signed off on a business case, set of shared objectives and operational plan?*

- *Are processes in place to regularly analyze and report performance based on the alliance’s strategic objectives?*

As globalization and competitiveness intensify, more companies are likely to turn to JVs and alliances as an effective strategy to win in the marketplace. Nevertheless, the complexity and level of commitment associated with these arrangements cannot be underestimated. Yet companies that take a collaborative approach built on trust and gain sharing — and combine it with formalized and well-planned execution — will dramatically increase their chance of success and be well-positioned to leverage these arrangements to create a sustainable competitive advantage.
Appendix A: Types of strategic alliances

A variety of structures are available to anyone looking to initiate a JV or business alliance, with options including both contractual and structural arrangements, as shown in the table. Each has distinct characteristics and features that should be evaluated and assessed to help establish that the most appropriate structure is employed.

<table>
<thead>
<tr>
<th>Structural alliances</th>
<th>Contractual alliances</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Joint Ventures</strong></td>
<td><strong>Virtual JVs</strong></td>
</tr>
<tr>
<td>Structure in which two or more parties contribute assets to</td>
<td>A collaborative arrangement formed via a contractual</td>
</tr>
<tr>
<td>a legal entity (“NewCo”) and share in the profits and losses</td>
<td>agreement through which the parties manage governance and</td>
</tr>
<tr>
<td></td>
<td>oversight and risks and rewards; the arrangement is</td>
</tr>
<tr>
<td></td>
<td>“virtual” because no separate legal entity is formed</td>
</tr>
<tr>
<td><strong>Limited Partnerships and LLCs</strong></td>
<td><strong>Long-term Contracts</strong></td>
</tr>
<tr>
<td>Structure in which two or more partners contribute assets</td>
<td>An arrangement for a specific task (purchase or supply)</td>
</tr>
<tr>
<td>to a NewCo and share in the profits and losses using a pass-</td>
<td>that can also be used by the parties to allocate risks and</td>
</tr>
<tr>
<td>through structure for tax purposes</td>
<td>rewards</td>
</tr>
<tr>
<td></td>
<td><strong>Seller Financing</strong></td>
</tr>
<tr>
<td>Structure in which the investor contributes funds, IP, or</td>
<td>An arrangement where a seller provides financing to the</td>
</tr>
<tr>
<td>other property to an existing entity or target and takes</td>
<td>buyer for a portion of the purchase price in exchange for</td>
</tr>
<tr>
<td>back a minority equity stake</td>
<td>a promissory note from the buyer</td>
</tr>
</tbody>
</table>
# Joint ventures

Characteristics and common features.

<table>
<thead>
<tr>
<th>Description</th>
<th>• A corporate structure in which two or more parties create a separate company by jointly funding and managing it and sharing in its profits and losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Typical industries</td>
<td>• All industries</td>
</tr>
</tbody>
</table>
| Potential features | • Disproportionate economics and/or vote among participating entities  
• Long-term contracts with investors and cooperative agreements  
• Redemption rights  
• Transfer restrictions on equity  
• Shotgun (buy/sell) clause, put and/or calls, or rights of first refusal  
• Licensing agreement allowing both companies to use the technology developed or execute an IPO, spin-off, or sale of the joint venture |
| Potential benefits | • Enables investors to share risks, rewards, and talents in developing a new market, product, or technology  
• Enables investors to combine complementary technical knowledge or to pool resources in developing production or other facilities  
• Can be a prelude to a larger deal or similar deals in other regions/markets  
• Transfers of property to corporation can be structured to avoid taxable gain to transferors  
• Combination of two businesses may allow for the accelerated use of tax attributes (e.g., the losses of one business may be offset against the income of the other business to reduce combined taxes) |
| Potential challenges | • Complex to negotiate and structure—including business plan, operating structure, governance, plan for dissolving, service level agreement, cost sharing, etc.  
• Requires ongoing negotiations to manage and leverage JV activities  
• Risk to investor’s reputation due to lack of control/oversight over partner  
• Limited useful life  
• Parties should agree upfront how “contributed” tax attributes affect pricing (e.g., whether one should pay for tax attributes such as high-basis depreciable assets contributed by the counterparty)  
• Corporate tax upon liquidation/exit |
| Accounting and financial reporting | • Partial or full gain recognition may result upon contributing appreciated assets/business/subsidiary to the JV  
• Consolidation assessment can be challenging with near 50-50 deals, non-equity investor contracts or financings, related-party relationships, puts and calls, and/or transfer restrictions among the participants  
• If not consolidated, consider equity-method vs. cost-method (or mark-to-market) accounting for the investment  
• Puts and calls, considered derivatives, may need to be marked to market through earnings each period  
• JV accounting applies only when there is true joint control |
**Limited partnerships (LPs) and LLCs**

Characteristics and common features.

<table>
<thead>
<tr>
<th>Description</th>
<th>Structure in which two or more partners contribute assets to a NewCo and share in the profits and losses using a pass-through structure for tax purposes</th>
</tr>
</thead>
</table>
| **Typical industries** | Alternative Investment Management (private equity firms, hedge funds)  
Real estate  
All other industries |
| **Potential features** | Disproportionate economics and/or vote  
Long-term contracts with investors and/or cooperative agreements  
Redemption rights  
Transfer restrictions on equity  
Shotgun (buy/sell) clause, puts and/or calls, or right of first refusal  
Kick-out rights for LPs (to dissolve the partnership and/or remove/replace the general partner (GP))  
Participating rights for the LPs  
Incentive distribution rights (“carried interest”) for the GP  
Licensing agreement allowing both companies to use the technology developed or execute an IPO, spin-off, or sale of the limited partnership |
| **Potential benefits** | Favorable tax treatment on profits earned  
Reduced regulatory burden  
Can decrease liability assumed  
Can be structured to avoid taxable gain to transferors upon formation  
Any tax losses can flow through to its partners  
Can be liquidated on a tax-deferred basis (as opposed to corporate structures)  
Flexibility in allocating items of income and losses to the partners  
Step-up in basis in the partnership’s assets, which can be passed on to future buyers upon exit |
| **Potential challenges** | Limits investors’ share of income on a profitable venture  
Limited control (unless you are the GP)  
GP usually obtains and retains majority of liability risk  
Potential future tax-law changes to tax carried interest at ordinary tax rates rather than at capital-gains tax rate  
Complexity of partnership agreements for special allocations of income and losses  
Additional compliance burden for partnership tax returns |
| **Accounting and financial reporting** | Partial or full gain recognition may be achieved upon contributing appreciated assets/business/subsidiary to the partnership  
GP is generally presumed to control (and thus consolidate), but it may not control if it can be unilaterally exercised by a single party  
As the LP gains more control over the partnership and/or exposure to risk of losses increases, the risk of consolidation by the LP increases  
Puts and calls, considered derivatives, may need to be marked to market through earnings each period |
## Minority equity investments

Characteristics and common features.

**Description**
- Investor contributes funds, IP, or other property to a target and takes back a minority equity stake

**Typical industries**
- Pharmaceutical
- Technology
- Private Equity and other industries

**Potential features**
- Upside potential—can be locked in by the minority investor via puts/calls, distribution arrangements, or other contracts
- Minority investor—may get board representation or a role as technical advisor

**Potential benefits**
- Early investment in a new product or technology buys access and bars competitor access
- Opportunity to observe/evaluate management team with limited downside
- Transfers of property to the target—likely to trigger taxable gain to the minority investor/transferee, but, if properly structured, can be transferred on a tax-deferred basis with the cooperation of the counterparty (the other shareholders)

**Potential challenges**
- Access to upside—may be limited due to consolidation risk
- Limited control/influence over operations and milestones without majority investment or contractual rights

**Accounting and financial reporting**
- Partial or full gain recognition may be achieved upon contributing appreciated assets/business/subsidiary to the venture
- As an investor gains more control over the venture, or is exposed to more of the risk of losses, or has rights to receive benefits related to the entity, the risk of consolidation increases, depending on which consolidation model applies
- If not consolidated, the investor would treat this as an equity-method investment if it can exert significant influence on the venture; otherwise, the cost method or a mark-to-market security would be appropriate
- Puts and/or calls, considered derivatives, may need to be marked to market through earnings

<table>
<thead>
<tr>
<th>Company A</th>
<th>Cash and/or net assets</th>
<th>Limited Partnership</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Less than 50%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td>Less than 50%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>More than 50%</td>
<td>Cash and/or net assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td>More than 50%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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**Virtual joint ventures**

Characteristics and common features.

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**Description**
- Collaborative arrangements that are formed via contractual arrangements to manage governance and oversight and to provide a mechanism for risk and reward allocations. Unlike a joint venture, no separate legal entity is formed.

**Typical industries**
- Pharmaceutical
- Biotechnology
- Entertainment
- Technology
- Manufacturing

**Potential features**
- Each party able to maintain contractual rights to underlying IP
- Payments between parties typically structured based on milestones (specified time or event), time and materials, or royalties/profit-sharing on eventual product sales
- Possible to arrange direct loans, guarantees, or equity investments in the partner

**Potential benefits**
- Means of avoiding complexity and tax impacts associated with negotiation, formation, and unwinding of a legal structure
- Reduces or eliminates need to capitalize upfront
- Accelerates time to market
- Frees each company to focus on core competencies
- Provides access to broader range of resources, technologies, and capabilities

**Potential challenges**
- Reduced ability to monitor and oversee partner activities as compared to a JV
- Risk of IP and data-security breaches
- Puts investor’s reputation at risk due to lack of control/oversight over partner

**Accounting and financial reporting**
- Collaborative arrangements not involving a legal entity are generally outside the scope of the consolidation/equity method accounting guidance
- Investors report their share of income and expenses in accordance with the substance of the transactions
- No gains would be recognized for the “contribution” of appreciated assets to the virtual entity
- Interests in the partner, even if only a guarantee of its debt, may need to be evaluated for consolidation
**Long-term contracts**

Characteristics and common features.

**Description**
- Long-term contracts allow one company to partner with another, often solely for a specific task over specified term

**Typical industries**
- Automotive
- Aerospace and defense
- Manufacturing, technology, and construction

**Potential features**
- Pay-to-play provisions
- Options to acquire rights to the results of R&D activities
- Liquidated damages clauses/termination provisions
- Price adjustments based on volume, increased costs, cost-plus and related measurement, changes in market prices, or other factors

**Potential benefits**
- Locked-in pricing and/or quantity or built-in price adjustment features enabled
- Transferring uncertainty and risk to others, particularly for R&D activities, sometimes enabled
- Commoditized functions or functions not within company’s core competency outsourced
- Possibility of enhanced ability to obtain long-term financing
- Management free to focus more on production and less on marketing/supply chain management
- Limited tax deferral for deferred revenue possible (i.e., payments received before economic performance; deferral for one taxable year available); income from certain long-term contracts (those involving building, installation, construction, or manufacturing) can be reported under the percentage-of-completion method for tax purposes; net profit on the entire contract, in very limited circumstances, may be reported under the completed-contract method in the year in which the contract is completed and accepted

**Potential challenges**
- Possibility of buyers being locked into a contract that may no longer be economical (i.e., price received does not adjust based on changing market conditions)
- Reduced market flexibility
- Penalties for non-delivery or not taking delivery

**Accounting and financial reporting**
- Manufacturers may be able to capitalize pre-production costs
- Pay-to-play payments may be capitalized rather than expensed; pay-to-play receipts are generally deferred
- Long-term construction contracts are recognized on a completed-contract or percentage-of-completion basis
- Long-term contracts may expose the buyer to risks and rewards related to the counterparty, increasing consolidation risk
**Seller financing**

Characteristics and common features.

**Description**
- Seller provides financing to the buyer for a portion of the purchase price in exchange for a promissory note from the buyer

**Typical industries**
- All industry groups in current market

**Potential features**
- Interest rate typically at or below bank prime rates
- Term of the seller note usually similar to that of a bank

**Potential benefits**
- Seller may be in a stronger position to receive a higher sale price and/or close the deal faster
- May act like a bond for performance to assure that seller will live up to promises made to the buyer during sales process
- May be seen by buyer as indication that seller has faith in the future of the business
- Motivates seller to maintain business goodwill if they have a remaining stake in its future ability to pay back the seller note
- Attracts more buyers who may not be able to receive financing from traditional lenders
- Size of business may make cash sale difficult for buyer
- If seller is to receive deferred payments on the sale of property, gain may be reported using the “installment-sale method,” where gain is pro-rated and recognized over the period in which payments are received
- If carefully structured as an “open transaction,” where total purchase price is contingent, upfront tax could be avoided

**Potential challenges**
- Risk that seller may act like a bank, asking buyer to secure the loan and sign a personal guaranty
- Shifts more risk to the seller, which may impact the consolidation and/or gain-recognition analysis
- Risk that seller might not recover full purchase price if the business fails
- Likelihood that seller will need to pay tax upfront on any gain inherent in the assets sold, even though there are no cash proceeds on the sale; limited exceptions apply (e.g., installment sale, open transaction)

**Accounting and financial reporting**
- Seller financing may be considered a form of continuing involvement with the entity that may preclude deconsolidation and gain recognition
- Seller financing may significantly impact the consolidation analysis, shifting more risk of consolidation to the seller
## Appendix B: Accounting considerations

There are some basic building blocks for accounting considerations for JVs and alliances. The characteristics of each business alliance structure should be carefully evaluated, as the structure will impact the accounting, operations, and economics of the deal.

The following table outlines the typical accounting matters associated with these structures.

<table>
<thead>
<tr>
<th>Key accounting matters: Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Consolidation</strong></td>
</tr>
<tr>
<td>Voting control. Investor with voting control generally consolidates.</td>
</tr>
<tr>
<td>- Minority investors with participating and/or significant veto rights may preclude consolidation by the majority investor.</td>
</tr>
<tr>
<td>- Only substantial kick-out rights and participating rights that can be unilaterally exercised by a single party should be considered in determining the primary beneficiary.</td>
</tr>
<tr>
<td>Variable interest entity (&quot;VIE&quot;). Investor with a variable interest in a VIE must qualitatively assess whether it has a controlling financial interest in the entity and, if so, whether it is the primary beneficiary based on whether the investor has the following two characteristics:</td>
</tr>
<tr>
<td>- The power to direct activities of the VIE that most significantly impact the VIE economic performance</td>
</tr>
<tr>
<td>- Obligation to absorb losses from, or right to receive benefits of, the VIE that could be significant to the VIE</td>
</tr>
<tr>
<td>Only substantial kick-out rights and participating rights that can be unilaterally exercised by a single party should be considered in determining the primary beneficiary.</td>
</tr>
<tr>
<td>Variable interest entity (&quot;VIE&quot;). Investor with a variable interest in a VIE must qualitatively assess whether it has a controlling financial interest in the entity and, if so, whether it is the primary beneficiary based on whether the investor has the following two characteristics:</td>
</tr>
<tr>
<td>- The power to direct activities of the VIE that most significantly impact the VIE economic performance</td>
</tr>
<tr>
<td>- Obligation to absorb losses from, or right to receive benefits of, the VIE that could be significant to the VIE</td>
</tr>
<tr>
<td>Consider cost, equity method and/or mark-to-market treatment for unconsolidated investments</td>
</tr>
<tr>
<td><strong>Gain recognition</strong></td>
</tr>
<tr>
<td>Need to determine nature of involvement and consideration</td>
</tr>
<tr>
<td>Deconsolidation of a controlled (substantive) subsidiary generally results in full gain recognition.</td>
</tr>
<tr>
<td>- Appropriateness of full or partial gain treatment is subject to uncertainty when contributing a business that is not in a subsidiary.</td>
</tr>
<tr>
<td>- Continuing involvement may preclude divestiture treatment.</td>
</tr>
<tr>
<td>Consider non-monetary exchanges.</td>
</tr>
<tr>
<td>- Full gain recognition is generally appropriate when exchanging appreciated assets for a cost-method investment.</td>
</tr>
<tr>
<td>- Partial gain recognition is generally appropriate when exchanging appreciated assets for an equity-method investment.</td>
</tr>
<tr>
<td>Seller financing can be a form of continuing involvement with the entity that would preclude divestiture recognition and any potential gain that may be associated with the transaction.</td>
</tr>
<tr>
<td><strong>Derivatives</strong></td>
</tr>
<tr>
<td>Identifying the population and treatment of derivatives</td>
</tr>
<tr>
<td>Formula pricing in long-term contracts may contain embedded derivatives requiring separate market-to-market accounting.</td>
</tr>
<tr>
<td>Puts/calls on equity may be derivatives requiring mark-to-market accounting.</td>
</tr>
<tr>
<td>Consider classification of financial instruments in the capital structure (i.e., liability, equity, or mezzanine equity), and evaluate for embedded derivatives that may require bifurcation and market-to-market accounting.</td>
</tr>
<tr>
<td><strong>Embedded leases</strong></td>
</tr>
<tr>
<td>Identifying the population of leases</td>
</tr>
<tr>
<td>Arrangements not structured as leases may be deemed to contain a lease.</td>
</tr>
<tr>
<td>If a purchaser has the “right to use” specific property, plant, or equipment, then both the purchaser and the supplier would perform lease-classification tests.</td>
</tr>
<tr>
<td>Common in power-purchase agreements and purchase/supply agreements.</td>
</tr>
<tr>
<td><strong>Revenue recognition</strong></td>
</tr>
<tr>
<td>Identification and treatment</td>
</tr>
<tr>
<td>In long-term construction contracts, evaluate whether percentage-of-completion or completed-contract method is appropriate.</td>
</tr>
<tr>
<td>Consider a revenue-recognition pattern for fees received upfront.</td>
</tr>
<tr>
<td>In collaboration arrangements, consider gross vs. net reporting and classification of income and expenses.</td>
</tr>
<tr>
<td>Funding received for research and development expenses may require liability treatment.</td>
</tr>
<tr>
<td><strong>Deferred expenses</strong></td>
</tr>
<tr>
<td>Treatment</td>
</tr>
<tr>
<td>Consider whether upfront costs should be capitalized and amortized and, if so, determine the amortization period.</td>
</tr>
<tr>
<td>Consider whether losses on executory contracts should be recognized.</td>
</tr>
</tbody>
</table>
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