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Making Partnerships Work

*A Relationship Guide for
Chinese and Foreign
Companies*

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Making Partnerships Work

A Relationship Guide for Chinese and Foreign Companies

Many foreign companies first begin doing business in China through partnerships, without having overall management control. These partnerships can take the form of either joint ventures, with shareholdings that are more or less equally balanced, or minority stakes, in which the foreign company's holdings can be as little as 5 percent of the Chinese company's equity. Some foreign companies choose this route to combine their own global capabilities with the local knowledge, distribution systems, and management teams of their Chinese partners. Others do so because the regulatory environment provides no alternative; for example, no foreign company can own more than 33 percent of a Chinese securities company. There is often a strategic choice to be made between slower, organic expansion and working with a partner to build a national presence more rapidly at the cost of a lower ownership stake. For example, banking regulations currently make organic expansion for foreign banks a slow, city-by-city process. While a partnership may allow for faster expansion, a foreign bank can own a maximum of only 20 percent of any Chinese bank.

Whatever reason foreign companies have for choosing to work with a partner, it is useful for them, when assessing the challenges of making such partnerships work, to consider that the experience of those who have done so has not been overwhelmingly positive: Booz Allen Hamilton research in 2005 found that, although 64 percent of foreign respondents were operating in a joint venture, only 5 percent of the respondents would choose that option now if a wholly owned structure were an alternative.

Because foreign and local partners often diverge in their objectives, working successfully in a partnership requires two things: First, each company needs to make a realistic assessment of objectives, including its own objectives for the partnership, the likely objectives of the partner, and how both of these are likely to evolve over time as market needs, competitive position, and relative capabilities change. Second, this clarity regarding objectives and future partnership dynamics needs to be accompanied by a

systematic implementation of specific actions that focus on the highest value-creation opportunities within the partnership.

I. Determining Realistic Objectives—For the Present and the Future

Given that foreign and Chinese companies may come to their joint partnerships with very different aspirations and perspectives, each side needs to both maintain a clear view of its own objectives for the partnership and to develop a realistic assessment of the likely underlying objectives of its partner. Moreover, as the partnership develops and the market and profit opportunity evolve, each side needs to refresh this assessment to understand current and likely future changes in objectives.

Such changes may lead to adjustments of roles within the partnership or even a winding-down or breakup of the partnership. This makes it essential for both partners to think strategically about how to preempt or influence such moves and how to creatively reshape partnership roles to support changing objectives. Equally, it reinforces the need for robust contingency plans to deal with an unexpected and unfavorable change in partnership dynamics or the sudden withdrawal of a partner.

One example of changing partnership dynamics that can serve as a warning to both foreign and Chinese companies is the rocky relationship between Harbin Brewery, China's fourth-largest beer company, and SABMiller, which bought a 29 percent stake in Harbin in 2003. Harbin Brewery saw the partnership as an opportunity to upgrade its capabilities. However, because it had sold only a minority stake, it remained independent in its business strategy and objectives. SABMiller was unable to persuade Harbin to rein in its aggressive price war with China Resources Breweries (CRB). Moreover, SABMiller's hopes of realizing synergies between Harbin Brewery and CRB—in which SABMiller already held a 49 percent stake—came to nothing. The outcome was a hostile takeover bid for Harbin launched by SABMiller and a subsequent counterbid by Anheuser-Busch. Harbin's management supported Anheuser-Busch's higher bid and the joint venture with SABMiller came to a rapid end.

The Evolving Objectives of Foreign Companies

For overseas companies that have already made invest-

ments and formed partnerships, getting this far has required navigating between the extremes of optimism and skepticism about the attractiveness of the Chinese market.

For some, the opportunity in China is too big to pass up. China offers foreign companies a chance to generate top-line and bottom-line growth. For some investment stakes, in which the Chinese partner is planning a stock market listing within a few years, there is the prospect of capital gains as the share price of the Chinese partner rises following the IPO. This financial play can supplement any operating profits and provide insurance against problems in getting business operations off the ground. Other companies view their investments as options, in which the partnership represents an initial move into China and an opportunity to learn more about the business opportunity before making a larger commitment.

For other companies, the very mention of a “China strategy” or suggestions of purchasing a minority stake that does not bring management control is enough to make top management and institutional investors uneasy and cause the share price to fall. The underlying argument here is that the prospects for profit are poor in many markets within China as a result of the competitive intensity, excess capacity, and lack of profit orientation among domestic competitors. Further, the financial play of post-IPO capital gains is risky, if current exuberance about China’s prospects should prove transitory; besides, investing for capital gains alone does not represent the core competence of most corporations. Such investments are best left to private equity houses and asset managers. As for creating options, some argue that buying a minority stake at what can be a high price, measured against earnings or assets, is an expensive way to learn a limited amount.

In this environment, understanding the business case for China is critical. This first requires a clear understanding of market opportunities, the prospects for profit, and the capabilities required to establish an advantageous market position. It is this understanding that in turn should determine the business objectives of a partnership or joint venture and the specific capabilities that each side will bring to capture the profit opportunity. It will allow firms to navigate the extremes of optimism and pessimism about the opportunity to establish a sustainable business in China.

Many senior policymakers and executives see participation by foreign companies as an important means of building capabilities and a valuable stimulus for change in management practices, as well as a source of capital.

Companies that have already created partnerships and joint ventures now face the challenge of developing joint business performance in a way that creates shareholder value. Many foreign companies that have already agreed to a partnership will not remain content with a limited minority stake in one organization. To take the banking sector as an example, regulations and agreements permitting, companies may seek greater control and profit participation where businesses are successful. This may involve spinning off separate businesses (such as credit cards) or, as market and regulatory conditions evolve, outright acquisitions. Such intentions can already be seen in cases where financial institutions have made agreements-in-principle to create 50/50 ventures in credit cards, ahead of the required regulatory framework. For example, Citigroup was able to secure effective management control of newly established joint credit card operations with Shanghai Pudong Development Bank and 50 percent economic participation, even though it initially only acquired a 5 percent stake in the bank.

Foreign companies may also wish to work with more than one partner in the future, as the range of potential partnerships evolves. A new partner may bring distinct geographic coverage, products, or capabilities that the current partner can’t offer—or the prospect of a better working relationship and/or more management control. At the same time, adding a partner may antagonize relations with the first partner. Again, Citigroup provides an example: It has sought to acquire a stake in Guangdong Development Bank in addition to its stake in Shanghai Pudong Development Bank, despite its previous agreement to develop its credit card business in China exclusively with the Shanghai bank. After negotiations with its Shanghai partner, this exclusivity agreement has been renegotiated to expire in 2008, although the two partners have reaffirmed their mutual commitment and Citigroup is raising its 5 percent stake in Shanghai Pudong Development Bank to 19.9 percent.

If the route to greater control and ownership is not open as the business develops, foreign partners may seek to exit at a profit and look for new ways to develop their China business, making use of the experience gained in the partnership. This possibility—together with the risk that the Chinese partner will decide to terminate the partnership or prove uncooperative—highlights an important additional objective for foreign institutions that is often neglected once business planning starts: Foreign companies must continue to develop their capabilities in China in a way that provides options for the future—both inside the current partnership and, if needed, outside the partnership in a new wholly owned enterprise or with a new partner in the future. One way to do this is to develop an explicit plan for learning and capability transfer from the Chinese partner,

alongside the more common planning for capability transfer from the foreign partner to the Chinese partner. Such a plan would cover issues such as gaining market knowledge, building distribution capabilities (where the Chinese partner often takes the lead in joint ventures), and learning how to recruit, develop, and retain Chinese staff.

The Evolving Objectives of Chinese Companies

Chinese companies have a number of objectives in confirming partnerships with overseas institutions. Many senior policymakers and executives see participation by foreign companies as an important means of building capabilities and a valuable stimulus for change in management practices, as well as a source of capital. From a more short-term perspective, securing an investment from a brand-name global company has also proven helpful in laying the foundations for listing on an overseas stock market.

Having seasoned overseas executives from institutions that focus on shareholder value on a company's board brings different perspectives and experience to critical management debates. It also increases the leverage for change against those who are more conservative in their ambitions. Working with foreign companies to gain capabilities can lay the foundation for building world-class Chinese institutions that can compete on equal terms with U.S. and European institutions.

These objectives provide a useful means for Chinese companies to assess potential, often competing, partners. While the financial price agreed for the investment stake is important, nonfinancial contributions have the potential to offer substantially more value over the longer term. In particular, the Chinese company entering a partnership needs to assess the willingness and ability of the foreign partner to deploy market-relevant capabilities in China. The foreign partner may find it hard to deliver capability transfer when the realities of the cultural differences become clear and concerns about intellectual property protection are raised. Additionally, the Chinese company needs to assess the capability of the potential foreign partner to act as an effective catalyst for change, within the context of the Chinese organization's own culture, aspirations, and environment.

As their experience in partnerships with foreign companies grows, Chinese companies will reassess the role of the partnership in light of their own evolving business objectives and capabilities.

Just as there are foreigners skeptical about the merits of investing in China, so too are there those who argue that China is selling equity stakes in its prized institutions at too low a price—a price that does not reflect the growth potential of the Chinese market and the particular value of local brands, distribution, and management. These differing views may both constrain the rapid confirmation of new partnerships and influence the behavior of some senior executives in partnerships that have been already confirmed.

Chinese auto companies, including Shanghai Automotive Industry Corporation (SAIC) and Dongfeng Motor Corp., provide examples of how to seek capabilities from partnerships with overseas companies. They formed joint ventures with global auto manufacturers, gaining new technologies, experience, and capital to drive the development of their businesses, in exchange for their market access and local distribution capabilities. Doing this effectively has been and will continue to be an important determinant of future success. It requires a sizable but nuanced change-management effort that goes beyond a transfer of technical engineering capabilities to include cultural change and management.

This is the road that many Chinese financial institutions are now embarking on. Banks such as Bank of Communications and Huaxia Bank are seeking to develop capabilities in areas such as credit cards, risk management, and corporate governance through cooperation with foreign banks (HSBC and Deutsche Bank, respectively) that have taken minority stakes. For those of the Big Four state banks that have recently listed overseas or are in the process of doing so—Industrial and Commercial Bank of China (ICBC); Bank of China (BOC); China Construction Bank (CCB); and Agricultural Bank of China (ABC)—the benefits of capability transfer come alongside the reputational benefits of securing an investment from major global financial institutions.

However, partnerships between foreign and local institutions are in their early stages in the financial sector. Experience in other sectors shows how partnership objectives and dynamics can evolve as conditions change. To return to the automotive sector, senior executives in some Chinese auto manufacturers have become frustrated at not gaining full access to the R&D technologies of their global partners—technologies that the global partner often fears may not be adequately protected by China's weak intellectual property regulations. The leading Chinese auto manufacturers are keen to compete globally and establish their own brand names with their own designs. As their own capabilities develop, they will be less willing to work together with the global auto companies that are, increasingly, their competitors, as a natural result of changing dynamics in the partnership relationships.

As their experience in partnerships with foreign companies grows, Chinese companies will reassess the role of the partnership in light of their own evolving business objectives and capabilities. They will consider whether to seek a buyout of their joint-venture partners to regain full control and profit participation once core capabilities have been developed. They will review what the limits to capability sharing and technology transfer really are, given the business ambitions of each side. They will, in some cases, decide to exit lines of business or sell out to a foreign partner, if and when regulations permit. In some cases, they will conclude that the partnership has not lived up to expectations and seek a new partner. They may even conclude that—in the future—the joint-venture partner will in fact be their closest and toughest competitor.

II. Focus Effort on Value Creation

Although each company in a partnership may have different specific objectives, they can typically agree on the common objective of value creation. This is often based on bringing together the foreign partner's manufacturing, technology, and marketing capabilities and the local partner's market and regulatory knowledge, market access, and sales and distribution capabilities.

What remains a challenge is that each side may have a different understanding of the meaning of "value creation," place different priorities on it, and have different views on what actions need to be taken at what pace in order to capture value. Unfortunately, an initial agreement on value creation may not last long as the realities of change management hit and individual partnership objectives evolve. Success requires that high-level value-creation objectives are rapidly translated into a very specific set of agreements on how the partnership will work.¹ It is worth remembering that through this process, each side will be seeking both to develop the business together and to build individual capabilities that can, if necessary, outlast the life of the partnership itself. As a result, reaching an agreement on priorities and actions is often far from straightforward. Yet despite the difficulties, a resolute focus on value-creation priorities—at the business and geography levels as well as in designing the change-management effort—is critical to success.

At the business level, the first priority is to deploy implementation capabilities to those business lines with the highest value-creation potential. Because implementation capabilities are the scarcest resource, their use needs to be clearly and effectively prioritized. Every foreign company faces constraints on the scale and speed with which it can transfer its capabilities into China. The number of people with the appropriate mix of technical, managerial, and cross-cultural skills is always limited in comparison to the scale of the joint-venture

partner's desire for improvement and the size of the market opportunity. On the Chinese side, companies have a limited number of people with the international exposure to work rapidly with transfers from overseas.

A prioritized plan to transfer capabilities also potentially opens the way for a greater degree of management control and influence by the overseas institution in the areas of focus. When AIG took a 9.9 percent stake in the People's Insurance Company of China (PICC), China's largest non-life insurer, in 2003, it focused capability transfer on accident and supplemental health (A&H) insurance and on product innovation. This product expertise was particularly valuable given the growth of the A&H market. Chinese insurers have relatively underdeveloped product innovation capabilities, because the market has previously seen little product differentiation. This made AIG's innovation capabilities particularly valuable.

There is merit to focusing resources on the highest value-creation opportunities.

Similarly, in the automotive sector, the joint venture between Guangzhou Automotive Group and Peugeot foundered when Peugeot failed to meet Guangzhou Auto's expectations on innovative design and technology transfer, two key elements of value creation. Honda replaced Peugeot as the JV partner and invested aggressively in technology innovation, leading to a much more successful business. This focus on key capabilities and achievable value creation is, of course, in line with the best lessons of business startup and implementation. A focused approach produces early results from working together in partnership.

A similarly intense focus at the geographic level provides another way of setting priorities for scarce resources. In their Beijing Hyundai joint venture, the Korean auto manufacturer Hyundai and its Chinese partner, BAIC, have placed first priority on establishing Beijing Hyundai's position in the relatively affluent Beijing market ahead of broadening out across China. Hyundai's technology and design ensure a competitive product. BAIC's knowledge and relations in Beijing have helped secure Beijing Hyundai's position as both the official police car and the new taxi model in the Beijing market.

The benefits of focus are reinforced by the often decentralized structure of many large Chinese institutions that have a national franchise. This is despite recent centralization initiatives by many institutions—Ping An Insurance Group of China is the most advanced example, having created a single, central customer database;

incorporated back-end processing onto a single IT platform; and established a nationwide call center. The geographical scale of these organizations, the diversity of local operations, and the ongoing influence of provincial governments and regulatory offices mean that much change management and capability building needs to happen province by province, city by city.

Above all, focus is critical in determining which capabilities to address first in capability transfer and change management. Given the fast-changing competitive and regulatory environment, most Chinese companies can identify a long list of initiatives required to build capabilities to meet the new challenges. This list can soon turn into a laundry list of organizational change along every step of the company's value chain. The winners will be those that go beyond the laundry list to set clear priorities on building capabilities that will drive customer value and profit ahead of what competitors can offer.

For example, in automotive joint ventures, both sides can identify potential for value throughout the value chain, from R&D through to auto financing, after-sales service, and the used-car aftermarket. However, at the current level of Chinese automotive market development, the greatest value comes from focusing first on design and manufacturing-technology transfer, then on supplier management and setting quality standards in the dealer network. Given this already long list, areas such as auto-financing offerings, which contribute significantly to company profitability in the United States, are given less priority.

A final point to note is that many times, the initial assessment of which capability transfer will create the most value is based on a distant view from overseas of what is needed in China. It is rooted in a foreign company's experience in its home market and does not take into account what is right in the Chinese environment. Left unchallenged, this leads to a poor use of resources and wasted market opportunities.

In some businesses, such as credit cards in Shanghai, a greenfield operation provides the opportunity to build an infrastructure with the same data-management capability that the foreign partner has overseas. However, we have found that in many areas, foreign companies need to deploy the most appropriate capabilities for the Chinese market and the Chinese partner's situation. These may be different from those capabilities that make the foreign partner successful in its home market and in markets where it has a competitive advantage. For example, one European bank and its local partner were confident that credit-risk capabilities could be built by transferring its European credit-assessment manual with only limited modifications. In practice, both information availability and

the credit process were so different that a new process design was required. In another case, a British company wanted to transfer the use of its sophisticated algorithms, whereas the local Chinese partner was more interested in the fundamentals of establishing its first-ever call center.

III. Conclusion

Managing partnerships to build capabilities that win in the market and build sustainable positions is a complicated, uncertain, and, at times, emotional process. Even once the tough negotiations to sign the partnership agreement have been completed, success requires continued engagement, pragmatism, and focus. Differences in culture, experience, and management practices mean that each side needs to pay systematic and explicit attention to clarity of communication and trust-building between the partners. Many partnerships have foundered and others will certainly do so in the future—be it from conflicting objectives, lack of mutual understanding, sheer cultural distance, or lack of effective follow-through on capability transfer and change management.

However, the ambitions of many Chinese senior executives and the commitment of many of the world's leading companies mean that there will be partnerships that win in the marketplace. Those that do will do so by relentlessly focusing on market opportunities, selecting opportunities where they can profit; remaining alert to evolving partnership objectives; and focusing implementation efforts on the highest value-creation opportunities through the inevitable emotional ups and downs of the relationship with their partners. However, winning in the partnership will not be sufficient on its own. Success may lead to one side seeking greater control: as, for example, in the growing ambitions of the Chinese auto manufacturers. Ironically, market success may leave one partner stranded as the other seeks full control of the successful new business.

There will be winners, too, among those whose initial partnerships do not work out. These winners will have gained experience and created options for themselves from their first partnership and gone on to create a more sustainable business base, either alone or with a new partner. Whichever the route, the China market offers rewards worth the effort to those who build and deploy distinctive capabilities.

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