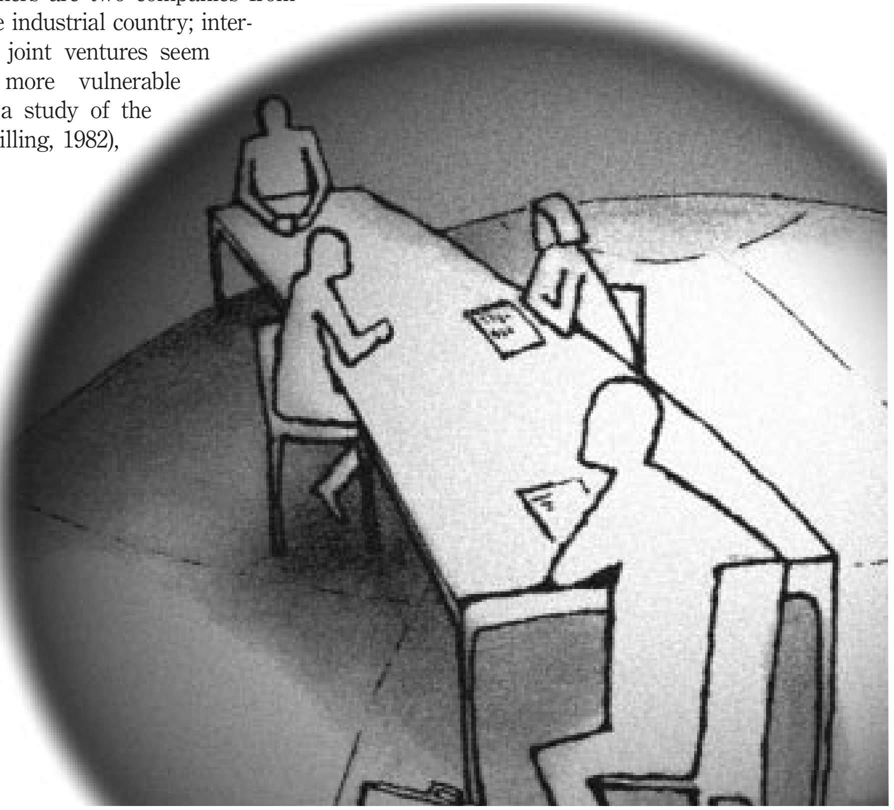
International Joint Ventures in Developing Countries

ROBERT MILLER, JACK GLEN, FRED JASPERSEN, AND YANNIS KARMOKOLIAS

International joint ventures offer attractive opportunities, yet they frequently perform unsatisfactorily. Why do they run into trouble, and what can partners and managers do to maximize the chances of success?

JOINT ventures between domestic companies in developing countries and foreign companies have become a popular means for both managements to satisfy their objectives. They offer, at least in principle, an opportunity for each partner to benefit significantly from the comparative advantages of the other. Local partners bring knowledge of the domestic market; familiarity with government bureaucracies and regulations; understanding of local labor markets; and, possibly, existing manufacturing facilities. Foreign partners can offer advanced process and product technologies, management know-how, and access to export markets. For either side, the possibility of joining with another company in the new venture lowers capital requirements relative to going it alone.

As attractive as joint ventures might seem, however, they frequently perform unsatisfactorily and are comparatively unstable. This seems to be true even when the partners are two companies from the same industrial country; international joint ventures seem to be more vulnerable still. In a study of the latter (Killing, 1982), for example, 36 percent were rated by participants as having performed poorly—a high proportion indeed. An obvious set of questions therefore arises: If international joint ventures are established to exploit the



Robert Miller,
a US national, is a Consultant to the International Finance Corporation's Economics Department.

Jack Glen,
a US national, is a Principal Economist in the International Finance Corporation's Economics Department.

Fred Jaspersen,
a US national, is Lead Economist in the International Finance Corporation's Economics Department.

Yannis Karmokolias,
a Greek national, is a Senior Economist in the International Finance Corporation's Economics Department.

complementary features of each partner, why are the partners frequently disappointed with their joint performance? What problems cause them to be unstable? Can these problems be alleviated to improve these ventures' prospects for success? On behalf of the International Finance Corporation (IFC), we surveyed joint ventures between domestic companies in developing countries and foreign companies based in industrial countries to try to understand the difficulties that arise in negotiations leading up to a joint venture agreement and those that arise during the venture's implementation and operation. About 75 joint ventures in 6 countries were included in the study.

Negotiating agreements

The managers we contacted expressed mixed feelings about the formal joint venture agreement, with some managers viewing it as a critical element in defining the longer-term relationship and others discounting its significance. The latter group tended to stress that no agreement can work without the good will and dedication of both partners, a point that may be true but that does not diminish the importance of a well-crafted working agreement. The former group, which included the vast majority of managers contacted, believed the agreement to be an essential building block in structuring the joint venture. On the one hand, an indication of the seriousness managers attached to such agreements was that nearly 85 percent of the agreements required at least 6 months, and about 20 percent took more than 18 months, to negotiate. On the other hand, the survey found no relationship between the length of time required to complete an agreement and the partners' ultimate satisfaction with the venture's operation.

Two issues were clearly more important in joint venture negotiations (see table). First was the equity structure (noted by four-fifths of respondents), which was also viewed as the most difficult issue to negotiate. Control of a joint venture is not something surrendered easily, although, as noted below, majority ownership does not necessarily confer control of all aspects of a joint venture's operations. Second was the set of conditions for technology transfer, almost always from the industrial country partner. Important aspects include defining precisely what technologies (possibly including technologies not yet developed by either side) are to be covered in the agreement and the terms under which they are to be made available to the venture.

Importance and difficulty of negotiating points in joint venture agreements
(percentage of respondents noting category)

	Important	Difficult
Equity structure	80	33
Technology transfer	78	26
Marketing issues	45	28
Staffing issues	44	26
Dividend policy	42	21

Source: Robert Miller, Jack Glen, Fred Jaspersen, and Yannis Karmokolias, 1996, *International Joint Ventures in Developing Countries*, IFC Discussion Paper No. 29 (Washington: World Bank).

Both sides are aware that payments for technology are an important means of transferring benefits from the venture and of indirectly maintaining control, which inevitably leads to prolonged discussion of technology transfer. Technology providers are interested in protecting their intellectual property and, therefore, want to set limits on where and how the technology can be used by the joint venture and to place restrictions on who controls derivative technologies, no matter where developed. The developing country partners hope to set bounds on the royalties and fees they will have to pay providers, especially as the technology becomes older, and to broaden the joint venture's control over its use.

There are other problems that frequently arise during negotiations:

Valuation problems. Each partner brings financial and other assets to the joint venture, and it is often not easy to determine what these assets are worth. One side may bring a going business, which may not have equity shares traded on a secondary market. Or technology may already be incorporated into a product that is to be produced and sold by the venture. What are such assets worth? Such problems are among the most difficult to sort through in negotiations.

Transparency. Getting accurate data upon which to base valuations and other decisions can be very difficult in some countries, especially where accounting standards are quite different from international standards. Transparency is a particular problem in former command economies, where, until recently, there have been no real markets for outputs, supplies, or financial instruments.

Conflict resolution. Many joint venture agreements spell out how disputes between partners are to be resolved. These provisions are important, since disputes are virtually inevitable in a relationship as complex and dynamic as a joint venture. At the extreme, conflicts can lead to the desire of one partner or the other to dissolve the enterprise, so provisions detailing procedures to be followed in the event of a dissolution are obviously necessary.

Division of management responsibility and degree of management independence. There is some evidence that protection of a joint venture's management from parent company interference is an important determinant of the venture's success. Attempts by parent companies to micromanage an enterprise that may be thousands of miles away are doomed to failure. A better strategy is for them to set up clear operational parameters and then let the venture's management succeed or fail on its own.

Changes in ownership shares. How should the ownership structure be changed as a joint venture matures? Although most partners agree that they should address this issue early on, rather than waiting for a crisis to occur, it remains a sensitive one. Developing country partners, especially, can be leery of such provisions, which they see as potential death warrants—that is, as vehicles that industrial country partners may, for one reason or another, use to take full control.

Dividend policy and other financial matters. Dividend policy goes to the heart of why companies enter into joint ventures, with some companies hoping to expand and gain market share rapidly while others are striving to achieve quick increases in cash flows that they can use to support other operations. Potential conflicts between these differing objectives are best handled when the joint venture agreement is being negotiated.

Marketing and staffing issues. Because marketing is so critical to the joint venture's success, it should not be surprising that it can be a difficult matter to negotiate. From the viewpoint of the local partner's management, maintaining control over distribution channels and marketing is one way in which its continuing contribution to the joint venture can be assured. Such a view, however, may conflict with the plans of the multinational company (MNC) partner, which may see the joint venture as only part of a larger strategy to enter the developing country market. Similarly, insistence by the MNC partner on control of key positions in the joint venture may be seen by the local partner, first, as overly expensive and, second, as an effort to marginalize it.

Box 1

How joint ventures can adjust:

Manufacturing consumer electronics products in India

One joint venture included in our study had brought together Indian and US partners to manufacture a consumer electronics product. The joint venture was established with a clear division of responsibilities, and, at the beginning, its target market was India. Since the Indian partner had existing complementary products, it was agreed that this company would be responsible for marketing and distribution channel development, while the US side would supply product and process technologies. The joint venture has been enormously successful, manufacturing high-quality products throughout the country. Now the question of exporting these products has arisen. The agreement specifies that exporting must be done through the US partner—a multinational company that distributes similar products, manufactured in plants in a variety of countries, through its worldwide network. The difficult question now arising is how the Indian joint venture's products can best be exported through the US company's existing distribution structure.

This evolving problem is one that has been confronted by countless other joint ventures, and, judging from their accumulated experience, the solution is likely to be an incremental one. First, exports will probably be shipped, through the US parent, to regions not now covered by its distribution network. If that works out, then the joint venture could be asked to supply products ancillary to the US firm's main product lines—line fillers, so to speak—that would be distributed through its normal channels of distribution. As the joint venture's volume increases and the quality of its output improves, its costs could come down to those of other, now much larger, manufacturing plants in the MNC partner's system. At that point, a decision would need to be made as to whether to include the joint venture as part of the US company's global sourcing network.

Operational problems

Once joint ventures are in operation, they may experience various problems, some of which might have been foreseeable at the time the agreement was negotiated, others of which could not.

Problems related to multinationality. Many joint ventures undertaken in developing countries involve large MNCs that participate in a variety of other joint ventures and run wholly owned subsidiaries elsewhere in the world. The developing country firms that are their joint venture partners, though they may be quite large by local standards, are often dwarfed by their MNC partners. One possible source of difficulty, for example, is the differing basic objectives of the two types of firms. An MNC may hope the joint venture will operate in a way that will be optimal from the standpoint of its entire global network, not merely within the local market on which their domestic joint venture partner usually focuses. These differing objectives can lead to a variety of disagreements, including the following:

• *Export rights*. Typically, the MNC would prefer not to allow the joint venture to export products, which may be of inferior quality (compared with those it manufactures elsewhere), into markets already served by other manufacturing points in its own system. It therefore favors insertion of strict export limitations into the agreement in such situations. The developing country partner, however, often has quite different ideas, looking to the venture as a natural vehicle for expanding into foreign markets. In most of the agreements we examined, exports were restricted in one way or another (see Boxes 1 and 2).

• *Tax issues.* An MNC generally wishes to minimize its worldwide tax burden. This objective can dramatically affect its relations with a joint venture, especially when the latter either imports parts and components from the MNC or, as is usual, exports products through the MNC parent. The MNC may manipulate transfer prices—that is, the prices charged by one part of the MNC when transferring them to another part—to lower its taxes, a strategy that is not necessarily in the interests of the local partner—a problem frequently mentioned by local partners in our interviews with them.

• *Dividend and investment policies*. The MNC partner may have global investment programs that involve transferring of funds from one region to another. It might, therefore, prefer to receive dividends from the joint venture instead of reinvesting earnings, a position not necessarily compatible with that of its domestic partner. The opposite situation—in which the MNC partner is content to delay dividends in favor of faster expansion, and the local partner demurs—also occurs on occasion.

• *Differences in partner size.* The local partner is likely to be considerably smaller than the MNC partner, a difference that can have important consequences for operating the joint venture. MNC managers note, for example, that early, rapid expansion of the venture can require substantial capital infusions that the developing country partner may not be able to provide. It is also true, however, that the joint venture may be far more important to the smaller partner than to the MNC partner; several managers we spoke with noted that the joint ventures they were involved in seemed to be unimportant to the MNC and to have received too little of its attention. The MNC might assign managers to the venture on a rotating basis, allowing too little time for them to become truly effective there.

Ownership and control problems. One problem that frequently arises in the management of joint ventures occurs when an owner's attitude changes. For example, the local partner might be a closely held family corporation in which the driving force behind formation of the venture has come from the family patriarch, often the founder of the company. Not infrequently, the partner's commitment to the venture changes materially when the patriarch is succeeded by other family members who may not share his original interest. Similar attitudinal shifts can occur in MNC partners when their management, or even their ownership, changes (see Box 2).

There may be other control problems:

• *Product line disputes*. The interests of the two partners diverge over time, with one desiring to extend the current product line while the other demurs.

• *Material and component sourcing*. Local, and possibly cheaper, sources of components can emerge, but the MNC partner, which has been supplying them, remains adamant about continuing the supply relationship unchanged.

• *Technology utilization*. The MNC partner withholds some technologies, to the perceived detriment of the joint venture. Or new technology extensions developed within the venture are prevented from being used more widely by the MNC partner's management.

• *Cultural problems.* Joint venture managements often are drawn from different cultures, and misunderstandings can occur for that reason alone. MNC executives assigned to a joint venture can be seen by local nationals as "arrogant" or "narrow-minded" individuals who are not able or willing to comprehend the nuances of the culture where the venture's business is

Box 2

When joint venture partners disagree

The need for care in negotiating and, when necessary, renegotiating joint venture agreements can be illustrated by briefly describing cases from the International Finance Corporation (IFC) study in which serious disagreements arose between the partners. In one case, a large foreign company that had failed in an attempt to become established in India retreated by forming a joint venture with a local company with roughly comparable products. All worked smoothly until recently, when new management in the foreign partner called for a new strategy that would, once again, involve trying to establish the company on its own. The negotiated agreement between the joint venture partners prevents such an attempt, however, because it reserves to the joint venture any local product manufacturing and sales. No resolution to this dilemma had been found at the time of the IFC's study.

In a second case, a provision in the agreement setting up a joint venture in Turkey to manufacture automotive components called for all export sales to be made through the foreign partner, and this eventually became a constraint for the joint venture. The venture, which made products carrying the foreign company's well-known brand, originally made products for only the domestic market. As time went on, however, the venture's products became internationally competitive, both in quality and in price, and there was perhaps a natural inclination to take advantage of this competitiveness by beginning exports to Europe. Unfortunately, the foreign partner's headquarters and main factories were in Europe, and it had little interest in displacing its own production with Turkish-made items, despite what appeared to be clear cost advantages. Time may change the foreign partner's viewpoint and provide a stronger incentive for modification of the joint venture agreement, but in the meantime, the venture's ability to expand its sales beyond Turkey's borders will remain tightly circumscribed.

being done. For their part, MNC managers may dislike some business practices that they view as unacceptable and deeply embedded corruption that local nationals might see as quite normal. At the root of such problems is the fact that common events can be interpreted in different ways by individuals from different countries (or companies). This can be a particular problem in transition economies, where the economic and political system may persist in transmitting ambiguous signals to individuals on what behavior is expected of them.

Changing relationships. Joint ventures involve dynamic relationships, and it is almost impossible to foresee at the time of agreement just how underlying conditions might change. For example, learning takes place, and it can modify how one partner views the contributions of the other. A developing country partner often is seen at the outset as mainly contributing knowledge of local practices, and the perceived value of its contribution can decrease as the MNC partner learns more about the local setting.

Technological change also can lead to modifications in the partners' relationship. Unforeseen advancements in product or process technologies can obviate the original need for the joint venture from the perspective of one or the other partner. Or new technology might require the venture to adopt much more capital-intensive production methods in order to maintain competitive costs and quality. Such a change can necessitate new and large capital infusions that might be acceptable to one partner but not the other.

Obsolescing provisions of a joint venture agreement are another cause of disputes. Disputes occur in instances where excessive detail has been initially inserted into the agreement, and they are difficult to resolve once the conditions that motivated the provisions change. An example of a problem provision is one dictating that the MNC partner will purchase a fixed proportion of the joint venture's output, which may ultimately prove to be inappropriate for sale in the MNC's other markets. In general, too strong a drive for legalistic purity in spelling out the precise joint venture relationship in the partners' initial agreement creates rigidities that may require lengthy renegotiations later on.

Conclusions

Joint venture relationships are often fragile and both difficult to negotiate and, once negotiated, to hold together. Yet many do succeed and, indeed, thrive. Some of the lessons learned in this study are as follows:

- Although no joint venture agreement can serve as a substitute for the commitment of the partners, even deeply committed partners can expect to have conflicts. A suitable agreement, therefore, is a vital component of a successful relationship. Such an agreement does not have to be an overly legalistic document to provide the basis for overcoming these future conflicts in an orderly manner.
- The agreement is best considered as a "living" document, in the sense that among its provisions should be procedures for changing the agreement. Partners need to realize at the outset that their respective comparative advantages in the joint venture can change over time. Such ventures, after all, necessarily entail power relationships. Wise partners make sure that their companies are vital to the venture's success over the long run. It is not sufficient for firms to depend on their intimate knowledge of government affairs or familiarity with local financial markets if they wish to have continuing relevance to the joint venture, since the perceived value of these contributions is bound to erode over time; more substantive advantages—technology, distribution channel control, export control, etc.—will be required.
- Technology transfer is one of the more sensitive and difficult issues confronting joint venture managements. Although the relevant provisions of the venture agreement provisions are important in establishing an operational framework, technology is one area where formal provisions cannot serve as an adequate substitute for good will and understanding between the partners.
- Agreements need to contain fairly detailed provisions covering dispute resolution and, in the event of failure to reconcile differences, the exit mechanism to be employed in terminating the joint venture. Negotiation of such provisions should not be avoided because of an optimistic belief that good relations will be maintained over the life of the venture, since trying to resolve disputes in an ad hoc fashion can be highly problematic. F&D

This article is based on the authors' International Joint Ventures in Developing Countries, *IFC Discussion Paper No. 29 (Washington: World Bank, 1996).*

Reference:

J. Peter Killing, "How to Make a Global Joint Venture Work," Harvard Business Review, *Vol. 60 (May/June 1982), pp. 120–27.*