McKinsey&Company

DECEMBER 2010

McKinsey Quarterly

CORPORATE FINANCE PRACTICE

Past lessons for China's new joint ventures

As multinationals revive interest in collaborating with Chinese partners, the lessons of past ventures bear remembering.

Stephan Bosshart, Thomas Luedi, and Emma Wang

It's been ten years since multinationals first began turning away from joint ventures in China as the preferred way to take part in the world's hottest growth story. Many joint ventures failed to endure, and as multinationals gained experience in China, and foreign investment restrictions loosened, multinationals found it easier in many sectors to start a business from scratch—or to acquire an existing one outright—than to negotiate, establish, and manage a joint venture in the long term.

No longer. China's hot growth has boosted valuations and increased competition for outright acquisitions of Chinese companies that are often less interested in being acquired. That makes joint ventures a more appealing option, and so does a growing pool of healthier prospective Chinese partners. All this is prompting some multinationals to reconsider the joint-venture approach as an alternate avenue for getting a stake in the continuing strength of China's economy.

But while the dynamics have changed, the fundamentals have not: companies pursuing joint ventures would do well to reflect on the lessons of past deals to improve the chances of success. In China, some of those lessons are especially critical, such as choosing partners that can make tangible business contributions, safeguarding intellectual property, ensuring operational control of the joint venture, and managing talent. Others are critical for joint ventures in all geographies, such as aligning strategic priorities, creating a structure that permits rapid responses to change, and preparing up front for eventual restructuring.

Choosing better partners

When China first opened its doors to multinationals, in the 1980s, some multinational corporations undertook joint ventures with local companies that appeared to be safe bets because of their access to and influence with the local or national government. Even today, many foreign executives prefer to engage with large, well-established Chinese partners.

Yet that preference hasn't benefited joint ventures, typically because the parent companies didn't share the same strategic or commercial interests. Multinationals, for example, have emphasized profitability, even when growth is slow, while their Chinese partners have emphasized growth, even without profitability. The result has been different priorities for investments and a lack of cooperation, both between the parent companies and within the mixed management team.

Instead, multinationals should pair with local companies that explicitly share their strategic goals. This doesn't eliminate large, well-established Chinese companies. But it does open the door to faster-growing, privately owned, and smaller companies that bring a strong commercial mind-set and tangible business assets to joint ventures. The global pharmaceutical corporations GlaxoSmithKline and Novartis, for example, chose such partners in 2009 for their joint ventures in the vaccine market. Thanks to partnerships with smaller local companies—Shenzhen Neptunus Interlong Bio-Technique Company and Zhejiang Tianyuan Bio-Pharmaceutical, respectively—both joint ventures had the access they needed to government vaccine-procurement programs, as well as a talent pool, R&D know-how, and an entrepreneurial management mind-set for further rapid growth.

One drawback that foreign companies may not have encountered in China before: as Chinese executives grow increasingly confident, many of these smaller players themselves hope to become national, regional, or even global players. That aspiration can make it difficult to agree on the scope of the partnership if it's to be limited to China or to specific products. One approach is to outline the extent of cooperation both domestically and globally—for instance, whether it includes access to overseas sales channels, noncompete clauses for specific markets, and agreement in principle on the potential evolution of the partnership into additional product lines.

Safeguarding intellectual property

Multinational companies still struggle to protect their intellectual property in China, and joint ventures are particularly vulnerable. Protection in most developed markets occurs primarily through legally binding agreements enforced in courts of law. But the concept of intellectual-property protection is still new in China, and recourse to the legal system can be lengthy and inadequate. Companies have had some success with more pragmatic, operational efforts, including the following:

- Bringing only older technology to China. This approach works for products that may have been available in developed markets for some time but are still competitive in China's market. It also works in industries—such as bacteria streams for fermentation, vaccines, and certain motor engines—where innovation cycles are short.

- Leaving the blueprints at home. Multinationals can protect their intellectual property by delivering equipment or technology ready to be installed, without detailed design specifications. Negotiating agreements to do so can signal a lack of trust in the local partners, however, and can increase costs if spare parts and maintenance must be provided from overseas.

- Keeping critical intellectual property completely out of a joint venture. Some companies have set up joint ventures that are restricted to those steps in the value chain that involve limited intellectual property, like assembling, packaging, or tailoring. Such an approach is feasible only when local innovation lags behind global standards and, obviously, when the critical intellectual-property component can easily be separated into a step of the value chain.

- Charging for intellectual property up front. Some multinationals have chosen to sell their intellectual property to joint ventures, either through up-front cash payments or licensing fees. This approach can be challenging to execute, for while it resonates well with local companies, they generally are willing to pay for technology up front only at a significant discount.

Taking charge

In the past, foreign companies agreed to invest in joint ventures as minority or equal stakeholders, often failing to secure management positions that were meaningful enough to guide the development of the joint entity. Such companies often found themselves relegated to providing know-how and capital, with little influence other than board voting rights. In one extreme case, a global multinational had set up multiple joint ventures with leading national players in China. The company was unable to exercise sufficient operational control over, for example, decisions around roll-out plans or product development. Ultimately, it had to sell off its stakes in these ventures.

The ability to influence the course of a joint venture depends largely on the partners' ability to build trust-based relationships at the working level, the joint-venture board level, and even outside the joint venture, with the government or other industry players. Successful multinationals map out critical stakeholders in and around the joint venture (from local management to central regulatory bodies) and assign relationship responsibilities at multiple levels of the organization.

This approach requires developing interaction protocols—the composition of any delegation, the number of visits, the specific topics to be discussed, and so on, depending on the relative importance of the stakeholders and their specific agendas. The CEO of a leading global insurer, for example, often teaches management practices at the Central Party School. His willingness to do so gives him credibility with joint-venture partners by allowing him to interact with current and future decision makers who directly and indirectly influence the course of business in China.

Managing talent

Most leading multinationals learned from the first round of joint ventures in China that getting the right managers in place was critical. Many of these companies had simply dispatched available executives—often not top performers but rather average executives searching for new challenges. Most of these executives therefore had limited credibility with the corporate parent and were ill-prepared to manage demanding joint-venture partners. Today, experienced multinationals recognize that a successful joint venture requires credible, high-performing executives supported by strong local teams.

Yet with so many companies competing for the best local candidates, those men and women can afford to be choosy, and they understandably prefer leading companies that have a strong image and offer good prospects for career progression. So today, joint ventures must not only invest in their corporate brands but also partner with top universities to sponsor undergraduate and graduate students and to establish a training platform for current employees. CEIBS, a leading business school in China (and itself a joint venture), has more than 80 corporate sponsors, which provide funding and in return can recruit on campus and send their executives on advanced training courses.

Finally, companies must continue their commitment even after candidates are hired. In our observation, this means sending some of a multinational's best people to the joint venture to create a strong team, compensating employees at or above relevant market rates, and fast-tracking the advancement of high performers—even breaking away from more tenure-based advancement systems.[1]

Aligning priorities

Regardless of where a joint venture is located, companies spend too little time building a shared understanding of its future business, the markets it will compete in, and how it will evolve over time. Differences of opinion that are deeply rooted in competing expectations of future performance can affect the joint venture's strategy and focus and eventually lead to its failure.

Take, for example, four life insurance joint ventures that failed in China over the past 12 months, after an average of four to five years of unsatisfactory business development and shareholder disputes. Chinese life insurance partners have been nonfinancial companies accustomed to short breakeven periods of three years or less, with an emphasis on top-line growth and profits. Foreign insurers, on the other hand, take a longer-term view and emphasize sustainable growth in the value of the insurance policies underwritten rather than accounting profits. In the four failed joint ventures, the inevitable tension over strategic priorities led to disagreements about, for example, the right channels for pursuing lower-profitability volume or whether to scale up an agency workforce more quickly, but with a lower level of skills, or more deliberately, with a higher-quality workforce.

These failures might have been avoided if the CEOs of the parent companies and the joint ventures' future management teams had spent time collectively developing business plans and preparing for changes in market dynamics. In contrast, at one of the three most successful foreign life insurers in China, a standing business-development group and a part of the future management team went through multiple iterations with its joint-venture partner to agree on key business priorities, such as volume versus value, channels, products, and target customer segments.

Responding to change

Once a joint venture is up and running, multinationals should aspire to manage it as if it were their own, putting in place short lines of reporting from the joint venture back to the

[1] See Jeff Galvin, Jimmy Hexter, and Martin Hirt, "Building a second home in China," mckinseyquarterly.com, June 2010.

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parent company. This move is important in any joint venture, to give senior managers the timely information they need to assess its performance. But it’s especially true in China, where the fast pace in many sectors requires both partners to react quickly to changes in the marketplace or the regulatory environment.

In this respect, multinationals can be at a disadvantage. Decision-making processes for Chinese parent companies might include more people, but once decisions are made, managers execute them quickly. In contrast, foreign companies are slower to react, often encumbered by layers of country and regional management. It is not uncommon for the foreign executives of a joint venture to report back to the multinational’s China head, who reports to the head of the international unit, who then eventually reports back to the CEO.

Some of the more successful multinationals we’ve observed provide for direct reporting lines to their CEOs. Others have assigned responsibility for China to a member of their management boards, sometimes with a dual-reporting line into the regional organization. When a European transportation company made China its second home market, for example, it elevated its China president to the global management board and sent its global CEO to China at least six times a year to meet with the joint-venture partners. The result was improved cooperation with regulators and therefore faster approvals, more frequent interactions and deeper relationships between the senior management of the parent companies, and closer alignment within the joint ventures’ mixed management teams.

Preparing for breakup

Even in developed markets, joint ventures are often restructured within a decade of being set up. But in a market as dynamic as China’s, partnership terms negotiated today might be ineffective in a few years, and even strong partners may struggle to survive. This dynamism and uncertainty mean that the partners in a joint venture must include provisions for restructuring its contract if the competitive landscape changes. HSBC, for example, in its credit card partnership with China’s Bank of Communications, agreed to very specific steps if a change in regulation made it possible to convert the partnership into an independent credit card company. These detailed steps included the resulting board structure and the consideration to be paid to the partners.

Lacking such provisions, some multinationals have had to enter into tough negotiations with their Chinese partners to reach agreement on exit conditions. Others have languished in joint ventures that continued as formal partnerships while either partner pursued other avenues for growth.

Stephan Bosshart is an associate principal in McKinsey’s Shanghai office, where **Thomas Luedi** is a partner; **Emma Wang** is a consultant in the Hong Kong office.