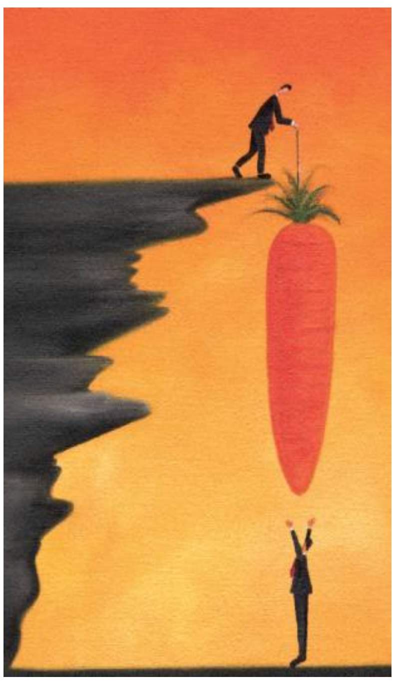
Designing Long-Term Incentive Plans in JVs

By Joshua Kwicinski and Paul McConnell



THE CEO OF A RELATIVELY NEW JV was struggling with his long-term incentive program (LTIP). His problem? The JV didn't have one – and some of his best senior managers were now ready to leave for opportunities with a richer upside. Unfortunately, establishing an LTIP required the CEO to overcome some high hurdles.

Unlike a public company, his venture lacked a stock to use as cheap currency for the plan. Likewise, the CEO had to convince six parent companies, each with a separate corporate culture and approach to incentive design, to agree on a model. And he had to come up with a design that reflected the oddities of life in a joint venture – including whether and how parent company benefits not seen on the JV P&L should be included in the plan targets, and how to deal with parent-company imposed restrictions on the venture's product and market scope that limited the JV's earnings potential.

Such compensation struggles are typical for JVs.

And our work with dozens of JV Boards and CEOs shows that many JVs with LTIP programs find the current design suboptimal in important ways. In some cases, the program has unintended limitations in its likely value to employees. In other cases, the program does not sufficiently target the outcomes that the shareholders want to incentivize. This might include pursuing synergies with the parent companies, or maintaining plant uptime rather than profitability.

Exhibit 1: Common LTIP Structures in JVs

	Performance Plan	Profit Shares	Phantom Equity	Parent Equity
Description	• Closest in structure to annual bonus – cash payment • Target payout set at start, but actual payout tied to performance against internal / external benchmarks – usually from 0-300% of target payout, based on benchmark performance • Funded by JV cash flow • Performance cycle typically 1-3 years, followed by payout over 1-5 years	• Provides management with a fixed share of income (net, Pre-tax, EBITDA) in excess of minimum return (e.g., x% ROE) • Profit share is typically banked for 1-3 years, where it is at risk against future loses • In a LLC can be structured as real equity with limited rights	• Based on value of notional JV share – either tied directly to JV (using peer group valuation multiple applied to a JV earnings metric like EBIT); to market using average value of peer group stock; or via valuation • Typically pays difference in value of JV shares from cycle start to finish (e.g., 5 years) • Award of full value shares (not just growth) is determined by performance against goals	• Target award of stock or options in one or more parents set at start of cycle • Final size of award tied to performance against internal / external benchmarks
Benefits	• Simplicity – no complex asset valuation • Direct links to JV performance	• Provides excellent balance of short versus longer term performance • Has unlimited upside potential	• Fosters ownership culture, esp. with near-term liquidity event • Theoretically best connection to long-term performance • Unlimited upside potential	• No cash flow implications to JV • Unlimited upside potential
Issues	• Limited upside opportunity relative to stock / options • "Long-term" nature compromised by any low performance that limits award (no chance to recover lost value) and by cash nature	• Potential loss of value to management if JV experiences poor performance • Does not reward management if value created on parent P&L instead of on JV P&L	• Most complex to run – can be hard for employees to perceive value • If paid in cash, has cash flow implications for JV that are hard to predict (no upside)	• Without JV performance conditions, has limited link to JV performance • Value heavily dependent on parent performance and external events
When to Consider	• Most JVs	• Most effective where transfer pricing issues are minimal and operations are profitable • JVs trying to attract highly entrepreneurial talent or having difficulty attracting/retaining talent because of LTIP value proposition	• JVs actively contemplating IPO / near-term liquidity event • JVs trying to attract highly entrepreneurial talent or having difficulty attracting/retaining talent because of LTIP value proposition • JVs with straightforward valuation, i.e. profitable and with good comps	• JVs that represent significant portion of parent (s) earnings • Recent consolidation JVs – where most of JV staff have come from parent • JVs clearly operated and majority owned by one partner – run on its HR systems • JVs where one partner is planning to buyout others at a future date

The purpose of this memo is to outline four common LTIP structures used by JVs, share some thoughts on how to select the right plan, and explore certain JV-specific challenges that can arise. While this topic won't be relevant for every JV, our hope is it will stimulate thinking in executives who are grappling with these LTIP-related issues in new or existing JVs.

COMMON LTIP STRUCTURES IN JVs

JVs use four common LTIP structures: 1) performance plans; 2) profit shares; 3) phantom stock; and 4) parent company restricted stock / options / units (Exhibit 1), each of which introduces unique benefits and drawbacks.

1. Performance Plans. The most common and easiest to implement is a cash-based performance plan. Simply stated, a performance plan pays out cash for performance against a set of Board-agreed targets.

Payouts are based on a targeted percentage of the participant's base salary[1], with the final size of the award then calibrated by how the venture performed against the targets across a given period (typically the preceding 1 to 3 years). The payment is then delivered over a period (typically 1 to 5 years). Participants begin a new performance cycle on an annual

[1] Eligible participants in a JV LTIP can vary from a handful of senior managers to the entire venture workforce, but in most cases it represents some combination of the JV management team and the next few layers of executives.

basis, so even if the evaluation window and payment window for a cycle run over multiple years, they should eventually be receiving some payout on an annual basis.[2]

The primary advantages of performance plans are their simplicity and direct tie to performance targets. However, it can be difficult to set realistic multi-year performance goals, particularly in a start-up venture where there is little history for business projections or parent behaviors. Unrealistic goals have the potential to de-motivate employees. Conversely, goals that are not aggressive enough can over-reward employees while failing to drive performance.

Realistic goals are key to achieving performance targets.

2. Profit Shares. Another approach is to offer employees a fixed share of venture profit, typically the amount in excess of a threshold. If the threshold is tied to the cost of equity, this is usually referred to an Economic Value Added (EVA) plan. These plans are similar to a private equity or venture capital incentive structures where executives have a "share of the company," though a key difference is that JV executives benefit even when a liquidity event is not anticipated.[3]

Typically, the plan will allocate an annual share of venture profits into some form of earnings "bank" for each participant. The profits in each bank vest over a period of time and then are distributed on a fixed date (e.g., 3 years after being earned). During that vesting period, any losses will offset prior profits, resulting in removal of funds from the participant's bank. An additional interesting element is that in some cases, these plans can be structured so that participants are actually members of the LLC (or equivalent entity structure) that constitutes the JV.

This approach can provide a strong incentive for participating JV employees. Unlike performance plans, where goals often increase as performance does, these plans ensure that participants will continue to earn a fixed piece of incremental returns, and can provide rich rewards for good venture performance. These plans also do not require ongoing goal setting or concern with most external factors.

Despite the positive benefits, profit share plans create some unique challenges in JVs. Many joint ventures are structured so that a large portion of the economic value and/or profit created by the JV is realized inside the parents, and not on the JV P&L. This means that JVs considering a profit share plan should look closely at value creation outside the JV when considering the program's share of earnings.[4] Also, these plans will also deliver below market compensation when results are not consistent with long-term expectations.

3. Phantom Equity. Some JVs have experimented with phantom equity as a creative way to replicate some of the benefits of incentive programs based on company stock. The idea is to value the JV, usually on an annual basis, and then distribute phantom stock to participants tied to this valuation. The concept directly ties compensation to ongoing venture value creation as measured by changes in the value of a phantom share of the JV.[5]

---

2 See Box 1 – Tale of Two JVs – for an example of how a JV performance plan was structured.

3 The private equity or venture capital approach is almost always focused on creating a liquidity event and deriving the primary economic benefit from that sale.

4 For more information about value creation inside and outside the JV P&L, see "Assessing Total Venture Economics," *JVX*, November 2008.

5 See Box 1 – Tale of Two JVs – for an example of how a JV phantom stock plan was structured.

Generally, the JV's valuation is based on either a formal valuation conducted by an external professional firm, typically using a formula derived from a multiple of earnings (e.g., EBITDA),[6] book value or some operational metric that better captures the underlying value creation (e.g. level of output/sales).

Phantom equity plans then begin with a grant of phantom shares at the beginning of a cycle. This grant is worth some percentage of a participant's compensation, and the number of shares is based on the current JV valuation. A cycle usually lasts for 2-3 years. At the end of a cycle, ventures commonly use one of two methods for calculating payouts: either award the face value of the shares at current valuation levels, or award the increase in valuation of the shares as if they were stock appreciation rights. In some cases, ventures further modify the award value based on venture performance against one or more goals (i.e., the full value of an award is only granted if the JV meets a set of operational performance metrics, or has a particularly strong HSE performance during the plan cycle). Distribution windows are typically 3-5 years.

Phantom equity aligns compensation to financial performance.

The appeal of phantom equity is clear. It allows a JV to compete in a talent market place where other companies are offering equity. It aligns compensation closely to financial performance. And it helps foster an ownership ethos that can be developed by employee ownership of company stock. This may be particularly appealing if the JV is contemplating a near-term liquidity event.

However, the valuation process itself is complicated and significantly dependent on the input choices in plan design. As a JV CEO who recently switched from phantom stock to a performance plan told us, "You can affect the valuation in a plan by playing with things like cost of capital, which can bring about large changes in valuation that have nothing to do with a linkage to employee efforts."[7] Later, if new members are brought into the JV or additional investments are required by the parents, the phantom equity plan also needs to be adjusted for that change in capitalization, which can de-value the phantom equity currently held by plan participants.

4. Restricted stock / options / appreciation rights / units in a parent company. The last common LTIP structure is an award of parent company restricted stock, options, appreciation rights, or units[8]. This award may be a mixture of different parent companies' stock – or simply be an award tied to one parent. When a mixture is used, the relative allocation would likely be based on the companies' ownership percentage of the venture. When the award is only of one parent company stock, it is usually due to the fact that one partner is the majority or operating partner,[9] or that the other partner(s) are privately held or state-owned enterprises, and thus do not have publicly traded shares.

---

6 The multiple utilized can float with comparable multiples from a set of peer companies. However, it should be noted that this approach does introduce market volatility into the program.

7 The CEO moved his JV from phantom equity to a performance plan that focuses on CAGR growth over a three year period, which he believes is a more effective tool to motivate his employees.

8 A restricted stock unit is a grant valued in terms of company stock at issue, but held as a "unit" until the award vests, at which point the company has the choice of paying the value of the unit in cash or in actual shares of stock. In some cases, the employee has the option of choosing whether to receive cash or stock.

9 Many incentive plans at independent companies restrict participation to employees of that company, plus any subsidiaries (or JVs) that are 50.1% or more owned by that company.

In these circumstances, the scope of the JV's LTIP design decisions can be limited, because the most common approach is for JV employees to simply participate in the parent company LTIP program instead of designing one from the ground-up in the JV. The only decisions left for a venture would be on eligibility and award sizes, and whether the JV is reimbursing the parents for the cost of the stock.

By virtue of not being paid in cash (unless it happens to be an appreciation right or a restricted stock unit paid in cash), this introduces the potential for long-term value creation lost with cash-only awards, while also being much more favorable to the balance sheet of the JV itself. It can also be a positive in some situations to have a strong connection to one of the parents, particularly if the venture is extremely interconnected with that parent.

But parent company-based LTIPs do not directly reward JV executives for financial, operational or strategic achievements of the JV itself. By extension, having a parent-company LTIP removes a key lever for supporting the creation of a JV culture. And, venture employees would be exposed to all of the down-side risk of a stock-based plan with no fixed value – potentially receiving worthless shares or options.

SELECTING AN LTIP FOR YOUR JV

JV Boards and executives seeking the right LTIP design should start thinking about three core questions. First, what does the JV need the LTIP to accomplish? Second, how do the JV's financial limitations influence the design options? Third, how should the vision of a future path for the JV influence the LTIP design (Exhibit 2)?

For example, a JV CEO might want to replicate the tech industry's entrepreneurial environment driven by equity awards, which might be achieved with a phantom equity program. Or, perhaps the Board wants to drive JV management to meet a set of operational performance metrics by linking those metrics to a performance plan. Understanding what the JV is trying to accomplish with the LTIP, and the constraints it faces in execution, is a key part of aligning around the right LTIP for a JV.

Decision-makers also need to calibrate their thinking about LTIP against the venture's level of independence relative to its parents and where the venture is in its lifecycle (Exhibit 3). Some LTIP choices are poorly-suited for relative combinations of independence and lifecycle stage. For example, a highly-independent start-up JV looking to create an entrepreneurial culture would not be fostering that cultural ethos – or encouraging independence from the parents – by participating in the parent's stock-based LTIP.

Exhibit 2: Key Design Considerations for JV LTIPs

JV Organizational Needs

- Is the JV facing challenges in recruiting or retaining employees? Do its competitors offer more financially-compelling LTIPs?
- Does the JV have a cultural ethos it wants to create or maintain?
- What are the key strategic, operational or financial goals of the venture in the near future – and what benchmarks should it track to incentivize employee performance towards those goals?

JV Financial Considerations

- What currencies are available to the venture – does it have access to a parent company LTIP program, is it considering an IPO in the near future, or does it need to use cash?
- How long should the performance cycles run, and how long should the vesting period run (e.g., does the venture need to encourage retention)?
- How should outstanding and/or unvested awards be affected by termination of employment? Does this answer vary if an employees leaves the JV for a parent's employment?
- What are the tax and accounting aspects of the plan that must be anticipated and accounted for?

JV Evolution

- Is the JV anticipating significant merger or acquisition activity? If so, what impact will potential corporate changes have on the plan or outstanding awards under the plan?
- What will happen to the plan and/or awards under the plan in the event of a change in control of the Joint Venture (sale or IPO)?

The initial process for designing an LTIP in a JV may feel similar to that of an independent company, which would also be thinking about its goals and constraints in designing an LTIP. But JV Boards and executives will also need to think about a set of broader JV-specific challenges that should influence their thinking about the right LTIP for their venture.

Many JVs will grapple with a set of challenges related to LTIP. These include: 1) lack of stock as a currency; 2) parent-defined restrictions on the JV's growth and scope; 3) disadvantaged transfer pricing with parents; 4) the need to develop a unique culture different from the parents; and 5) compressed and rapidly evolving lifecycles. Each of these challenges could impact the design of the venture's LTIP, as well as its appeal to the JV's employees.

Exhibit 3: Different LTIPs for Different JV Operating Models and Lifecycle Stages

Different LTIPs more appropriate as JV evolves across lifecycle

Operating Model – overall level of JV independence	JV Lifecycle: Start-up	Growth	Maturity
Independent (JV is a freestanding, separate co with few operational links with parents)	Performance Plan Phantom Equity	Performance Plan Profit Shares Phantom Equity	Performance Plan Profit Shares Phantom Equity
Interdependent (JV has significant operational links with both / multiple parent co's)	Performance Plan Phantom Equity Parent Equity	Performance Plans Profit Shares	Performance Plans Profit Shares Phantom Equity
Dependent (JV operated by one parent)	Performance Plan Parent Equity	Performance Plan Parent Equity	Performance Plan Profit Shares

1. Lack of stock as a currency. Public companies – including the parents in most of the largest JVs – often use their corporate stock as the key currency in long-term incentive design. Except for the rare case of JVs that have gone through an IPO (or the handful of ventures that have chosen to simply participate in the parent company LTIP), most JVs fundamentally lack similar access to stock.[10]

This means that most JVs are forced to fund the LTIP with cash, which can be a significant drain on the venture's cash flow. By reducing cash available for re-investment in the JV, this can have a compounding effect on the venture's financial performance. Similarly, because the size of this cash drain can't be entirely predicted ahead of time – and could be much larger than expected if the JV significantly exceeds performance expectations – a cash-based plan can be additionally problematic.

---

[10] For more information on JVs that have gone public, see "When and How to Take a JV Public," *JVX*, November 2009. Examples of prominent ventures that have gone public include Orbitz, Visa, Alstom, EADS and Tech Mahindra.

Box 1: Tale of Two JVs

How two JVs got their LTIP right

To understand how some JVs successfully worked through their compensation issues, consider the stories of two very different JVs.

Case 1: Chemical Industry Consolidation JV

A joint venture between two very large chemical companies was developed to enable the parents to achieve critical mass in the manufacture and sale of specialty chemicals. The company was much smaller than its parents and operated very autonomously, except for one key executive (e.g. CEO, CFO) seconded to the management team by each parent. The JV had its own customers, sales force, and human resource policies. Since the feed stocks used by the JV were sourced evenly from both parents and the open market, transfer pricing had relatively little impact. The key strategic issue for the parents was achieving growth and scale consistent with appropriate return on capital employed (Exhibit A).

LTIP Choice – "Economic Value Added" Profit Share: Since neither parent owned more than 50% of the JV, their corporate plans did not allow JV employees to participate. The JV Board considered a cash-based performance plan, but management did not feel capable of establishing reasonable multiple-year performance goals, since results could vary significantly with market success and the trend in feedstock costs.

Because the Board wanted management to be motivated to maximize performance and was also willing to share that success with the team, it decided on an EVA-based profit-sharing plan. The plan created an annual incentive pool equal to a fixed share of EBITDA, reduced by a charge for all of the capital employed. Bank and other debt was charged at the cost of interest while equity (including retained earnings) was charged at a fixed rate consistent with parent's capital budgeting process.

The pool was allocated to participants each year based on a fixed share established for that position. Individual accounts were then maintained for each participant.

Since it was possible that EVA could be negative in a year, the Plan allowed for a three-year look back that would reduce prior balances earned. Balances earned more than three years ago (the vesting period) were not subject to reduction. The Plan provided motivation to maximize performance – there were no caps on annual awards, while providing a reasonable risk reward profile consistent with the parents.

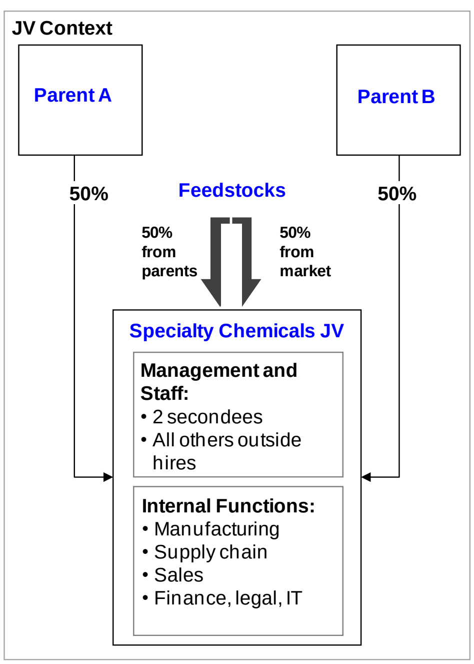
Case 2: IT Platform New Business JV

A joint venture was initially formed by two partners to develop and bring to market a web-based transaction system that would improve the operating efficiency, cost structure and capabilities of their underlying business.

To be successful, the venture needed to achieve significant scale in various geographic markets so that it could become the functionality of choice for customers – who were other financial organizations similar to the partners. The growth strategy involved finding additional partners that could deliver

continued on next page

Exhibit A: LTIP Program Design for 50/50 Consolidation JV



Situation

- 50/50 consolidation JV formed to sell specialty chemicals
- JV much smaller than parents – and operated very autonomously , including own HR systems and sales force, except for 2 management secondees and sourcing of 50% of feed stocks from parents
- **Key LTIP design challenge:** Motivating growth and scale consistent with return on capital employed

LTIP Plan

- EVA profit-sharing plan chosen as best available option to incentivize management's pursuit of growth and scale
  - JV employees unable to access either parent LTIP because of <50.1% ownership
  - Parents uncomfortable with setting multi-year performance plan goals for a new JV
- Plan designed around annual incentive pool equal to fixed share of EBITDA generated by JV, less cost of capital
- Incentive pool allocated via fixed shares set for each position
- Account balances vest over 3 years and subjected during vesting period to a loop-back that can reduce the balance if EVA is negative in a year
- No caps on annual awards, and balances more than 3 years old not subject to reduction

continued from previous page

critical scale in additional markets, thereby driving the cost of transactions down. The JV was staffed with employees hired from outside the parents, with most coming from backgrounds in IT start-ups where the focus of compensation was on equity and a potential IPO. However, given the strategic importance of the JV to the parents, an IPO was highly unlikely (Exhibit B).

LTIP Choice – Phantom Stock: From a recruiting standpoint, the JV needed an equity-based incentive – one where the upside potential was virtually unlimited, although not guaranteed. One of the founding partners had a long-term incentive plan that would allow JV employees to participate and receive grants in stock of that company. However, given the differences in business models and scale between the two companies, that would provide little motivation to employees, who would be receiving stock that had very little relation to their performance in the venture.

The JV Board decided that a phantom equity plan would provide the equity link required to be competitive in recruiting talent, while allowing for an LTIP related to the JV's success. However, traditional valuation measures (e.g., multiples of EBITDA) were unlikely to work here, because creating a profit stream was not central to the strategy. Profits earned by the JV were reinvested in new capabilities and returned to the parents in the form of lower operating costs and transaction fees for the services provided by the JV to each parent. Similarly, the JV couldn't use a multiple of revenue because the JV's price per unit was expected to decline sharply as the venture achieved economies of scale.

Instead, the JV based the valuation on transaction volumes, using a multiple that represented the value created for the JV and the parents from each transaction. This phantom share price was periodically validated through market valuations that were prepared as new partners joined the JV. Since new partners often merged their businesses into the JV, the venture would increase the shares outstanding under the plan to reflect the increase in valuation.

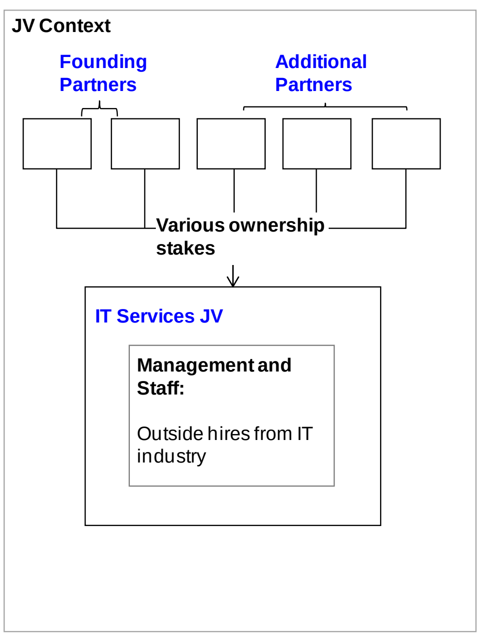
The Board considered structuring the award as stock appreciation rights, where management received the growth in value on a set number of shares. However, the Board preferred that the compensation be tied more directly to achieving strategic objectives that were critical to the JV's success.

Accordingly, the Board made grants of shares that were contingent on achieving specific goals. The first goal was becoming cash-flow positive so that the JV would no longer be a financial drain to the parents. Later awards were made for opening new geographical regions, successful mergers and building new capabilities into the venture product.

Shares awarded vested over a period of time and were paid out in cash at a set date, based on the then-current valuation formula.

If the JV was ultimately taken public (or merged with a public entity), the plan allowed for a conversion of unpaid shares into shares of the new entity consistent with the terms received by the partners. This plan enabled the JV to recruit critical talent in a time when their sector was extremely "hot" by offering a reward that had many of the upsides of equity, but without the volatility – a situation that was very analogous to a pre-IPO start-up.

Exhibit B: **LTIP Program Design for Multi-Owner New Business JV**



Situation

- Multi-owner IT services JV created to provide cost-effective transaction support to parents; staffed with outside hires
- JV founded by two parents, but needed to add additional partners to achieve critical scale and drive down costs
- **Key LTIP design challenge:** Recruiting high-caliber IT industry talent accustomed to equity-driven compensation in a cost-center JV so strategic to owners core business platform that an IPO was unlikely

LTIP Plan

- Phantom stock program chosen as best method to incentivize performance while giving appearance of equity linkage for recruitment
  - One parent had LTIP that would allow JV employees to participate, but option seen as disconnected from JV performance, and moreso as additional partners added
  - Performance plan possible – but would hamper recruiting efforts relative to equity expectations
- JV was cost-center for parents, so traditional valuation methods (i.e., EBITDA) not appropriate – no interest in driving profits or increasing revenues, only goal was lowering costs for parents
- Instead, plan utilized unique valuation methodology based on transaction volumes – using a multiple that represented discounted value of those volumes to the parents

Paying in cash also inhibits the ability of the LTIP to be financially compelling at many points in the business cycle, both to current and potential employees. Stock-based LTIP plans have significant potential upside through long-term growth in stock prices, but cash awards have no opportunity for future growth in value. Similarly, if the size of the cash award is low because of short-term performance difficulties, the recipient has no chance to recoup the lost value (unlike stock, which can recover its losses). Ultimately, the venture loses out on the power of ongoing stock possession to continually influence executive performance. Executives with the option of working for a company with stock-based LTIP may find it very hard to accept a position with a much-less compelling financial upside.

As one JV executive told us, "People took pay cuts to be here, and while they joined for the entrepreneurial environment and to work with the talent here, we know we need to get them back to where they were financially – or have a liquidity event that gives us access to stock."

2. Parent-defined restrictions on the JV's growth and scope. In many JVs, the relationship between the JV and its parents can keep the JV performance and, by extension, the value of an LTIP program below what JV management could achieve if independent.

For example, the JV CEO might see a large potential for growth, but the specific path to achieving that growth often goes through the hands of the parent companies and is outside of the CEO's control. Growth might require approval from the parents to increase capital spending, and the answer may be "no" even if the economic returns are good.

In some cases, delivering on robust growth targets requires a JV to edge into adjacent markets not initially included in the authorized scope defined in the JV agreement. Many parents might respond by blocking this move, either to prevent encroachment on their current business or simply to preserve the right to enter that space in the future.

3. Disadvantaged transfer pricing with parents. A related issue is tied to transfer pricing of goods and services flowing between the parents and the venture. Our work has shown that it is not uncommon for 5-20% of a JV's operating budget to be spent on parent provided inputs (raw materials, components, administrative and technical services) – and that 30-50% or more of a JVs output might be sold to the parents. In some JVs, parent companies structure transfer pricing arrangements on a non-market basis – i.e., provide certain inputs to the venture on a cost-basis, or agree for the JV to sell its services or outputs to the parent companies at a fixed mark-up or preferred price.

> Transfer pricing can adversely affect incentive plans tied to profitability.

There can be plenty of good reasons – tax and otherwise – to structure transfer pricing agreements in this way. But doing so can have a huge swing in the profitability of the JV – and the attractiveness of any long-term incentive plan tied to profitability.

4. Need to develop a unique culture from the parents. Every JV will have a culture different from the parents – and compensation is one of the levers in the JV that impacts the development and maintenance of that culture. In consolidation JVs, there is usually a complex blend of employees coming from separate corporate cultures, while many new business JVs are filled with outside hires and have a start-up mentality (Exhibit 4). This leads to significant differences in LTIP needs.

For new business JVs, which are usually designed to pursue growth into new markets, the best LTIP might be one that incentivizes bringing new products to market and developing revenues – as opposed to metrics like improved margins, which would probably feature in the parent LTIP. Ensuring that the LTIP program is different from the parent would also help to define a new entrepreneurial culture in the JV that is different from the bureaucratic culture of the parent.

In the case of a consolidation JV, it can be a delicate balance to maintain morale while fusing together pre-existing corporate cultures. Employees might need an LTIP program that reflects what they were previously receiving, at least in value if not in structure. Additionally, consolidation JVs are often interested in creating a new culture that is sharply focused on cost-cutting and pursuit of synergies, which are two common goals in consolidation JVs. An LTIP focused on cost-cutting and synergies is likely different from the LTIP in a parent, which is probably focused on top-line growth and profitability.

Keep in mind that the challenge of impacting JV culture through LTIP is only applicable to direct JV employees, whether either outside hires or former parent company employees now directly working for the JV. It doesn't apply to secondees, who almost always stay on the parent LTIP plan, though the JV is sometimes charged with funding the cost of the LTIP payout earned by a secondee in his time at the JV.[11]

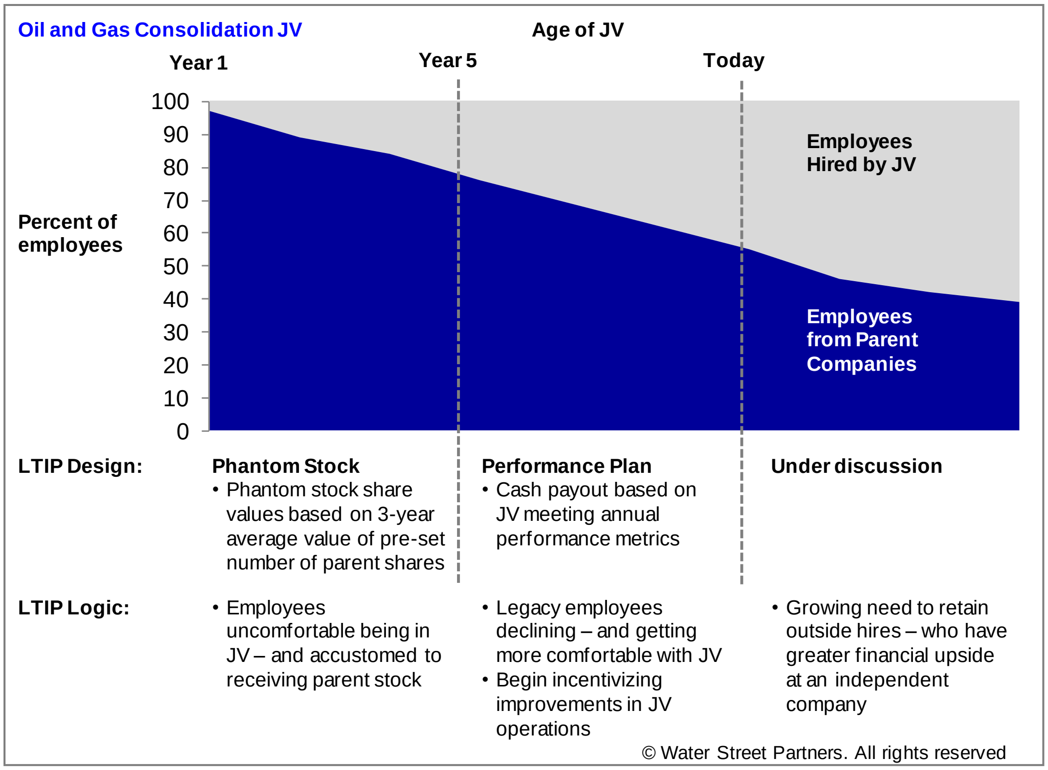
Exhibit 4: Tale of the Tape: Differences between new business and consolidation JVs

New Business JVs		Consolidation JVs
• Parent companies contribute capital, skills, other intangibles to enter new markets or develop new products	**Venture Description**	• Parent companies combine existing, often mature businesses, typically to gain economies of scale, reduce costs
• Often a mixture of parent secondees and outside hires	**Initial Employee Source**	• Former parent-company employees converted to JV employees
• Entrepreneurial and start-up; typically very different from Parents	**Initial Culture**	• Complex blend of traditional, large corporate cultures in Parents
• Product introduction and revenue growth – profits not always an initial goal	**Initial Business Goals**	• Higher profits / improves financial returns driven by synergies and economies of scale; enhanced operational performance
• Create employee value proposition matching potential employees' other entrepreneurial options • Incentivize management to drive growth and adoption of JV product	**Typical LTIP Role at Venture Onset**	• Support employee transition from parent companies to JV – and help create distance from parents, if needed • Incentivize pursuit of operational and financial metrics – at least maintaining pre-JV steady state
• Hulu • International Aero Engines • Cereal Partners Worldwide	**Example JVs**	• Infineum • CP Chemicals • Ilim Group • ST Ericsson • Nokia Siemens Networks

5. Compressed and rapidly evolving lifecycles. A JV can quickly evolve from an unprofitable new business pursuing market share into a profitable venture focused on margins, and shortly thereafter find itself spun-off in an IPO. Or, a venture can move from a tightly-held consolidation JV focused on serving the parents into a venture operated with a great deal of independence and given the freedom to chart much of its own course. In some cases the evolution of the JV may be even more subtle, reflecting a change in the motivating factors driving employee behavior or changes in compensation at a competitor that need to be matched.

[11] It is possible for secondees to have a second-order effect on JV LTIP programs – the value of their LTIP can be a source of friction with direct JV employees who are comparing their LTIP program to that of the JV's secondees.

Exhibit 5: Changing LTIP as Source of Employees Shifts



All of this can all happen fast – the average lifecycle of a JV is just seven years – and ventures need the flexibility to consider a different LTIP at each point in their lifecycle and relative to their level of independence from their parent companies. This seems tangibly different from the experience of independent companies, which tend to evolve slowly, especially once they've gone public and have access to stock. How often are Microsoft, IBM and GE re-evaluating the structural components they use to deliver LTIP?

Consider the experience of one consolidation JV in the oil and gas industry, which is thinking about moving to its third LTIP program since it was created a decade ago (Exhibit 5). The first LTIP program was designed to track the stock of the parent companies, giving an "imaginary tie" to the parents "that was important 10 years ago when the JV was 100% legacy employees." A few years later, as the population of legacy employees declined, a second LTIP was introduced that was based on the JV's performance against internal metrics, and was designed "as a retention tool which could also drive behaviors." Now the venture is concerned that there isn't enough growth or financial value for top executives relative to its independent peers, so it's thinking about how to design a new LTIP plan (its third in the last decade) to face the latest retention challenge.

~ ~ ~

Despite the challenges, there is a path for any JV to create a long-term incentive program that is compelling and appropriate. Doing so may require weighing a set of competing options around the plan design and potential value, and it may be no easy task to find something that parents find reasonable and JV employees find compelling. But the end result – creating a tool that makes employees want to stay with the JV and perform at their best to support its evolution – is something that not only can increase employee compensation, but can ultimately lead to a better-performing venture. Isn't that what this is all about? ഌ

Joshua Kwicinski *is a Consultant with Water Street Partners.* ***Paul McConnell*** *is a Managing Director with [Board Advisory LLC](), which supports compensation committees and Boards of Directors in their management of executive compensation, performance and succession planning for senior executives.*

THE JOINT VENTURE EXCHANGE

The Joint Venture Exchange is a forum that connects senior joint venture practitioners, including Joint Venture Board members and CEOs, through the sharing of ideas, practices and experiences unique to joint ventures. It was conceptualized and is managed by Water Street Partners, a boutique consulting, research and information services company focused exclusively on joint ventures and partnerships, founded by the former co-leaders of the Joint Venture and Alliance Practice at McKinsey & Company.

Editorial Team:
Jim Bamford, Lois D'Costa, David Ernst, Michal Kisilevitz, Josh Kwicinski, Mary Menard, Geoff Walker

You can contact us at:
Water Street Partners LLC, 3050 K Street NW, Suite 225, Washington, DC 20007 USA
phone: +1 202 280 2366 email: partners@waterstreetpartners.net

For questions regarding the data, perspectives, or other content in this issue, please contact us at partners@waterstreetpartners.net
For other questions or information regarding the Joint Venture Advisory Group, please contact Geoff Walker at geoff.walker@waterstreetpartners.net

Water Street Partners