

COVER STORY

Win-Win?

Joint ventures may be on the verge of
a comeback

By **James Roy**

The pitfalls of the Sino-foreign joint venture in China are well documented. For many foreign business people in China, the phrase conjures up all manner of frightening images, from disregarded contracts and foot-dragging partners to stolen trademarks, embezzled funds and bitter lawsuits.

However, since more industries became open to 100 percent foreign ownership in the late 1990s, it has become an accepted truth for many that investing through a wholly foreign-owned entity, or WFOE (pronounced “woofie”), is preferable in any sector in which foreign direct investment (FDI) is not restricted. The numbers show a clear trend: Utilised FDI has declined steadily over the last 10 years – roughly since restrictions on many sectors were removed – while so-called “organic” investment through WFOEs has soared (see graphs).

There are many reasons why WFOEs are widely preferred. They generally take less time, effort and money to set up, and managing a relationship with a partner quickly complicates things, particularly when there are cultural differences between the two sides. Plus, if a business structured as a WFOE does fail, “you don’t need to worry about your partner suing you for negligence or bad faith,” says Richard Grams, a partner at the Guangzhou office of the law firm Stephenson Harwood & Lo.

It is unlikely that JVs will ever re-

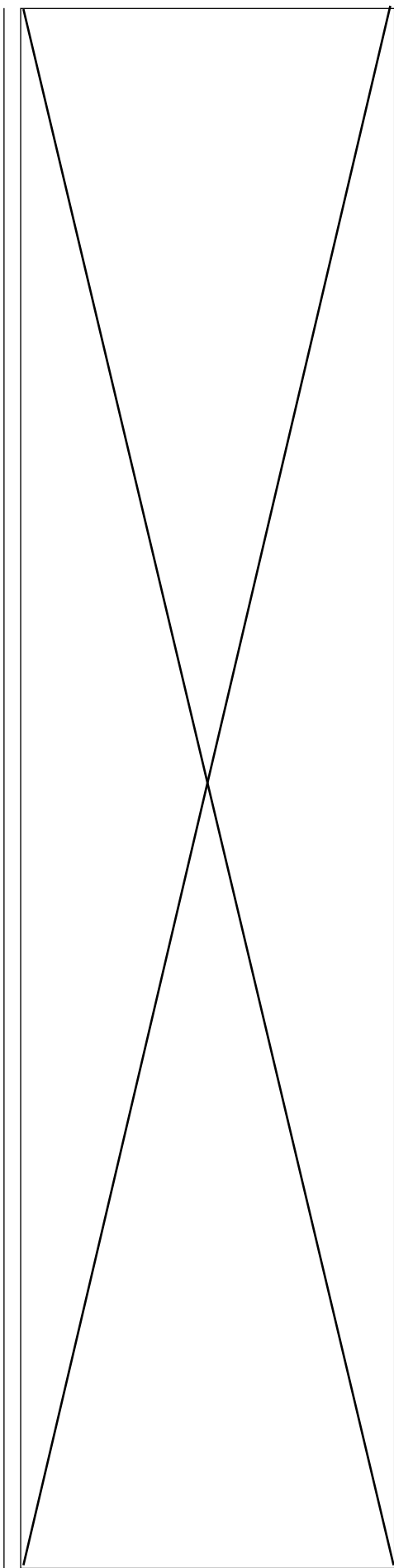
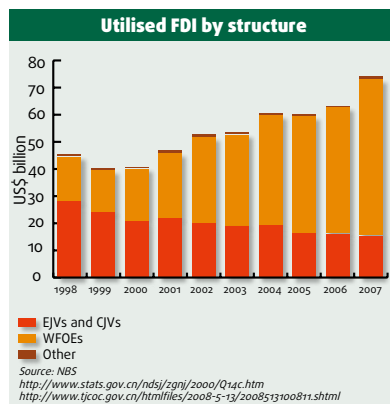
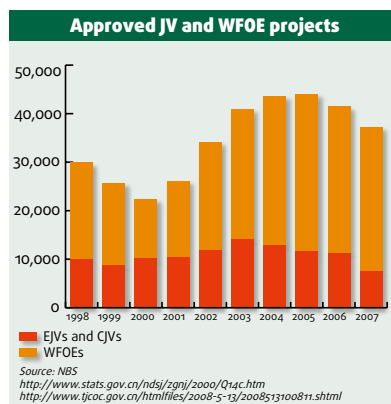
gain the prevalence they had in the 1990s. On the other hand, argues Jan Borgonjon, president of InterChina, a consulting firm based in Beijing, “they are becoming more interesting than they used to be.” Recent shifts in China’s investment environment are making the much-decried investment vehicle more necessary – and more attractive.

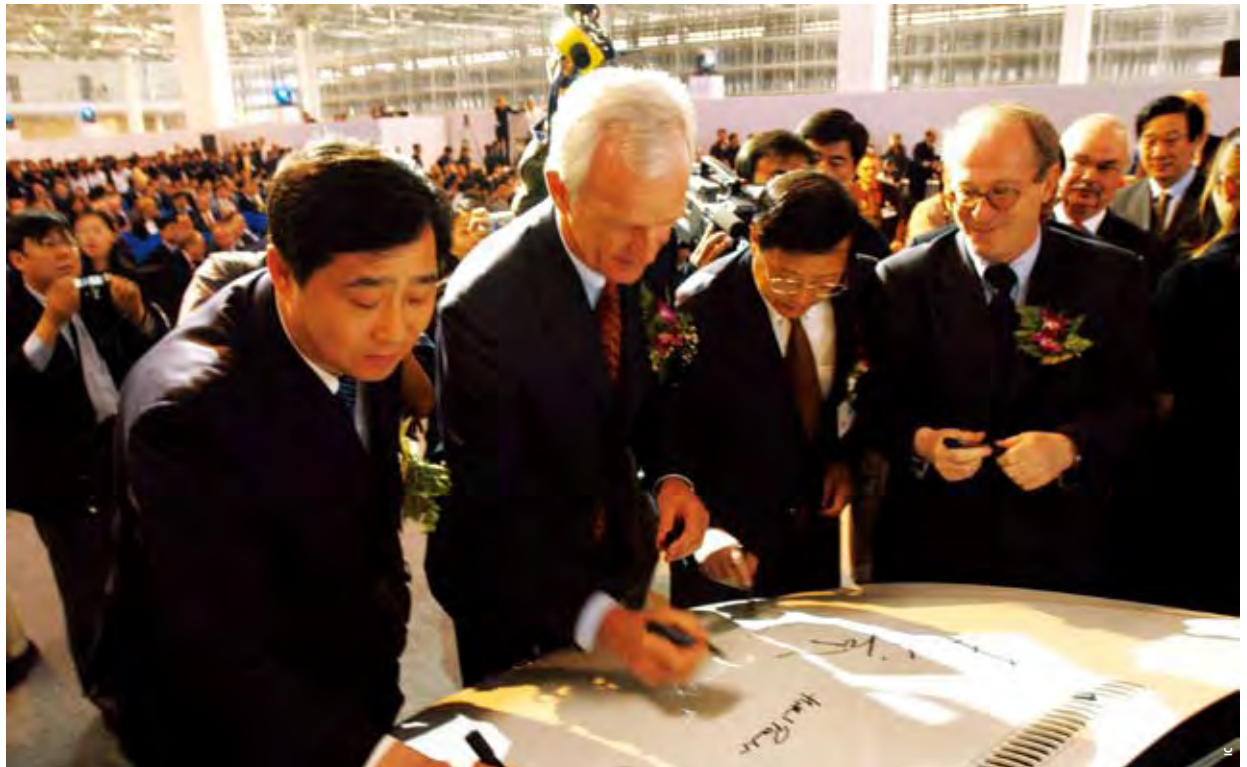
New dynamics

While legal and regulatory tightening has limited foreign participation to some extent (such as in the steel industry, where a new policy in 2005 barred 100 percent foreign-owned participation), the larger change has been political. Under the drive for a “harmonious society”, with government emphasis shifting from encouraging investment of any kind to promoting sustainable development and strong home-grown companies, foreign firms are finding it harder to set up on their own in some industries, such as chemicals and petrochemicals, says Borgonjon. “The government is less willing to provide foreign companies with advantages than in the past.” In these areas, joint ventures have become a necessity.

Foreign companies’ priorities have shifted as well, with more and more firms turning their attention from exports to China’s own market. Accordingly, local knowledge and access to distribution networks have become more important to them.

A number of domestic firms have developed into efficient com- ➤➤





Strategic sectors like the automotive industry are limited to joint venture participation from foreign firms

“The government is less willing to provide foreign companies with advantages than in the past”

petitors, with strong market position, good organisation and low cost structures. “That wasn’t the case 10 years ago,” says Borgonjon. “Before, they were just big.” Now, they are looking more attractive as potential partners.

However, “it’s not as clear if the Chinese side is as interested in joint ventures as it used to be,” Borgonjon says. Unlike their forebears, many of which entered into JVs for cash and political favour, many Chinese businesses – especially privately owned ones – are focused on growing, and have clearer ideas of what they would want from a foreign partner. In many cases, they may want things – sensitive technology, management and business-process know-how and, increasingly, access to overseas markets – that a foreign firm might not be willing to give them. “It must be a win-win situation, which is often not that easy to find.”

Late to the game

In non-restricted industries, the joint venture can be a useful tool in a

number of ways. Some foreign firms may wish to extend their products into areas traditionally dominated by domestic companies in order to remain competitive. Borgonjon cites the example of a company selling high-end food products at supermarkets in China looking to branch into lower price segments and sell its goods in smaller shops. “That’s a very Chinese area,” he says, adding that a company run according to foreign practices would not be able to operate with the same flexibility as a Chinese firm already entrenched in the sector. The company’s solution was to partner with a local firm that had not only the right network but also the low cost structure to operate in that segment. “It might be either that or nothing.”

Companies that are new to China and want to catch up to their competitors already in the market don’t have time to build their sales and distribution channels from scratch, says Grams. “If you’re in wholesaling and retail in China, it could take years and millions and millions of >>>

“Bad marriages are bad. Good marriages are fine. Good JVs ... they can be great”

➤➤ US dollars to set up your own distribution outlets. And from one part of China to the other there are totally different business considerations, as well as legal and regulatory requirements, that will apply.”

A WFOE could accomplish the same thing without the fuss of a joint venture simply by poaching key people who are already plugged in to a network, contends Tim Lamb, director of FDI services at the JLJ Group, a consultancy in Shanghai. “Networks depend mainly on relationships. Those can often be recruited.”

Lamb cautions that joint ventures are not for rank beginners. “It’s a myth that establishing a joint venture is an easy way of entering the market. JVs take longer, and require more China savvy on the foreign investor’s part, than WFOEs do.”

Kent Kedl, general manager of Technomic Asia, a Shanghai-based consulting firm, is more sanguine about joint ventures. He likens the avoid-unless-absolutely-necessary view of JVs to concluding that marriage is bad because the divorce rate is high. “Bad marriages are bad. Good marriages are fine. Good JVs – where you have a well-thought-out strategy, a well-negotiated arrangement and both sides are going in with eyes wide open – they can be great.”

For more established companies that are making second- and third-stage investments in China, joint ventures are a possible way to structure an acquisition. A firm that already has a WFOE in China and wants to become more vertically integrated on the mainland, for example, may want to eventually buy out its Chinese sup-



Getting control of the company chop means having control over the company’s pursestrings

pliers through a contractual joint venture, or CJV. Using this structure, as opposed to the more rigid equity joint venture (EJV) or a WFOE, allows the acquiring company greater choice, as it can carve out which assets of the target company it will eventually buy.

Grams estimates that about 80-90 percent of his clients in joint ventures have this type of eventual exit strategy in mind. "This is a typical rationale for using a JV structure in China, especially when investing in a restricted industry."

Keeping control

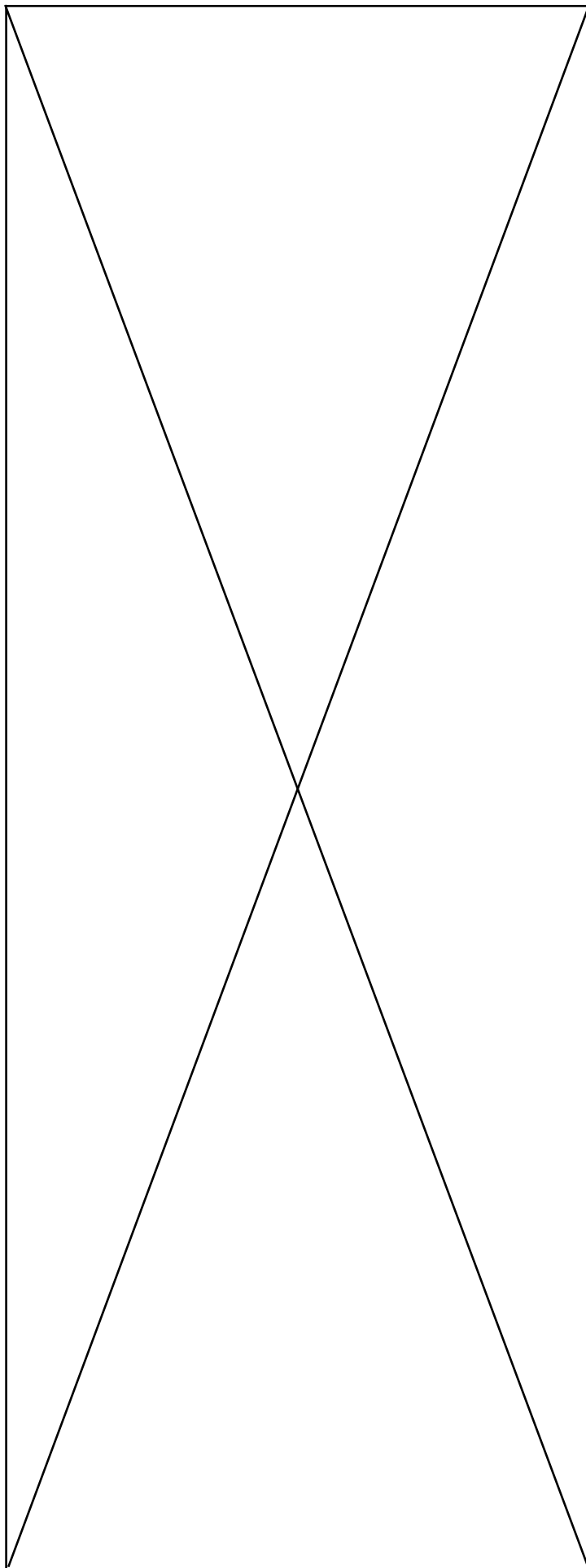
Despite its usefulness, there is a fundamental element of risk in any joint venture, and there are plenty of opportunities for mistakes. Careful planning, constant communication and follow-through after the contract is signed are essential to making sure the new company runs as intended.

Companies should first get independent market research as they conduct their partner search in order to get an objective view of the market, rather than relying on prospective partners for information. When narrowing down their list, they should have a clear idea of what contributions the targets can make, and whether they fit with their strategic needs in the market.

Once a company chooses a partner for the JV, it should take its time to conduct thorough due diligence. Checks on the target company's financial and legal history are important steps in the process, particularly as many Chinese firms keep multiple sets of accounting books. Commercial due diligence – ensuring that the company can do what it says it can – is crucial but often overlooked in China, says Kedl.

The negotiation stage of a joint venture "can have all the high theatre of opera and the tension of a tightly fought boxing match," says Grams. Many aspects of the company, including the level of ownership and the power to appoint officers and directors, can be used as bargaining chips. While there are differing views on the value of some positions, it is generally considered most important to secure the power to appoint and remove the JV's representative and general manager as well as control over the company chop. "The things my clients want most control over are the JV's ability to spend and its ability to carry out its primary business function," says Grams. Many agree that the power to appoint the chairman of the joint venture is a good concession to give the partner.

Just as important as the contract itself – though often neglected – are the articles of association, which lay out arrangements for liquidating the company and resolving disputes. "It rankles me to see articles with little thought put into them," says Grams. "Foreign companies should be more careful, so they can ensure that any difficulties get managed according to a properly thought-out framework. Often they're not – they're vague and devoid of meaning. ➤➤



➤➤ ful instruction. It's a missed opportunity to avoid problems in the first place, and solve them in a cost- and time-effective way."

Throughout the entire process, Kedl stresses the importance of "cultivating the relationship" with a JV partner. Though many Western dealmakers tend to stress the financial aspects of a venture over all else, Chinese JV partners tend to place higher value on building a relationship based on trust. Taking an impersonal, strictly-business approach can create bad blood and cause permanent damage to the relationship.

Once the JV is underway, headquarters must maintain communications and keep appropriate oversight to make sure proper practices are upheld. "You see a lot of orphaned GMs and staff that have been parachuted in to Kunshan, or Suzhou, who over time lose touch with people at the home office," says Grams. "A lot of



Joint ventures with domestic "national champions" are encouraged

them become disgruntled, and productivity then drops." In worse cases, he has seen control over finance and procurement departments slip, opening the door to massive fraud – though this does not just apply to JVs.

Regular visits to check compliance and ensure the factory is operating to standard can help avoid. An even

better option is for headquarters to have more people in China permanently, says Grams. "It's a more expensive option, but the more people you have in China who are executive grade and understand the local environment the greater chance there is of making the most of business opportunities here."

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