Joint ventures – old risks and new challenges

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Abstract

There are many joint ventures (JVs), in the construction, automotive, manufacturing, resource and energy industries. Those in resources and energy involve capital intensive long life plants and infrastructure. Some have lasted for fifty years and represent approximately half of the aluminium and iron ore industries. However, the risk profile is changing. Many newer JV's are trying to establish large operations in less stable countries where they will dominate the economy. All have to weather many changes in product pricing, supply contracts and changes in competitive market positions. They will also have to address changes in infrastructure (power, rail and ports), in the resource base, the entry of state owned companies and governments as well as weather a trend of increased social sovereign risk and resource nationalization. Many of the parties to the JV's market their own products, while the remainder contract to others in the JV's, with prices set on international terminal markets. The aluminium industry and iron mines have relatively simple products and market arrangements, making it easier to learn as to the operation of the JV.

Keywords: Joint Ventures; risk framework; aluminium; iron ore.

1. Forms and rationale for joint ventures

1.1 Why establish a joint venture

A Joint Venture (JV) is usually established when the parties have a common objective, but each party does not have the resources or ability or appetite to develop, finance and manage the business and associated business risks by itself.

In the current environment of commodity price volatility, increased capital costs for projects restrictions on capital raising and debt finance, enhanced sovereign risk especially in respect of large scale projects and the drive amongst developers to reduce costs generally; de-risking projects through JV structures is necessary for developers to consider.

The JV is usually structured to carry out a business in a way that leverages the inputs and minimises the risks to the parties, or at least allocate the risks accordingly to that party best able to manage them.

The allocation of capital thus allows each organization to focus on that which it does best and address those risks that it is best equipped to manage. It also seeks to build on the competitive advantage of the parties. It is generally accepted that JV's, on average, create value for parent firms and that value creation is increased mainly due to synergies and common beliefs of individual participants, but decreased by the inherent tension between co-operative and non-cooperative behaviour in JVs [1].

The JV can be incorporated and governed by country company law or unincorporated and governed by specific agreements. As a collaborative commercial undertaking between parties, JVs resemble partnerships in many respects, but the law of partnership does not necessarily hold all the answers to the host of difficulties that may arise where the express terms of a JV agreement are in adequate. An outline of a legal framework is provided in [2].

Some [13], separate out two forms of joint arrangements, namely

(a) A joint venture arrangement in which the parties that share joint control have right to the net assets of the arrangements, and

(b) Joint arrangements in which the parties that share joint control have rights to the assets, and obligations for the liabilities, relating to the arrangement. This includes situations where the parties benefit from the joint activity through a share of the output, rather than by receiving a share of the trading.

The differences give rise to different ways of treating the assets and liabilities in the consolidated balance sheet. The generic term JV is used in this paper.

There is an increasing body of literature that covers long term and strategic management issues associated with general JVs [3, 5, 6, 7, 8, 9, 12]. Using a risk management approach, this paper provides a framework based on observations of a number of similar JVs within the aluminium and iron ore industries.

1.2 Types of JV's

1.2.1 Aluminium and iron ore examples

Some business types of JV are outlined in Table 1.

Table 1.Type of longer term Bbusiness JVs within alumina and aluminium industries and iron ore.

Identifier	Type of JV	Examples in bauxite and alumina	Examples in aluminium	Examples in iron ore
A	Companies where **a major industry** producer organises a development and provides the resource and **other industry** producers or consumers take a shareholding so as to get an economy of scale and access to output. This includes mine developments where the other companies buy into the resource, as well as operating where they buy the raw material and the plant tolls that into output.	Queensland Alumina Ltd, Eurallumina Spa.,	Boyne Smelters Ltd, New Zealand Aluminium Smelter Ltd.	Samarco Channar Hope Downs
B	Companies where a **major industry producer** provides technology, management and marketing services and sometimes raw material supply and takes a **minor shareholding** while the major shareholder(s) are new to the industry and want to facilitate a major development in country, supply energy and be involved in marketing.	Ma'aden Alumina	Sohar Aluminium Ltd and Ma'aden Aluminium	Robe River Iron Ore Associates.
C	Companies where a **major industry producer** provides technology, management and takes a **major shareholding**, while the other shareholder(s) are new to the industry, but can provide resources and capital.	Alcoa World Alumina,	Tomago and Qatalum.	

The author has contended [12] that when governance takes over from strategy, that it is time to exit the JV.

In a falling market and excess capacity, it now becomes apparent that simplification and strengthening of some JVs is required to address debt and market access arrangements.

This might include selling infrastructure to specialist third parties, consolidation of different plants and region, with a more streamlined management system etc. In addition, market access may need to be addressed by a rearrangement where traders and consumers take a bigger share in return for stronger off take agreements.

It is also appropriate to consider the closing down of smaller, inefficient or costly plants. For example, many Western aluminium smelters would have been closed a number of years ago if they had been located in China.

3.0 Conclusion

JVs make up approximately 50 % of production from aluminium and iron ore production. There are significant common features and lessons to be learned on strategy, governance and balance of interests. In time, new JV's are becoming more complex and have a larger production and may not be optimal in addressing risk. They also have inherent features that make it difficult for the JV to operate within the global industry in a falling market.

Few JV's have timely exit strategies or changes in interests that take into account changes in market circumstances.

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