THE CHALLENGE FOR SUCCESSFUL JOINT VENTURE MANAGEMENT IN CHINA: LESSONS FROM A FAILED JOINT VENTURE

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Drawing on a Chinese management perspective, this article examines factors that contributed to the failure of Faith Oriental, a Hong Kong-Sino -Japanese joint venture (JV). The JV involved a quarry provided by the Chinese partner that was vertically integrated for 60% of its planned sales to the Japanese JV partner. The JV began operations in April 1996 with an investment of US$10 million. By December 1996 it was legally bankrupt. Factors contributing to the failure include the lack of attention given to: (1) the alignment of partner strategies; (2) unanticipated costs due to PRC government and foreign exchange events; and (3) weak management controls. The findings of this study have significant implications for Sino-U.S. joint venture management.

Since reforms were initiated in the People's Republic of China (PRC) in 1978, growth in foreign investment has been dynamic. Foreign investment in 1995 was $US38 billion (China Statistical Press 1996). International Joint ventures (IJVs) between overseas companies and domestic state-owned enterprises (SOEs) have been the dominant mode of entry. However, many JV investments have been less than successful. Much has been written about the problems faced by foreign companies who joint venture with SOEs in the PRC (Allen et al. 1995; Yan and Gray, 1994; Beamish and Wang, 1993; Child and Markoczy 1993; Child, 1994; Shan, 1991; Shenkar 1990; Eiteman 1990). A recently published report on Chinese JV performance (Andersen Consulting 1995) is consistent with the academic literature findings of mixed IJV success. They found that among surveyed companies, only 44% reported meeting profit targets. The report concluded that predominant problems included: (1) business vision and strategy; (2) strength of relationship with Chinese partner; (3) choosing the right partner; (4) cost controls; (5) human resources; (6) product quality; and (7) product pricing.

Given the mixed success of IJVs in China, the question arises as to what challenges are facing managers and what solutions are available for foreign investors who joint venture in China. This study directly addresses this issue through a detailed case analysis of the failure of a Hong Kong-PRC-Japanese IJV (hereafter, JV). In particular, we posit that one of the main challenges facing managers is the attention given to: (1) the alignment of partner strategies; (2) the competitive cost structure under various host PRC government and foreign exchange scenarios; and (3) the lack of management control over the internal operations of the JV. The study proceeds as follows. We first outline the case background, including the partners, their respective contributions and JV motives. This is followed by an analysis of the problems faced by the venture. Finally, solutions for more successful JV management are proposed. Figure 1 presents the framework for the case study, framed in terms of the main challenges and solutions for successful venture management.

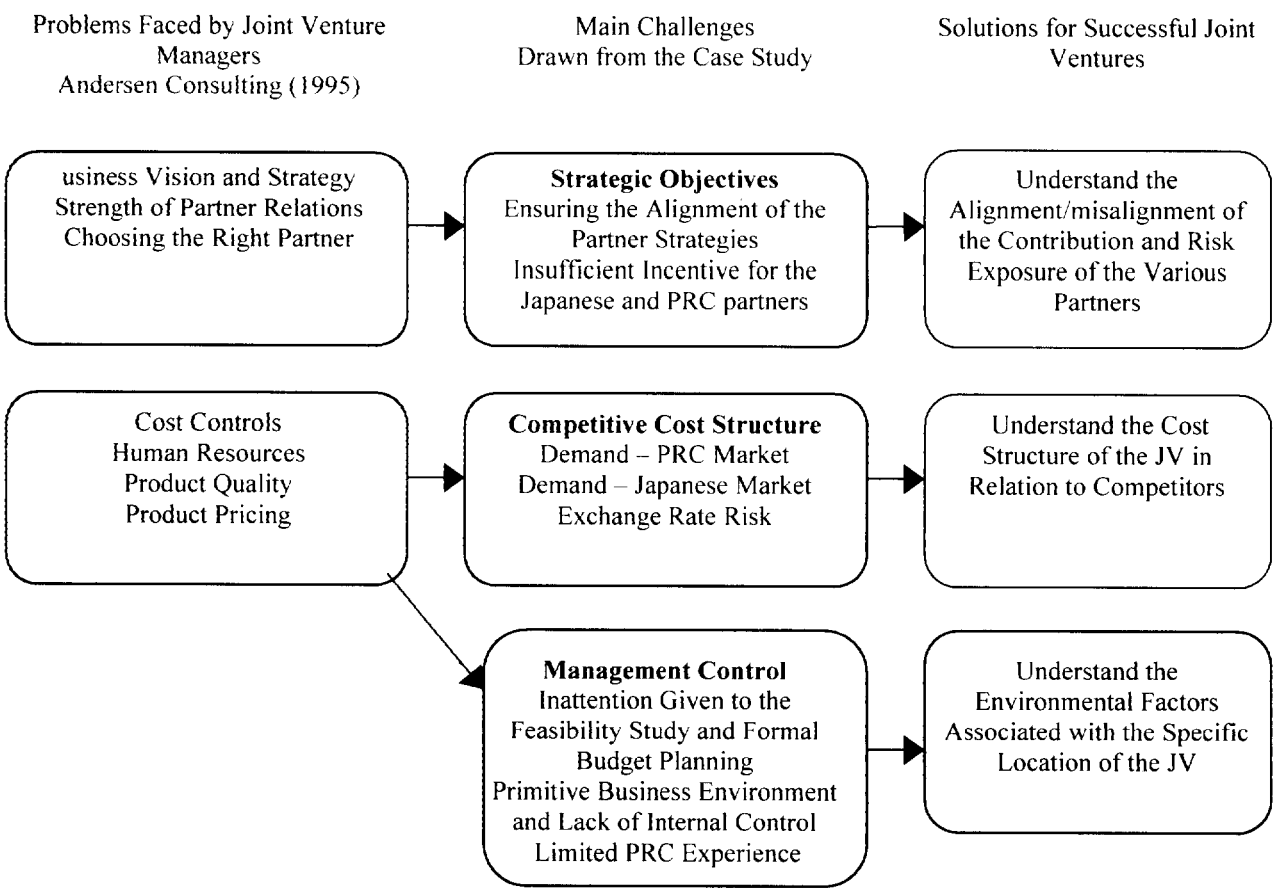
CASE BACKGROUND

Partners to the Joint Venture

Prosperity Ltd. was an experienced quarry extractor with existing quarry joint ventures in Guangdong. Building on its experience and connection with the Shanghai provincial office

of the State Administration for Industries and Commerce, Prosperity Ltd., in conjunction with two Japanese investors, set up ***Oriental Ltd.*** to extract high quality stone involving the use of heavy equipment in Shanghai. The shareholders of Oriental Ltd. comprised Prosperity Ltd. and two Japanese Companies, namely ***Tomiyama Construction Machinery Ltd*** ("Tomiyama") and ***Tagawa Crush Stone Ltd*** ("Tagawa") (see Figure 2). Under a separate shareholding agreement, Oriental Ltd. entered into a co-operative JV with a PRC company, named ***Tien Shan Ltd.*** The JV, estimated to have a 20-year life, was used to establish a quarry in an offshore island 18 kilometers from Shanghai. Annual production capacity was estimated at two million tons.

Figure 1. Framework for the Study



Strategic objectives of the Partners

Since the JV involved both the extraction of national resources in the PRC and vertical integration in subsequent distribution, both transactions costs (Buckley and Casson, 1988; Harrigan, 1988; Hennart, 1988) and bargaining power of the partners (Shan, 1991; Yan and Gray, 1994) were essential ingredients to the future success of the venture. The formation of the JV represented a guaranteed market for 60% of the output. Both the Hong Kong and Japanese partners viewed the venture in terms of a secure supply of crushed stone, while the Chinese partner, Tien Shan Ltd., viewed the venture as an opportunity to share in a stable return from the quarry operations and to ensure the employment of local Chinese (see Table 1).

Figure 2. Corporate Structure

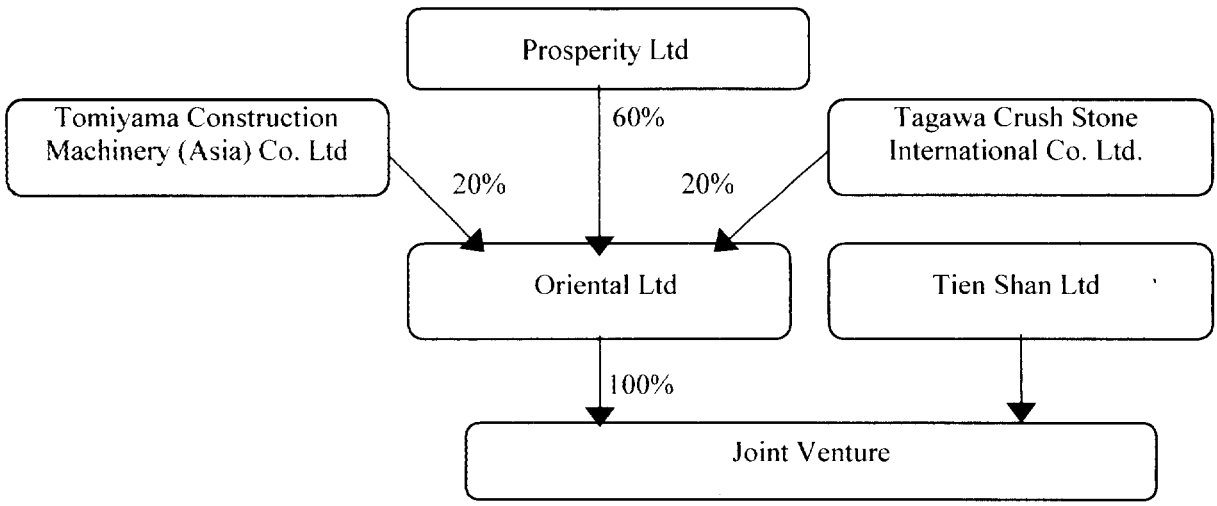


TABLE 1. Strategic Objectives and Contributions of Partners

Partner to the Joint Venture	Prosperity Ltd	Tomiyama Construction Machinery (Asia) Co Ltd	Tagawa Crush Stone International Co. Ltd.	Tien Shan Ltd
Core Business	Experience Quarry Extractor Operates a number of BOT ventures in the PRC	Vendor of Heavy Extraction Machines	Had Strong Sales Networks in Japan	Medium Size State Owned Enterprise
Origin	Hong Kong	Japan	Japan	PRC
Contribution	Major Financier Management and Control of Operations	Financed the Purchase of Machinery Used to Extract Stone.	Was Responsible for Marketing about 60% of the Output of the Quarry to Japan.	Provide Land use Rights for the Quarry
Strategic Aim	To Secure a Payback Term of 5 Years and Continue to Operate High Profits	To Secure Initial Inroads for the Sale of Heavy Machinery to the PRC Market	To Secure Source of Supply of Stone for the Japanese Market	To Share in a Stable Return from the Quarry Operations. To Ensure Employment of Local Chinese
Operating risk	High	Low	Low	Minimal Royalty Fee -Based on Production Units of the Sand Extracted.
Financial risk	High	Low	Low	Zero

Prosperity Ltd, a listed company incorporated in Hong Kong, engaged in a variety of activities, including civil and marine engineering, seawall construction, building and construction materials, trading of plant and machinery, and management of highways in the PRC. Aiming at consolidation and future expansion, it had started to re-organize the PRC investment division by recruiting high caliber management and technical staff. Prosperity's reasons for going into the JV were twofold. First, the company had a successful quarry operation in the PRC. Management thought that its current success could be transferred to the new quarry. Second, the company wanted to take further advantage of growing business opportunities in the PRC.

Tomiyama, the second partner, was a vendor of heavy extraction machines used to extract stone. It also financed the purchase of this machinery. The strategic objective of Tomiyama was to expand its distribution network of machinery in China. Investing in the JV provided a beachhead. The final partner, Tagawa, had a strong sales network in Japan. The strategic objective of Tagawa was to secure upstream supply channels for crushed stone for delivery through its distribution network in Japan.

Under PRC law, the rights to extract natural resources such as stones and rocks were not transferable to foreign investors. This effectively excluded the option of setting up a foreign wholly owned subsidiary, or acquiring an existing local corporation as a mode of entry. Under JV law, a minimum equity share of 25% is imposed on the foreign partner. The only solution for foreign investors, was to joint venture with a local Chinese corporation, in this case, Tien Shan Limited. The possession of the right to extract natural resources by the Chinese partner was embodied in the Business License granted by the State Administration for Industry and Commerce. This gave the Chinese partner significant bargaining leverage with minimal investment. In addition, if the quarry failed, the Chinese partner had little to loose relative to the substantial investments of its partners.

Contributions of the partners

Under the JV agreement, the foreign investor, Oriental Ltd was to contribute cash, heavy machinery and management expertise. Tien Shan Ltd would provide extraction and land rights. In the PRC, land is owned by the state, however this was not affected by the transfer of land use rights for "valuable consideration". Underground natural resources, mines and objects buried or hidden in the land did not form part of the transfer of land use rights. The land use rights for the JV in this case were concurrent with the terms or tenure of the JV, a period of 20 years.

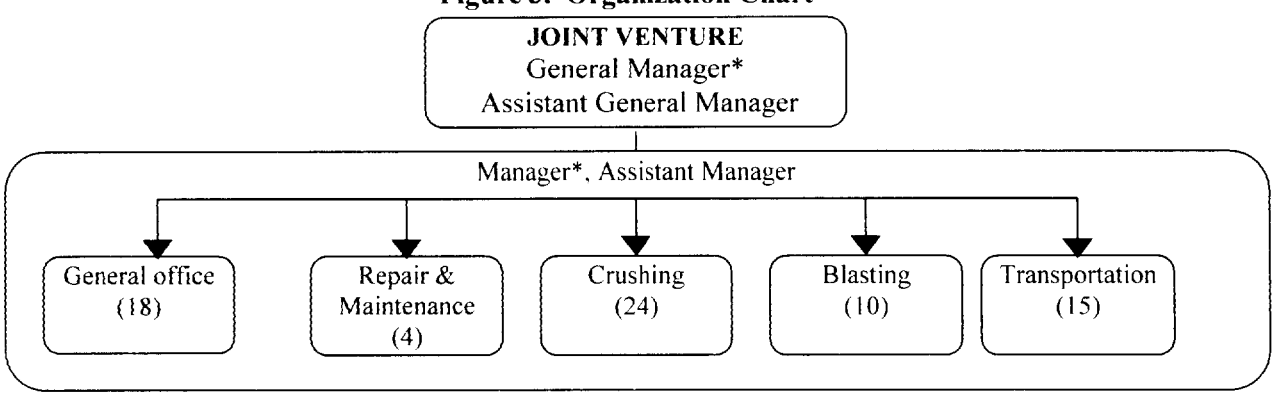
Normally, at the end of a contract period, all capital equipment would be taken back by Oriental, the foreign party. But that was not the case in this JV. The JV agreement provided that all capital equipment contributed by foreign party should be unconditionally taken back by the Chinese party. This reflected the intention and wish of the shareholders of Oriental Ltd for two reasons. First, the Chinese side intended to buy the equipment, but lacked the foreign currency to pay for the imported capital equipment. The Chinese party to the JV agreement did not intend to purchase the equipment in this case. Second, as the compensation trade was a form of disguised and prolonged sales arrangement, import duty and value added tax might be payable unless the PRC tax authority granted tax relief.

Management Structure

The main provision in the JV agreement and the articles for the co-operative JV provided that both partners be represented on the board of directors. Of the six directors, four were appointed by Oriental Ltd, while the remaining two were appointed by the Chinese. The Chinese directors in this case were not actively involved in monitoring the operations of the

venture. As Oriental controlled the JV operations, the financial statements of Oriental reported the JV as having 100% equity, despite the fact that the JV agreement and the Business License stated that there were two parties to the JV. In essence, Tien Shan was treated as a supplier rather than equity partner. Their role was to ensure that necessary procedures were followed leading to the granting of land use and extraction rights for the JV. The PRC partner would incur no operational risk. Instead, they requested a royalty fee based upon production units of sand extracted. Their motivation was not control, but only ensuring a stable return from the quarry operations. The foreign side retained overall control of the venture. The staffing of the JV included 65 PRC and 10 Hong Kong personnel. The general manager and manager were Hong Kong natives, while their respective deputies were PRC staff. Five of the Hong Kong staff were section heads (see Figure 3). Sections consisted of general office, repair and maintenance, crushing, blasting and transportation. All sections were located at the quarry site.

Figure 3. Organization Chart



*Hong Kong Staff (also the 5 section heads)

No. of Hong Kong Staff	10
No. of PRC Staff	65
Total	75

ANALYSIS OF JOINT VENTURE OPERATIONS

Situation Analysis

In the feasibility study submitted to the Provincial Ministry of Foreign Trade and Economic Cooperation, total investment in the JV was estimated to be US$10 million, over an economic life of 20 years. The first year was a start up period. In the subsequent two years, annual production volume per annum was estimated at 1.1 million tons. A gross margin of 20% and a 5 year payback period was anticipated.

Quarry products were broadly divided into *aggregates* (for production of ready mixed concrete) and *rockfill* (materials for reclamation and for construction of seawall). The production process was relatively simple and the production cycle could be as short as a few hours. The stock for aggregates was small due to the short production cycle and the deterioration of aggregates with time. In contrast, the stock for rockfill was high due to a larger variance in rock specifications purchased by buyers. The production cycle could be summarized as follows:

a. Drilling of holes to put in explosives
b. Blasting
c. Rocks picked up and transferred to dump trucks

d. Rocks as rockfill were delivered to an inspection warehouse and screened before loading to barges, while rocks to be converted into aggregates were delivered to crushing plants and crushed into various desired sizes before loading onto barges (the whole crushing process was fully automated).

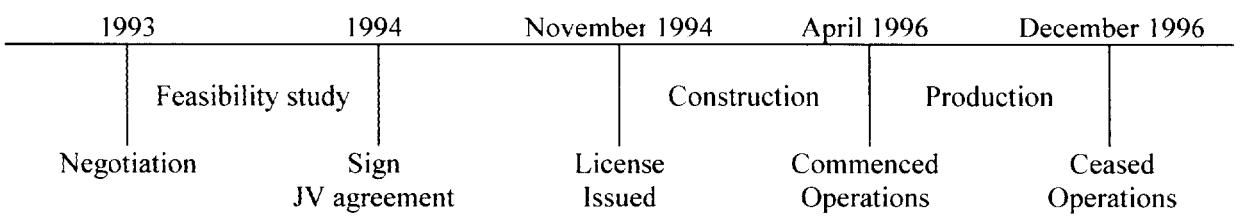
The quarry was capital intensive. Plant related expenses such as depreciation, diesel and oil, insurance, repair and maintenance, parts and consumables accounted for 80% of production costs. Labor costs accounted for the remainder. Fixed costs were approximately 50% of total costs. Hence, sales volume was crucial to profitability.

In the feasibility study, management concluded that there was keen competition from hundreds of small local private quarry operators who ran their quarries in a traditional manner. This involved the use of old and inefficient machines and the employment of thousands of people at each site. Existing quarry operators met market demand quite efficiently on a cost basis, but quality remained low. Management thought that Oriental's superior quality would be a primary competitive advantage. In sum, Oriental's competitive advantage included high productivity and quality. The major disadvantage was its high cost of capital for its supplier equipment and transportation costs because of island production.

Results of Operations

The business license was granted to the JV in November of 1994. Construction began in March of 1995 and the first lot of output was produced in April of 1996. For September of 1996, the interim results of the JV did not meet expectations. Production volume was only 270,000 tons. A period loss of US$1.6 million was incurred and a loss of US $3.4 million was estimated for the year. The shareholders immediately requested the management of the venture to provide them with an updated budget for the next three years. The loss was forecast to be US $2 million (1997); US $1.8 million (1998) and US $1.4 million (1999), resulting in a cumulative loss for the first five years of US $8.6 million, 86% of the total investment. The JV ceased operations at the end of 1996.

Figure 4. Timeline from Inception to Failure



Problems of the Joint Venture

JV problems resulted from the lack of attention given to: (1) the alignment of partner strategies given their different contributions and risk exposure; (2) the competitive cost structure under various host PRC government and foreign exchange scenarios; and (3) the lack of business and management control over the internal operations of the JV.

Strategic objectives

Lack of incentives for the Japanese and PRC partners

A fundamental question involving JV performance is whether a lack of alignment between the respective partner strategies exists, given their different contributions and risk exposure. In this case, the contributions of the various partners did not fully reflect their risk exposure. In the PRC, foreign partners are exposed to a greater amount of risk relative to their respective contributions. Such was the case in the extractive industry in the quarry JV. A comparison of the contributions and risk exposure of the three foreign partners however indicates that an unsuitable arrangement was struck between the Hong Kong and Japanese partners in sharing the risks of the JV (see Table 1).

The strategic aim of the Chinese partner was to share in a stable return from the quarry operations and to ensure employment of local Chinese. The Chinese side was able to extract a royalty fee calculated by reference to the production units of the rock extracted from the quarry. Since the quarry had less than 100 people employed from the mainland, operating risk was minimal. As a result, the failure of the JV to fulfill planned export sales did not raise any alarm among the representatives of the PRC government.

Tomiyama's strategic aim was to secure initial inroads for the sale of heavy machinery in the PRC market, through the supply and financing of machinery to the JV. Tomiyama financed the purchase of the machinery by the JV for an initial fee. The effective shareholding of 20% in the venture possibly overstated the risk exposure of Tomiyama, such that the Japanese partner was prepared to walk away from the venture when sales did not materialize as predicted. Tagawa was a quarry stone distributor with a strong sales network in Japan. Tagawa was responsible for marketing about 60% of the output of the quarry to Japan. The original idea for the JV in Shanghai was that the JV would sell to the Japanese shareholder, Tagawa, who would on-sell the material in Japan. But after the devaluation of the Japanese Yen, Tagawa refused to sell the material at a higher price. With 20 % equity, the Japanese shareholder had little incentive to obtain additional sales. The Hong Kong partner sought other buyers for the stone in Japan, but subsequent agreements were for smaller amounts of stone compared to planned exports.

Competitive cost structure

Many of the JV's problems revolved around management's optimism about the PRC and Japanese market. The change in demand and exchange rates were critical environmental factors that contributed to the JV's demise. The influence of these factors was accentuated by the operating structure, financial management and dependence on the buyers of the stone.

Demand - PRC market

At the time of forming the JV, the economic growth in the PRC was tremendous. Shanghai had a lot of property development and infrastructure projects involving foreign investors. Demand for high quality aggregates and ready mixed concrete was very high. The consumption of aggregate in Shanghai at the time was 4 million tons. Shanghai was planning to build 6 million square meters of housing each year for the next several years, which would consume 6 million tons of aggregates a year. Both Prosperity Ltd. and Tien Shan Ltd. were optimistic about the future of the JV. However, at the commencement of production in 1996, the Central Government took economic action to dampen activity in the overheated property market in Shanghai and other coastal cities. The demand for aggregate dropped significantly as competition intensified. Due to high fixed costs, the production volume did not meet the break-even point. At existing levels, it was estimated that the cost structure of the JV was 50% above local suppliers. Because PRC customers placed greater weighting on cost rather than quality, actual

PRC sales turned out to be 60% below forecast.

Demand - Japanese market
For the Japanese market, the competitive advantages were low production cost and high quality. Local PRC suppliers were considered unable to compete with the JV because they lacked production technology, economies of scale and connection with Japanese importers. Inclusive of transportation, Oriental was considered able to match the competitiveness of local Japanese suppliers. Tomiyama was the largest quarry operator in Japan and Tagawa was a well-known trading company. As the quality of stone produced by the JV was much better than that provided in Japan, both Japanese shareholders were confident about selling quarry products to Japan. Transportation costs would be high due to distance, but given the high selling price of quarry products in Japan, it was considered very profitable to export to Japan from Shanghai.

With the oversupply of stone and the depreciation of the Japanese Yen, this competitiveness disappeared. Prices dropped dramatically in the Japanese market. Because of high fixed overhead, the average cost per ton rose. The depreciation of the Yen accentuated this trend. As a result, the price was set higher to cover the drop in demand. This further depressed the demand for stone. One of the parties in the Japanese market requested that the JV lower its selling price by 20%. The Chinese manager refused to lower the selling price because by doing so, he could no longer recover his full production cost. Attempts were made to seek further buyers of the material in Japan but none were forthcoming. The results in terms of volume meant that actual sales during the operating period were half of those forecast.

Exchange rate risk
As mentioned, more than 60% of the JV's products were shipped to Japan quoted in Japanese Yen. In the feasibility study, it was anticipated that the exchange rate of Japanese Yen to U.S. Dollars would strengthen. The Yen subsequently depreciated over 20% by the end of 1996. As the exchange rate between United States Dollars and Chinese Renminbi remained constant, this increased the cost of Chinese products shipped to Japan. Coupled with lower prices resulting from keen competition in Japan, the JV could not be competitive at these higher prices. Aggravating this was the fact that loans undertaken for investment in the JV were denominated in U.S. dollars. Management did not engage in currency hedging. The subsequent depreciation of the Japanese Yen meant that the projected revenue was low relative to the liabilities that the venture had to repay.

Management Control
Control problems of the JV related to an absence of a well-defined set of management control guidelines. A lack of attention was paid to the feasibility study and to the formal budget plan. Internal controls were also weak.

Inattention given to the feasibility study
The Hong Kong business was family owned and one in which the father had significant influence. The feasibility study reinforced the decision of the owner of the Hong Kong company to go ahead with the investment. First, a discounted cash flow analysis of the investment was conducted. However, the financial analysts were not very familiar with the PRC environment. Certain costs were ignored such as VAT, duty and extra costs imposed by the government. Second, the results of the study were different from the business plan submitted to the PRC government, because the HK party thought the market would improve more than the PRC government representatives expected. Third, the company had previous experience with building and operating transfer toll roads and with another quarry JV in the PRC. The firm had been successful in the past, and projected this positive experience to the present venture. A more conservative feasibility study was

undertaken by accounting. When this feasibility study result was delivered to the father of the Hong Kong company, it was sent back for the figures to be revised upwards, to meet the desired forecast.

Inattention given to the formal budget plan

The accountants in both the Hong Kong company and the JV played a limited role in the startup and in providing feedback for management of the venture. First, the manager of the Hong Kong company failed to accept negative forecast results in his budget preparation. Revisions were made until an acceptable result was obtained. This practice was largely due to deference to the Chinese family culture, which resulted in a diminished role of the budget for management of the JV. The General Manager of the JV knew that the final budget was not realistic. As a result, it had little role in controlling the operations of the JV. Few alternative controls existed.

Second, only one partially qualified accountant from the PRC was employed at the venture. He was the only office employee to carry out financial administration. Information was passed back to central accounting of the holding company and sent back to the JV along with other material from the holding company and then accounts were prepared. The general manager had only a limited picture of operations from which to understand the value chain of operations. Very little of the cost structure was known until it was reported back to the holding company, every two months. The information had to pass to central accounting, and then return to the JV manager. This resulted in infrequent feedback for corrective managerial action.

Part of the inattention given to the formal budget plan was due to the non-financial orientation of management. The Hong Kong GM was previously a manager of another JV quarry. He was weak in financial analysis, and in controlling the financial aspects of the venture. He often sought the advice of the Hong Kong controller as to how to control the operations of the JV. For example, he delayed the payments of the venture to increase the profits. The general manager, manager and five sectional managers from Hong Kong were operationally but not financially trained.

Primitive business environment and the lack of internal control

The undeveloped PRC business environment played an important role in influencing daily transactions. Rather than using VAT invoices, many transactions were conducted in cash in order to evade taxes. Such practices left no audit trail for internal control purposes. The sales team reported that sales deals could be concluded if the JV insisted on using VAT invoices. Workers were paid in cash rather than by cheque. Fictitious workers were often reported on the payroll. As the JV management had little experience in collecting debt from the local people, they were reluctant to extend the generous credit terms necessary to do business in the PRC.

The JV did not fully implement a costing system, which controlled planned yields and measured variances between actual and budgeted sales quantity by keeping track of production. No costing system integrated financial and cost accounting except for some ad hoc reports on production status. Production variances in dollar sums consisted of quantity and price components, which were inseparable due to the lack of systematic reporting of production figures. The nature of business operations was such that actual production figures were difficult to ascertain. The absence of segregation of duties in the sales and production functions resulted in under-reported sales. Finally, as most products were sold for cash, it was difficult to control the operations management and the collection of cash. For example, it was impossible to trace the rock to the buyers for following up on payments. As a result, the internal audit committee could not discharge its duties. Operational controls were in many respects dependent upon the self-discipline of

JV management and the trust of Hong Kong headquarters.

Limited PRC Experience
Although the Hong Kong company had a successful quarry elsewhere in the PRC, the operation of the successful quarry was quite different. This quarry supplied crushed stone to the Hong Kong market. Sales were received in $HK. Both the $HK and Chinese Renminbi were pegged to the $US, eliminating foreign exchange risk. Second, the quarry served dozens of customers in Hong Kong, diversifying market risk.

On the operations side, previous PRC experience led management to believe that the informal control system in place at the successful quarry could be transferred to the new venture. That included design of control systems appropriate to the business environment peculiar to the PRC. All the management staff were sent from Hong Kong to the PRC JV operations. No training program had been provided for PRC local management in Hong Kong before the JV began.

Proposals for Successful Joint Venture Management
Many JVs in the PRC require a large amount of capital to be contributed by the foreign partner, relative to the local Chinese partner. In this case, the Hong Kong company, and to a lesser degree the Japanese partners, invested significant capital in infrastructure, building roads and setting up the quarry. The Hong Kong and Japanese partners brought machinery and capital, while the Chinese partner provided only land.

The initial contributions need to be evaluated in terms of how such contributions relate to the risk undertaken by each partner. In this case, the contributions (land for the Chinese partner and loans provided by the Japanese partner) did not reflect the risk exposure of each. The Chinese and Japanese partners were happy to walk away from such a venture when the environment suddenly changed, in particular with respect to product demand and foreign exchange. While each shareholder was in charge of a separate function—marketing, finance and operations—demand and environmental factors were the main causes of failure. The influence of overseas demand highlighted the dependence of the JV on a few buyers. Apparently, trust in the Japanese partners to secure sales gave the Hong Kong partner a false sense of security with no contingency plan for alternative buyers of the quarry output.

The cost structure of the JV needs to be assessed in relation to competitors. In this case, initial budget estimates indicated that the venture was not going to break even. The operating risk of the JV had to be assessed. The cost structure of the venture was higher than onshore competitors. Quality considerations aside, there were cheaper substitutable products. For example, the sand near the river in Shanghai provided the same function as the rock from the quarry, but was much cheaper.

The eagerness of the manager of the Hong Kong partner to expand investment in China appeared to dominate the decision to go ahead with the venture. However, the outcome also indicates the nature of the China environment. The Hong Kong partner had previously been successful in operating a JV in southern China. The failure of their second quarry also serves to highlight regional factors. Success in one region does not necessarily transfer to success in another. China is large, with diverse regional differences in its legal, political, operating and cultural environment.

CONCLUSIONS
JV failure in the PRC is quite common. This often arises due to a misunderstanding about the PRC market and over-optimism. Without careful and systematic consideration of financial and non-financial factors, success is far from certain. Prosperity Ltd. over-estimated its competitive advantage by failing

to understand its competitive positioning in an industry under various PRC government policy and foreign exchange scenarios. When the environment changed significantly, predicted competitive advantages turned into competitive disadvantages. The JV lost competitiveness, both in the domestic and in the Japanese market.

The Japanese and PRC partners to the JV were exposed to lower risk relative to their contributions. As such, the opportunity cost of pulling out when the market did not materialize was significantly less than for the Hong Kong partner. The absence of a contingency plan resulted in inaction in controlling costs. This led to a serious drain of capital and eventual failure. Management did not have proper financial management for overseas transactions. Hedging by means of option or forwards contracts had not been arranged. Sales were invoiced in Japanese Yen and loans financed in US $. When the Japanese Yen devalued against the US $, the JV was left with heavily devalued receivables and highly inflated liabilities.

Problems for the JV in this case were exacerbated by lack of control over the internal operations of the JV, in particular a lack of attention given to the feasibility study and budget plan. The lack of internal controls was inadequate for monitoring an uncertain business environment. Limited PRC experience added to management's complacency about the probable success of the JV. In order to be successful in the PRC, JV managers must understand the alignment of interests and risk exposure of the partners. Contingency plans must exist when partners fail to deliver. Sound internal controls and costing must be established. Management training must be emphasized and sound financial practices implemented. Only then may the potential of the venture be realized.

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