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Restructuring alliances in China

Twenty-five years after alliances first paved the way into the world's most dynamic emerging market, knowing how to structure them is more important than ever.

Jonathan R. Woetzel

In China, alliances have been the dominant form of foreign direct investment since Beijing officially opened the country to the outside world in 1978. Twenty-five years later, however, maturing local companies, more accessible markets, and progress toward a more stable regulatory environment have removed much of the initial rationale for alliances. Indeed, more than 50 percent of new foreign direct investment in China is now in wholly owned and contractual joint ventures.

At the same time, many existing alliances have become unstable, as fundamental imbalances in partner contributions have grown. Around the world, the hallmarks of sustainable alliances are partners' complementary skills, 50-50 contributions, and the ability to evolve beyond original expectations. In China, most joint ventures are between potential competitors, 50-50 deals are in the substantial minority, and both Chinese and multinational companies face cash constraints in the enormous Chinese market. It's no surprise, then, that many of the joint ventures signed in the early 1980s are now being restructured.

In view of these circumstances, executives of even successful ventures should take a hard look at their current and prospective China alliances to assess their rationale and potential for restructuring. Even successful ventures can go wrong as markets, partners, and competitors evolve.

Partner . . . or friend?

One of the most common pitfalls in striking an alliance in China is blurring the distinction between government friendships and business partnerships. Each can be helpful, but it is usually a mistake to expect their roles to overlap, such as in anticipating that a government approval authority will do a venture's marketing or that a business partner will secure government licenses. Companies must fully understand the need for and interests of both government friends and day-to-day partners.

Government entities can be enormously helpful when they intervene directly in resolving policy disputes, though some functional bureaus such as Customs and Finance will generally not make policy exceptions for individual companies. Even where government will get directly involved, companies must first understand the direction of reform. The government is unlikely to aggressively promote a foreign business agenda among the many industries nominally controlled by central planning entities that have been corporatized[1] in the past few years. These include steel, oil and gas, and automotive, among others. Finally, in those

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sectors where government influence can still be directly applied, such as health care, companies must understand what makes an offer interesting to the government—and what the government is prepared and able to give in return. For example, when Volkswagen proposed to move production of its Santana sedan to China in the 1980s, it did so in exchange for guaranteed marketing and support in component localization. The automaker was the only global original-equipment manufacturer willing to invest in China, and it knew the government desperately wanted a global OEM to kick-start the domestic industry. In return, the government virtually guaranteed profitability by buying all the sedans produced at preagreed prices and selling them to taxi fleets and government bureaus. In today's much more competitive market, this deal could not be repeated.

With day-to-day partners, it is essential to understand not merely a company's technical capabilities but also its business aspirations, partnership track record, and organizational depth. This is typically not done, and this oversight can be a costly mistake. Consider the experience of one CEO from the United States who on a onetime trip to China was introduced to and quickly partnered with a major Chinese supplier and distributor. But the CEO neither thoroughly checked out the business aspirations of his new partner nor monitored him, and the Chinese partner soon became a major competitor. In another case, the head of a global business unit negotiated a joint venture with the local market leader to quickly secure market share. But conflicts with the partner on product-line priorities and sales force control soon emerged. This ultimately led to an acrimonious divorce and a write-off for both partners.

Best practice due diligence might have prevented problems. This should include site visits to check physical location; interviews with key executives to assess their management philosophy, business aspirations, and execution skills; close analysis of financial and accounting information to codify a potential partner's operational and financial strength; and visits to retailers and distributors to assess and evaluate the partner's true marketing skill.

Plan for the power balance to shift

An alliance between partners whose skills are truly complementary can last a long time. However, shifts in power can occur over time and destabilize a partnership. Global players tend to have an advantage when global brands, world-class technology, global scale, or financial depth are key industry success factors. Local players have more of an upper hand when relationships with local suppliers, customers, or regulators are essential and when global competition is relatively weak. In an emerging economy these factors can change rapidly as markets evolve and skills are transferred. In China the resulting power shifts have been particularly dramatic.

Many early alliances in China were predicated on a technology-for-market swap. Local companies would bring marketing skills, and foreigners would contribute world-class equipment and cash. Unfortunately, some foreign companies have found that their Chinese partners lack any real marketing capability, often because the state distributors they used to sell to have gone under. As a result, among the executives we interviewed at 14 leading multinationals, half indicated that they had recently increased or were about to increase their equity share in their joint ventures. In the words of one: "If your ultimate goal is 100 percent ownership, the closer you start to that goal the less pain you have to go through later." For their part, local companies have sometimes found their foreign partners unwilling or unable to continually inject cash and technology. Said the chairman of a leading Chinese company: "Their initial technology was not suited to the Chinese market, and they have proved unwilling to reinvest to rebuild share."

For companies considering new ventures, the implications of power shifts should be considered in the negotiation. Because bargaining power will increase over time, likely buyers should choose smaller companies as partners and avoid setting acquisition prices. For example, one venture succeeded in reducing the initial buyout price by 20 percent by timing the offer to coincide with increases in the partner's cash needs in other businesses. Buyers should also hold both management and financial control. Experience suggests some best-practice requirements: hold two-thirds of the equity, keep proprietary generators of value such as brands and core technologies out of the alliance's control, and ensure that key elements of the alliance's business system itself can be absorbed, if necessary, at a later date.

Potential sellers . . . should seek to capture the full value of their participation in the alliance by striking presale agreements that include an exit option based on market value at the time of exit.

For example, one logistics firm separates its customer-relationship staff from the day-to-day transportation service joint venture to preserve its marketing capability outside the venture but ensures common electronic data interchange systems and standards.

Potential sellers, on the other hand, should seek to capture the full value of their participation in the alliance by striking presale agreements that include an exit option based on market value at the time of exit. Many Chinese firms now routinely seek such agreements by agreeing to base a buyout price on a specific market multiple, such as P/E, market-to-book, or other ratios, assuming that the market will fully reflect the value of the company at the time of buyout. Sellers should also acquire skills from the joint venture. Some do this, for example, by actively rotating managers over two- to three-year periods. These managers then return to the parent company to start up new businesses, even competing with the venture.

Fit the organization to the power balance

Equity arrangements alone cannot ensure that an alliance will go the way you wish. Equally important is fitting the softer organizational

elements of structure, such as skill transfer and human resources, to the alliance's evolution.

Stable alliances are characterized by independent organizations with their own board and direct control over their own business activities. Often, they develop their own unique business identity, complete with separate names, logos, uniforms, and personnel systems. Strong joint venture boards can effectively block multinationals that try to coordinate multiple joint ventures to improve the effectiveness of multiple sales forces. One consumer electronics company, for example, has 15 joint venture sales forces for the same customer base. Strong joint venture boards can also block efforts to reduce the overhead associated with having literally dozens of joint venture general managers. Some multinationals, after exhausting negotiations with each venture partner and its board, have achieved centralized sales and marketing cost centers, with joint ventures still acting as profit centers. However, only those who started with the end game in mind have achieved centralized sales profit centers that allow them to treat production joint ventures as contract manufacturing cost centers.

Unstable alliances typically feature direct intervention by partners into day-to-day business activities, and boards that are unable to set a clear direction for the company because the partners disagree. Trying to build a stable, independent joint venture on an unstable foundation of radically imbalanced partner contributions tempts trouble. As an illustration, one of the earliest automotive ventures was established as a 50-50 deal. The Chinese partner provided a basic facility and a ready market for the foreign OEM's global components exports. In return it expected the foreign OEM to provide not only parts and design but to build up the alliance's own manufacturing and design capability over time. The foreign OEM chose not to do so, instead sticking by the letter of the agreement, which allowed it to not source locally if it deemed quality insufficient. After eight years of wrangling, the Chinese partner thought it had been taken advantage of and forced the foreign OEM to exit.

On the human resources front, one important consideration is putting sufficient people into the alliance to ensure the critical mass necessary for alliance employees to learn effectively, and to systematically transfer local employees, particularly local executives, to develop their knowledge and skills. Many companies have learned the hard way that underinvesting in expatriates and relying on the local partner is counterproductive. In the short term, skills do not improve, leading to a weak organization and poor performance. This in turn makes it difficult to hire top-notch talent, perpetuating the skills gap. The parent becomes reluctant to throw good money after bad, making it ever more difficult to summon up the courage to send out yet another expensive expatriate. In our experience, this situation more than any other drives multinationals to leave China.

Negotiate from the top

Even with foresight and good planning there may be no alternative to a tough restructuring negotiation. In these situations, consider direct action from the top.

The best restructuring negotiations are prepared well in advance—even in the initial deal structuring. Negotiations in China are

protracted events, often lasting several years, not just to define the guidelines for cooperation but also to allow the parties to get to know one another. Given this opportunity, farsighted multinational companies clearly signal their intentions and prepare for likely restructuring by including equity put and call options in the joint venture contract to ensure management control and carefully define the joint venture's scope.

To illustrate, provisions can also be inserted into contracts that put pressure on a partner to agree to restructuring—for example, identifying early on events that require a unanimous resolution approving joint venture termination, if they occur.[2] Experienced negotiators insist that timeliness of negotiations is not critical but that avoiding major concessions is.

Planning ahead is particularly important in China as joint venture restructuring or divestiture is legally valid only with the consent of both partners and the original approval authority. The 1996 Foreign Invested Enterprise Liquidation Measures and other relevant regulations appear to indicate five circumstances where early joint venture termination is possible. They are failure to subscribe capital, divestiture by one party, bankruptcy, termination for cause,[3] and liquidation by unanimous board consent. In all cases, a unanimous board resolution is required.

If your partner does not agree with your restructuring proposal, reopening negotiations usually is best done at the partner-to-partner level. The same issues of partner selection and long-term strategy tackled in the initial negotiation need to be addressed. Venture managers may have an understanding of the issues, but they typically lack both internal and external credibility to make the tough decisions. Where the joint venture is clearly being looted by one partner, the other partner should not try to fight from inside but should appeal directly to government officials—typically the local mayor. If it's a large deal, appealing to the state council may be necessary. A final cautionary tale: one multinational relied on government goodwill and installed the former general manager of its Chinese partner as the joint venture CEO. As it happened, the general manager embezzled and transferred funds to the Chinese partner. After two years of fruitless discussions by local expatriate managers, the CEO of the multinational corporation appealed directly to the city government, which ousted the general manager within a month and agreed to the joint venture's restructuring.

Restructuring alliances in China is likely to be a significant trend. With adequate preparation, restructuring can be an effective tool for developing a sound business platform. Without it, the process is likely to be challenging and expensive. **MoF**

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[1] That is, which have been set up as companies as opposed to state-owned enterprises. This may or may not be coincident with an IPO or share sale.

[2] It must be noted, though, that the binding nature of these clauses is yet to be tested.

[3] That is, force majeure or breach of contract of a magnitude to prevent continuation of the business.

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