Sincerely Yours?

A Value Driven Management Approach

by Lub Bun CHONG

For many Foreign Players, working with a Chinese partner to adapt its home model for the Chinese market place seems the obvious option.

Yet, track record in this regard is generally less than encouraging, as many Foreign Players continue to be frustrated by what they perceive to be Concerns with their Chinese Partners.

"Sincerely Yours[1]? A Value Driven Management Approach" provides insights on why & how a Foreign Player can create a "win-win" environment to manage these Concerns and deliver long term sustainable value for its China JV –
A goal shared by many but achieved by few.

[1] As in: Is the Foreign Player "sincerely" a partner of the Chinese Partner (or vice versa)?

Getting burnt in China In 2003, Forbes published an article entitled "Pepsi's Chinese Torture" in which PepsiCo accused its Sichuan joint venture partner of "breach of contract" and "transferring ownership of its shares without consulting PepsiCo", amongst others. In 2004, in an article headlined "China: Virgin Radio joint venture ends after dispute", Hong Kong Standard reported that Richard Branson's Virgin Radio "has gone off the air in Beijing after falling out with its local partner over the financial terms of their relationship". In 2007, in an article entitled "Brawl threatens Danone's huge investment in China", International Herald Tribune reported that "Danone officials concluded that their closest partner in China was operating secret companies outside the joint venture and were siphoning off million of dollars" (Subsequently, Danone and Wahaha announced the "conclusion of their joint venture relations in 2009). PepsiCo, Virgin Radio and Danone are not alone as many Foreign Players had, and will continue, to grapple with the very real possibility of getting burnt in China.

So, better off doing it alone? Doing it alone in China will facilitate control, which is attractive to a Foreign Player whose competitive edge is contingent on a standardization strategy for reaping economies of scale. But for a Foreign Player that needs to differentiate according to local market conditions, a Chinese Partner will provide solid value-add in the complex cultural, regulatory and political environment of China. Although going with a Chinese Partner seems appropriate and is indeed the chosen route, Foreign Players may intuitively focus more on managing its China JV since this where its legal rights and economic interests reside. Consequently, inadequate consideration is given to its Chinese Partner and as the plights of PepsiCo, Virgin Radio and Danone have shown, this can lead to serious consequences.

Efforts to create value in China often hindered by Concerns Generally, efforts by Foreign Players to implement strategic, management and operational Initiatives (collectively "Initiatives") are often hindered by what they perceive to be concerns on working with Chinese Partners ("Concerns"). Often cited Concerns include firstly, inconsistency in delivering on what has been promised, especially in terms of leveraging on relationship for business; secondly, the alleged lack of commitment to completely abstain from engagement in conflicting and/or competing business; and thirdly, the resistance or lack of motivation to implement international best practises. For the Foreign Players who have managed these Concerns well, the rewards are great. For those who have stumbled, they have either opted to go alone (against conventional wisdom for a differentiation strategy) or leave the market place altogether. These Concerns should not deter a Foreign Player; rather, they serve to highlight the importance of managing a Chinese Partner to leverage on his* or her* local expertise and relationship to create value for the China JV.

**only "his" will be used hereafter for ease of reading; not to be viewed as discriminatory*

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Determine the underlying causes behind the Concerns A traditional Chinese medicine saying advises one to "treat the causes and not the symptoms" of an illness; meaning that merely treating the symptoms will not cure the illness. So it is also the case with managing the Concerns. A Foreign Player knows what it wants out of a Chinese Partner but often, it does not know enough about what the Chinese Partner wants. This is crucial because potential for the Chinese Partner to seek alternative ways of meeting his needs will exist in a "lop-sided" relationship that provides disproportionate benefits to the Foreign Player; and this often gives rise to the Concerns. Therefore, to manage the Concerns, a Foreign Player must first determine what a Chinese Partner wants from the China JV with a view to ascertaining the underlying causes for the Concerns.

Like his Foreign counterpart, the Chinese Partner is driven by success What each Chinese Partner wants from the China JV varies from case to case but as a general observation, most of them are driven by success, which is typically measured by stature and wealth – the more of these, the more successful. Although stature for a Chinese Partner can take on different forms, it is typically centred on securing a good reputation as a leading industry player amongst firstly, market peers, friends and relatives; and secondly, regulatory bodies, government related entities and officials. Wealth, in simple terms, is the Chinese Partner's net worth as determined by the value of his equity stake in the China JV and his remuneration and entertainment allowance relative to industry benchmarks (and/or peers), amongst other things. Foreign Players who do not consider the success of the Chinese Partners as a key factor in the management of the China JV often create many difficulties for themselves.

Impact of the Initiatives on the success of Chinese Partner In assessing the Initiatives, a Foreign Player should also consider the impact that the Initiatives will have on the success of the Chinese Partner. To the extent that the Initiatives can be demonstrated to have a positive co-relation to the success of the Chinese Partner, they are more likely to be successfully implemented in the China JV. In contrast, if the Initiatives are viewed negatively by the Chinese Partner, they are likely to be ignored, and in the extreme case, resisted. Any oversight in this regard will inadvertently create a potentially disruptive "I win" (as in a win for Foreign Player's Initiatives) and "You lose" (as in a loss for a Chinese Player's stature and wealth) environment. For this reason, it is not uncommon for many relationships to enjoy blissful beginnings from the initial euphoria of forming a China JV that, unfortunately, slip into being a source of discomfort or even downright pain as the Foreign Player's Initiatives begin to negatively impact the Chinese Partner's success, which in time lead to the Concerns.

Link short-mid term incentives to the success of the China JV The challenge for the Foreign Player is to link the Initiatives to the success of the Chinese Partner, which are

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often done by linking the wealth of the Chinese Partner to the earnings of the China JV through short-mid term incentives such as performance based earn-out, claw-back and put/call option arrangements. Although not without merits – and the frequent inclusion of these arrangements in JV shareholders agreements are indicative of this – these incentives do not always deliver the full intended results because firstly, they are perceived by the Chinese Partner as "I win, you lose" arrangements and secondly, they do not confer much by way of stature, focusing primarily on wealth as it is; both of these limitations will weaken the linkage between the Initiatives and the success of the Chinese Partners. Additionally, these short-mid term incentives will leave the Chinese Partner with little or no interests in the China JV after they have been triggered e.g. upon payment of the final performance based earn-out, which will significantly reduce the Chinese Partner's motivation for adding value to the China JV; and this will have significant strategic implications for a Foreign Player with a long term view of China, particularly if it is not quite ready to do it alone in China by the time that these arrangements are triggered.

Long term strategic option to achieve better & sustained alignment If available as a strategic option – and the vast potential of the China market will lend considerable weight to such an option – an initial public offering ("IPO") can overcome the limitations of the short-mid term incentives and better align the success of the Foreigner Player and Chinese Partner on a longer term, as well as, sustainable basis. Since the China JV will need to demonstrate to potential IPO investors that it has adopted appropriate best practices, the motivation for the Chinese Partner to embrace change will be stronger. Similarly, because value of the China JV at IPO is a function of earnings, the Chinese Partner will also be motivated to maximize earnings for the China JV. Given the high public profile nature of an IPO, negative publicity on the China JV from lapses in best practises and corporate governance will likewise blemish the stature of the China Partner; and this will give the implementation of the Initiatives further impetus. As seen above, an IPO has the potential to create a China JV "win-win" environment where the Chinese Partner has an interest to deliver on promises, embrace best practises and abstain from competing business – aligned with the Foreign Player interests. Over a longer term, the success of the Chinese Partner will continue be tied to that of the Foreign Player (and China JV) given the negative impact that the Concerns will have on his own success through a reduction of the value of his stake in the China JV post listing. The pros and cons of an IPO, such as access to funds for expansion in China, are well documented in management literature and is not the focus of this article; suffice to say that in addition to these strategic benefits, an IPO also provides a Foreign Partner with an additional (and powerful) strategic option to manage the Chinese Partner and create value in the China JV.

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Reinforce compliance of non-compete with meaningful stake Compliance with legal non-compete undertakings can be reinforced if the Chinese Partner has a meaningful equity stake (both pre and post IPO). Enforcement of legal undertakings can be a lengthy and complicated drawn out process, thereby limiting its effectiveness. In contrast, as a shareholder with a committed equity stake, the negative impact of a Chinese Partner's indiscretion on the value of his stake in the China JV will be direct and immediate; higher stake will per se lead to stronger deterrent. Similarly, equity linked incentives for key local managers should also be designed to discourage conflicting behaviour; and with a meaningful equity stake, the Chinese Partner will be committed and is of invaluable assistance in designing and more importantly, enforcing this amongst key local managers. Through equity, the Chinese Partner and key local management are better aligned with the Foreign Player to drive the business forward. As such, although factors such as earnings growth and assets quality are still important drivers of valuation used in determining the equity stake of the Chinese Partner, the accretive effect on value creation that flows from a Chinese partner's meaningful stake should also be considered. In effect, a trade off between foregoing a valuation gain at time of investment (within reasonable bounds that is) in return for a larger long term valuation gain stemming from the positive effect that a meaningful stake has on the Chinese Partner and senior management.

Chinese Partner takes the lead in functional areas that require local knowhow & relations Of all functions, sales & marketing often proves to be the most challenging in formulation of strategy, as well as, execution of best practises. A common scenario, which is often met with resistance by the Chinese Partner (and therefore less likely to be effective), will see a Foreign Player appoint a manager to head up and "improve" sales & marketing in China. Less common, but more likely to be effective, is for the Chinese Partner to draw up a sales & marketing plan with the support and input of the Foreign Player e.g. seconding a manager to assist and providing resources; this way, the Chinese Partner will "buy-in" and drive (as opposed to resist) the implementation of best practices in sales & marketing. Well managed participation by the Foreign Player is vital as this will influence moulding of sales and marketing best practises; and also set a precedent for future active involvement. Clearly, taking a supportive role does not reduce a Foreign Player's influence in sales and marketing best practises; on the contrary, if done appropriately and sensitively, this approach will be more effective. By the same token, a similar approach should be considered for other functional areas where in-depth local Chinese knowledge and relationships are important e.g. business development, regulatory compliance and acquisitions; provided that clear policies and guidelines on financial criterion and corporate governance are in place to protect the Foreign Player's interests.

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Foreign Player appoints "on the ground" managers in areas where it can add value Managers appointed by the Foreign Player to be on the ground in the China JV should ideally be perceived by the Chinese Partner as adding value to the business. In many instances, finance (including corporate governance and information systems) and international business are two areas where best practises are likely to meet with less resistance (and even welcomed). Appointed by the Foreign Player with the acknowledgment of the Chinese Partner, suitably qualified (read: understand mindset of a Chinese Partner and thrive in a Chinese environment) Finance and International Business managers are well placed to firstly, implement best practises in their own respective areas and secondly, act as a "on the ground" conduit for the Foreign Player to monitor and manage the other aspects of the China JV including the implementation of sales & marketing best practises.

Key Performance Indicators to track progress Financial as well as non-financial key performance indicators will provide a framework for the Chinese Partner to monitor progress towards his success, and for the Foreign Player to track the progress of the China JV in its transition to become a well managed business by its international standards. Additionally, this will provide the cornerstones for a robust management reporting system that the Foreign Player can rely on for managing the China JV and gaining insight on doing business in China – springboard for further pursuits in China on a longer term basis. In designing and negotiating key performance indicators with the Chinese Partners, appropriate weighting should be placed on China-specific qualitative factors such as maintaining good relationship with key government bodies so as to better align expectations between the Foreign Player and Chinese Partner; provided these factors can be linked to measurable outcomes.

Sincerely Yours: Playing the JV Game in China Success in the China market is a long and winding road; and is one that is best journeyed with a Chinese Partner. Managing the China JV is a necessary condition but not sufficient by itself. By duly considering the Chinese Partner's success and creating a "win-win" environment in the China JV, the Foreign Player will find itself in a better position to be "sincerely yours" with a view to playing the JV game in China. More importantly, it will also - over time - set the foundations for becoming a relevant player in China through the invaluable knowhow that it will gain by working with its Chinese Partner.

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