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Collection of Articles on Joint Ventures / Strategic Alliances

26 March 1996

Prepared for:
Industry Canada
IFI Seminar

Prepared by:
Deloitte & Touche Consulting Group
Guelph, Ontario, Canada

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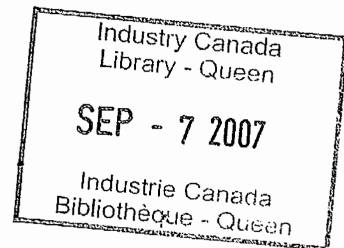
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Strategic partnerships can be made to work.

No existing text on management will tell you how to cope with the various forms of strategic partnership which we examined in our study. Strategic partnerships *can* be made to work if a company approaches them in the right way—and if its executives are equipped to manage them.

Our study identified the following eight principles of strategic-partnership management. While they cannot guarantee success, they do provide a good starting point from which a good manager can get a handle on this very complex phenomenon.

THE EIGHT GOLDEN RULES FOR SUCCESSFUL STRATEGIC PARTNERSHIP MANAGEMENT

1. Plan, plan, plan
2. Balance trust with self-interest
3. Anticipate strategic conflicts
4. Establish clear strategic leadership
5. Learn flexible management
6. Accommodate cultural differences
7. Orchestrate technology transfer
8. Learn from a partner's strengths

Plan, Plan, Plan

While it may not be possible to write the same kind of detailed operating plan for a strategic partnership that you can write for a wholly owned business, certain planning procedures can—and must—be followed, if the desired goals are ever to be reached:

- Examine how the proposed partnership can help achieve the strategic goals set for your business; before going ahead, a company should compare the partnership proposal with other, easier alternatives in terms of costs, benefits, risks and speed of execution.
- Prepare an outline of the activities to be undertaken within and the resources required by the partnership.
- Study the broader relationships with the rest of the company's business and the longer-term strategic impact.
- Plan how the relationship is to be structured and managed to obtain optimum benefit.

Without clear strategic thinking at the outset, it simply is not possible to decide whether a partnership has all the ingredients to be successful.

This kind of careful planning is essential, whether the partnership is about collaborating on R&D, setting up a new joint venture, or sourcing strategic components through an OEM agreement. Without clear strategic thinking at the outset, as well as the related development of plans that can work, it simply is not possible to decide whether a partnership has all the ingredients to be successful.

Balance Trust with Self-Interest

Virtually everyone with whom we spoke put trust at the top of the list of factors underpinning success. If planning ensures that the right machinery has been constructed to make a partnership successful, it is mutual trust that greases the wheels.

Genuine trust is based on:

- Understanding one another's business (What is the partner capable of delivering?)
- Appreciating one another's objectives
- Establishing good personal relationships

The partner's short-term objectives need to be understood because it is important that they be achieved; all partners must feel they are gaining if the strategic partnership is to get off the ground in the first place. Pushing for the best "deal" without regard to the other partner's interests merely sours the relationship before it has had a chance to bear fruit.

At the same time, one must also try to work out how the partnership fits into the other company's long-term strategy. What are the aspirations with regard to the partner's core business?

Knowing that one can work effectively with another management team — getting the chemistry right — is an important component in successful strategic partnership. The negotiating period is critical to establishing these personal relationships. By getting to know well the partner's key personnel socially early on, one will be able to see to it that any potential difficulties that may arise can be aired frankly and solved in an atmosphere of mutual self-interest, rather than confrontation.

Anticipate Strategic Conflicts

It always is important for companies entering strategic partnerships to be sure to identify the potential for conflicts and second-guess any hidden agendas that a partner might have. They must look carefully at their partner's overall strategy and at any other partnership in which it may be involved. The partner might secretly be trying to use a combination of alliances as a springboard to build up in-house capabilities and mount a competitive attack on the partner's business.

Understanding the webs of alliances that most multinational companies are spinning today is a complex task.

Understanding the webs of alliances that most multinational companies are spinning today is a complex task. It is often impossible to find partners with whom a potential conflict of some kind does not exist. Understanding what conflicts exist can also help establish areas where action must be taken to reduce competitive risks.

There are a number of ways in which competitive risks and conflict can be contained. (The way chosen will depend, of course, on the nature of the partnership entered into and the risks involved.) They are:

- Allocating geographic markets
- Choosing different applications markets
- Defining the scope of business
- Reducing seepage of technology

Any attempt to allocate geographic markets must, of course, be considered very carefully in light of the legal jurisdictions involved, since market sharing has major antitrust implications. The applications-market approach can be useful where the focus of business is genuinely different for the partners and there is a high level of mutual trust. Where a formal joint venture is formed, the scope of business must be very clearly defined to make sure that the potential for competition with the parent companies can be managed effectively.

One of the most important risks is unplanned seepage of technology.

One of the most important risks is unplanned seepage of technology. Any strategic partnership may be viewed as rather like a semipermeable membrane through which technology and expertise can flow unintentionally from the technologically stronger partner to the weaker. The risk is obviously greater in R&D collaborations. One way to reduce technological seepage is to divide the project into carefully defined components, so as to make the collaboration as vertical as possible. Another approach, which is possible in certain OEM-type situations, is for suppliers to restrict customers to older product models, reducing their ability to compete head on, as well as making it more difficult for them to catch up and bring production in-house.

Whether any of these methods of reducing competitive risk are adopted, it is important to manage carefully a competitor's access to one's personnel and resources. The limits of the relationship should be defined to ensure that staff knows what information can be shared and what information cannot.

Establish Clear Strategic Leadership

Ineffective leadership makes coordination difficult and expensive.

Clear leadership is essential in any business or project, and one of the most important aspects of structuring a strategic partnership is choosing the right leader. Ineffective leadership makes coordination difficult and expensive; it slows down development, and it can make it virtually impossible for important decisions to take effect. In our study, we noted that many avoidable strategic-partnership failures were attributed ultimately to the absence of clear leadership.

One way to establish strategic leadership is to create an independent leadership structure, that is, an independent entity headed up by a strong, politically adept chief executive or project director who is capable of providing independent but effective management. (Airbus Industrie, BT&D, MCC and ICOT are examples of the kinds of entities that can be created.[4])

In choosing this manager, the general rule is to choose the best person for the job and to give that person strong powers of authority. His or her personal future and remuneration should be linked closely to the success of the partnership, as should those of the other members of the management team. The board to which the manager reports, typically drawn from the senior echelons of the sponsors, should interfere with the management as little as possible, once the overall strategic direction has been agreed upon.

The second way to create strategic leadership is to have one of the partners take on the role of project management. This is the easiest solution to establishing strong leadership in major development projects that require the integration of complex inputs from many partners. And, as noted later in the presentation on partial mergers, strong management direction helps speed the process of integration in partial mergers, provided that the partner in charge is fair about the extensive hiring and firing decisions involved, and chooses the best executives from both companies solely on the basis of merit.

[4] MCC is Micro-electronics and Computer Technology Corporation. ICOT is the central laboratory at Japan's Fifth Generation Computer Project.

Learn Flexible Management

In strategic partnerships, where objectives may differ between partners as well as diverge over time, a different approach to business building is required. At best, plans and budgets might be negotiated; at worst, total control over them may have to be given to a management team over which there is no formal control.

Under these circumstances, it may be difficult for a company to obtain adequate information about the project's performance, and a company may have little opportunity to direct the project in the conventional sense. Therefore, companies involved in strategic partnerships must learn how to manage without the kind of control to which they are accustomed.

In strategic partnerships overall project management must be predominantly by persuasion and influence, with a willingness to adapt as circumstances change. The degree of influence one has over a project depends very much on the type of partnership it is and on the power balance that exists among the partners. A company's influence can also change over time along with the power balance. For example, a minority investor in a company that is doing well has little or no influence over its management. On the other hand, a company that is doing badly, and in need of orders or an injection of capital, must listen carefully.

The degree of involvement venture capitalists have in their invested companies fluctuates according to the phase and condition of the project: they offer advice and the injection of key business skills during periods of development; they keep an arm's-length relationship when things are going well; and they have to be able to demand changes in management if things are going badly.

Once a partnership has begun, companies involved in strategic partnerships must be able to adapt to changes, for the partnerships will not always continue to deliver the benefits envisaged. Companies must be prepared to tighten the degree of control. If tightening control is not possible, companies should be prepared to cut their losses and seek other means of achieving their strategic objectives.

Managers involved in partnerships should be both diplomatic and astute.

Managers involved in partnerships should be both diplomatic and astute. They must see to it that all the different levels within the team understand the importance of working with the other partners constructively. At the same time, the limits of cooperation must also be clear; sensitive information must be identified and isolated. And self-interest should always come first—even to the extent of being prepared to change partners if the partnership is not delivering the benefits sought.

Accommodate Cultural Differences

In strategic partnerships the potential for cultural conflict abounds.

In strategic partnerships the potential for cultural conflict abounds. Conflict can arise in any one of the following areas:

- Differences between large and small company management styles
- Differences in national business culture
- Differences among the established management styles of individual corporations

Differences between the large and small company styles of management are one of the major causes of difficulty in corporate venturing. Large companies tend to have complex structures with multiple tiers of manage-

ment, and they tend to have established procedures for making investment decisions.

Additionally, there are usually many different groups with an interest in any given project. This can slow down decision making. In small companies, where small numbers and regular day-to-day contact between employees make informal communications the norm for exchanging information, decisions can be made quickly by just one or two people.

There are as many differences among the business cultures of Western nations as there are differences between Japanese and Western cultures. For example, U.S. companies tend to enter legal discussions at an earlier point in negotiations than do European companies, and their executives are often more direct than a European manager would be.

Evaluating a prospective partner's business culture is an important part of the courtship process.

Evaluating a prospective partner's business culture is an important part of the courtship process. Bridging cultural gaps requires understanding and forbearance, and it is important that all members of the partnership team know what is involved. They should know how their partner makes decisions and where the limits of authority lie. Also of importance are the procedures for planning and measuring performance and the partner's rules for social and business behavior.

Orchestrate Technology Transfer

An important objective of many strategic partnerships is to develop a technology that will then be used or marketed by the sponsors. Yet, many strategic partnerships are initiated by the technical staff within their parent organizations. For example, collaborative R&D programs are usually the children of their sponsors' R&D departments. Also, lines of communication in corporate venturing relationships generally are first formed at a technical level, to enable the investors' R&D people to evaluate the technology that the venture is creating and perhaps offer practical help.

Commercial exploitation of the results of these efforts requires communication in the opposite direction—back to the parent companies—and to functions other than technical. In many partnerships, channels of communication at the commercial level are created too late. This situation, especially when considering the distance that may exist between partners, can make the transfer of technology from the project back to the sponsor more difficult. This difficulty is one of the limitations of international corporate venturing, and it also is one of the major disadvantages of basing collaborative R&D programs in central laboratories.

Communications problems are exacerbated by the turnover of managers, with key decision makers on both sides probably being replaced every three to five years. From the partnership's point of view, this means that the enthusiasm of the sponsoring companies can be very unreliable.

People are essential to transferring detailed technical knowledge and applying it commercially.

People are essential to transferring detailed technical knowledge and applying it commercially. To ensure that the technology developed is brought back into the sponsoring company, as well as to ensure that the commercial opportunities this technology offers are well promoted internally, a technology-transfer plan must be drawn up, and a clearly identified "receptor" team with the technical skills to understand and use the technology gained must be established. As the technical and marketing uncertainties are reduced and the technology or product comes closer to commercial exploitation, this contact with the receptor team must increase.

Learn from a Partner's Strengths

Every company has a different way of doing things, and strategic partnerships offer the opportunity for one company to observe how another operates — the way R&D programs are managed, how the business development program is organized, how management information systems operate, how overseas subsidiaries are managed and even how remuneration packages are determined.

Individuals involved in strategic partnerships must be chosen for their receptivity to new ideas.

But institutionalized learning does not take place automatically. The right mechanism must be in place to allow it to happen. At least some of the individuals involved in strategic partnerships must be chosen for their receptivity to new ideas, as well as for their ability to disseminate what they have learned throughout the organization. Internal seminars must be set up to spread this knowledge, special programs must be created to evaluate the relevance of this knowledge to the company's particular circumstances, and career patterns must be planned to see to it that ideas are rapidly passed on and implemented in key locations.

However, direct experience usually teaches most effectively. Therefore, the more people who can be involved in the learning experience that strategic partnerships provide, the sooner change will be made back home.

The term "Corporate Venturing" refers to the participation of large corporations in the venture-capital process. It involves the taking of minority equity positions in young companies with substantial growth prospects at a point in their development prior to going public. Companies and wealthy individuals have been investing in high-risk businesses for as long as capitalism has been around. But the venture-capital industry—the explosive growth in formalized managed funds for investing in small businesses—is a phenomenon of the 1980s.

Venture-capital funds are interested only in investments offering high financial returns. Investment targets are typically 50 percent per annum in individual investments—equivalent to a fivefold increase in the value of the investment over four years. Returns like this are generally attainable only in high-risk ventures in which companies are trying to introduce new technologies or open up new markets, or are at a critical phase in their growth plans.

Venture capitalists must have an "exit route" for their investments.

Venture capitalists must also have an "exit route" for their investments, that is, they must have a method of turning the investment into cash. A public offering of equity securities or acquisition by a large company are the main exit routes available.

The leading funds practice a "hands-on" approach to management, which entails monitoring performance closely against plan, providing advice and support when it is needed, and exerting pressure on management when things are going badly. All of these activities can be time consuming; start-up companies are great devourers of management time. As a result, six or eight investments are the most a venture-capital executive can generally handle at one time, and many funds will handle only one or two startup situations a year.

Industrial companies usually make venture-capital investments for one or more of the following strategic reasons:

- To obtain an advance warning of key technological and market developments that might affect their own businesses — "a window on emerging technologies"
- To provide selective opportunities for commercial relationships with investee companies — through OEM deals, licensing, joint ventures or research contracts
- To provide a mechanism for exploiting in-house technology in partnership with smaller companies, including business spinoffs
- To prospect during the early stages of a major diversification program for emerging growth sectors and companies

An important additional benefit of corporate venturing is access to the broader venture-capital "deal flow."

One of the most important additional benefits of corporate venturing is access to the broader venture-capital "deal flow." For example, an investment proposition that may be unsuitable for venture-capital investment per se may provide commercial opportunities through contract R&D or technology licensing. Some companies may represent legitimate acquisition candidates. And finally, involvement with entrepreneurial businesses can perform a valuable role in educating the investing company's executives, by exposing them to new ways of running a business and helping them develop the special management skills involved in the task of dealing with another company.

Benefits and Liabilities for Investee Companies

A corporate partner offers a small company access to large-company management skills, marketing networks and technical expertise, and to the credibility that a big company has. On the other hand, being tied to a large company can restrict a small company's freedom of action. For example, it may make it more difficult to obtain contracts with the corporate partner's competitors, and it could restrict the options if the shareholders wanted to sell out at a later date.

Approaches to Corporate Venturing

There are four ways in which corporate venturing activity can be organized, and many companies use a combination of these approaches. They are:

- Through an in-house new-ventures division
- By establishing a self-managed but independent fund
- By investing in externally managed funds
- By ad hoc investments and coventuring

Many companies have found it difficult to take a purely internal approach to venturing work.

Many companies have found it difficult to take a purely internal approach to venturing work. (Those that have tried and failed include Exxon and BOC.) First of all, it is difficult to attract the right kind of staff. Running a venture-capital portfolio requires considerable management skill, and it involves monitoring and decision-making processes different from those generally used for a wholly owned subsidiary. Professional venture capitalists avoid these staffing problems by offering financial incentives to management personnel including, for example, equity participation in portfolio companies and performance incentive programs.

Perhaps the greatest danger in all in-house ventures is overly high expectations.

But perhaps the greatest danger in all in-house ventures is overly high expectations. It usually takes well over five years for even very successful new businesses to become of major importance to the large company. Waiting for the results requires patience and continuity of commitment. In their desire to get internal support, promoters of corporate venturing deals often yield to the temptation of overplaying the benefits and giving insufficient emphasis to the risks. As a result, senior management overreacts to the inevitable delays and the problems that arise. The failure of a single company provides the ammunition for antagonists elsewhere in the company to sabotage the entire initiative. Furthermore, financial difficulties or changes in corporate objectives and management can torpedo a well-set-up venturing program. And because venture-capital decisions tend to be viewed in the same way as larger investments, they receive a high profile within the company.

In a self-managed fund, the venture is financed not on the basis of a case-by-case competition with other projects, but from a definite amount of money set aside in a special fund. A separate venture-capital team is usually recruited to run the fund at arm's length from the parent company. This is an approach commonly used in the United States, where there have in the past been important government incentives for investment through small business investment corporations (SBICs). Ferranti and Olivetti are two European companies that have set up funds to provide venture capital to U.S. businesses using the SBIC vehicle.

Investment in venture-capital funds has some important advantages over the other approaches to corporate venturing.

Investment in venture-capital funds has some important advantages over the other approaches to corporate venturing we already have discussed. First, investing in a fund that is external to the company provides a ready mechanism for making and managing long-term, high-risk investments without many of the cultural and organizational problems associated with an in-house or 100-percent-owned operation. Second, investing in an externally managed fund also ensures that the corporate investment will be reinforced by institutional money (perhaps by a factor of several times). This helps to spread the risks, and it increases the number of companies with which the investor can become involved. Finally, an externally managed fund provides a much better window on the venture-capital community. Participating fully in the venture-capital community gives companies many more opportunities for deals than if they invested alone.

On the other hand, many companies are not in favor of investing in externally managed funds because of the investors' limited access to the investee companies.

"Coventuring" is the process by which the corporate investor makes a direct capital investment *alongside* other venture capitalists or corporate investors. This is an approach used by companies with no specialized corporate venturing staff that want to make occasional investments in companies of interest to them.

Corporate venturing is now a well-established tool of corporate development in the United States, but many companies find it difficult to get the management formula right.

Corporate venturing is now a well-established tool of corporate development in the United States, but despite the continuing growth of interest, many companies find it difficult to get the management formula right. Europe has been slower to recognize the potential of corporate venturing. Companies active in it include Siemens, Olivetti, Philips and Elf Aquitaine. However, in many of these cases the first priority has been to establish venture-capital funds across the Atlantic — in order to watch trends and gain access to the wealth of developing technology in the United States. In other cases, attention has been focused on spinoffs.

Euroventures, founded in 1984 by the European Round Table of Industrialists, is one of the most interesting European venture-capital funds. One of its principal objectives is to encourage pan-European collaboration through investments from a network of regional funds throughout the European Community.

In Japan, the development of venture capital is still at a very early stage, and what there is tends to be more institutionalized and cautious than in the United States. Starting a business from scratch in Japan is extremely difficult, because it is difficult to attract good staff. This is because it would be extremely difficult for employees to find new employment in the event of business failure. However, Japanese companies do show increasing interest in investing in growing companies, particularly in the United States. The large trading companies have been active catalysts in this process. Both Mitsui & Co., Ltd. and Mitsubishi Corporation have organized U.S. venture funds, backed by Japanese industrial companies interested in accessing U.S. technology, and several Japanese funds are internationalizing their operations. For example, Japan Associated Finance Company (Jafco) now has operations in San Francisco, Hong Kong and Singapore.

For the present, though, Japanese companies seem to be more interested in making direct investments. One of the most active companies practicing this approach is Canon, with minority stakes in Energy Conversion Devices, Rise Technology and Zygo. Kyocera, Nippon Steel and Kobe Steel are also beginning to experiment with corporate venturing.

In developing a venturing strategy, it is necessary to establish:

- The business objectives
- Target sectors
- The geographic coverage sought
- The extent to which startups or more advanced investment opportunities are to be pursued
- The degree of influence sought in investee companies
- The eventual commercial benefits sought
- The relationship with other business-development strategies

The size of the investment will depend on the company's objectives, financial resources, and other business-development strategies.

Investment in venture-capital funds should always form part of the corporate venturing strategy.

In any case, investment in venture-capital funds should always form part of the corporate venturing strategy. Investing in a fund is a good way for a company to build up a portfolio of interests in a wide range of companies quickly, without having to get involved in complex internal discussions on a case-by-case basis. The sheer number of investments in which a fund is involved protects the program from many of the risks to which corporate initiatives are subject—and some of the portfolio companies can be expected to perform extremely well. The cost of initial entry is low: an investment of $1 million or less can secure involvement with a fund for a period of roughly five years.

With a larger investment it is possible to construct a tailormade fund that allows the investor to focus much more closely on its particular areas of interest. The investing company can expect to have full participation in the fund's management board, and it can expect to have the opportunity to attend regular meetings to discuss investment prospects. Having a larger corporate investor also will benefit the fund by attracting more passive institutional investors.

Whatever the approach adopted for corporate venturing, a systematic search should be made for professional fund managers. The final selection generally should rest on three factors — expertise in target industries and markets, track record, and a willingness to meet the corporate investor's requirements. Obviously, there must also be a suitable fund open for investment at the time, or the chosen fund manager should be willing to create one.

The real danger to a company's venture-capital team is direct investments. They will inevitably be subject to more intense scrutiny by company management, including more conservative forces quick to pounce on investment failures. One way of minimizing this danger is to focus the initial direct investments on second- or third-stage financing deals where the technology or product is well advanced, and where the strategic benefits to existing core businesses are more likely to come through quickly.

Corporate-venturing program managers must be excellent at networking — internally and externally.

Corporate-venturing program managers must be excellent at networking — internally and externally. And while they must be able to assess the relevance of technologies to the company's business, they must have a fundamentally commercial perspective. In order to manage a successful program, the fund manager should have a clear strategic vision of what corporate venturing can and cannot do for the company.

Top management support is vital for any corporate-venturing program.

Top management support is vital for any corporate-venturing program. The chief executive officer is sometimes tempted to try to retain the same degree of control over venture-capital decisions as over major acquisitions. This is a recipe for failure. Once the commitment to the program has been made, operational responsibility should be handed over to the corporate venturing team. Funds must be clearly set aside for investments — ideally over a five-year period. And all but major investments should be the responsibility of the corporate venturing team, so that decisions can be made quickly.

Gaining the Strategic Benefits

The real measure of the success of a corporate-venturing program is the impact it has on the corporation's business—something that very much depends on how the interface with portfolio companies is managed. In order to achieve a successful interface, managers at different levels and in different parts of the corporation must be closely involved in the program—they must be involved with the R&D staff to evaluate technology and to set up joint development projects, and with commercial managers to ensure effective exploitation. It is important to work out the organizational responsibilities early in the program and gain the commitment of senior-level opinion formers and decision makers.

Regular visits should be made to portfolio companies to watch progress and discuss possible areas of cooperation. This must be achieved, however, without trying to exert excessive influence. Establishing a single point of contact within the corporation for day-to-day exchanges is important for smooth relations.

Translating a technical interest in collaboration into commercial reality is one of the most difficult aspects of venturing.

Translating a technical interest in collaboration into commercial reality is one of the most difficult aspects of venturing. It is the task of the corporate-venturing team to get commercial departments involved in projects early and, if necessary, to sponsor directly the R&D work required to create these linkages. Good personal relationships between a few key individuals are essential to getting effective commercial collaboration.

Many multinationals fail to exploit international venturing opportunities.

For overseas investments, local management should have the primary responsibility for the liaison. It is usually practical for a company to engage in international venturing only if it has the business-development and R&D capabilities to investigate directly the opportunities for investment that exist in other countries. Many multinationals fail to exploit international venturing opportunities because they do not have the right people on the ground searching for them.

Managing the vertical supply relationships that many corporate investments are designed to facilitate is discussed below in more detail on pages 56 to 63.

While the term *joint venture* can refer to a variety of different business relationships, from OEM supply agreements to the merger of major operating units, in this section we are concerned with one type only: equity partnerships involving the creation of a totally new organization.

New joint ventures enable a company to gain access to a new geographic market or customer base, to circumvent import restrictions, to accelerate entry into a new product market requiring skills that neither partner can provide alone, and to share costs and risks. Many joint ventures also give partners the opportunity to exchange skills that are relevant to their broader business portfolios.

Any company considering creating a joint venture must evaluate the options carefully. It must make a thorough assessment of the resources it needs for the commercial operation, and it must evaluate the other means of obtaining those resources.

An equity joint venture differs from other forms of alliances in the extent of the power sharing involved. Once the agreement is signed, management is handed over to an executive team, which can usually behave autonomously. It must make the venture a success as an entity, while seeing to it that the interests of the shareholders are served. Unfortunately, as the circumstances and objectives of the partners change, the chances of any one partner being fully satisfied diminish.

Equity joint ventures are inherently unstable.

Equity joint ventures, therefore, are inherently unstable. Before negotiations with potential partners are started, a thorough analysis of the strategic and commercial context is essential. This analysis should cover such important questions as:

- What is the objective of the joint venture and how else might it be achieved?
- What are the strategic objectives of the partners in the medium and long term?
- What will be the commercial and financial relationships between the parents and the joint venture?
- What would be the impact on the joint venture and on its parents of possible changes in the commercial environment in which it operates?
- How are the strategy and role of the joint venture likely to develop, and what will be the joint venture's impact on the parents?

Companies that do not undertake the necessary analysis in advance will fail to exploit their joint ventures effectively, or will be outmaneuvered by a stronger partner or fall foul of changing circumstances.

Companies that do not undertake the necessary analysis in advance will fail to exploit their joint ventures effectively, or will be outmaneuvered by a stronger partner or fall foul of changing circumstances.

Understanding the Strategic Context

In many cases, the objectives of the partners to a joint venture are different. Nevertheless, there generally are four important reasons why companies embark on these new alliances:

- To exploit a new product-market opportunity
- To exploit an overseas market
- To manufacture in a local market
- To acquire knowledge or technology for the core business

Exploiting a New Product-Market Opportunity — Companies with a strong R&D base frequently develop a technology that offers the opportunity to enter a new area of business for which they lack the appropriate skills and resources. This happens more and more frequently as the interconnections between technologies grow more complex. The options for commercial exploitation in these circumstances include the following:

- License the technology for commercial exploitation by other companies
- Develop an in-house business by recruiting and buying-in key skills
- Acquire a company (or companies) with the missing skills
- Initiate an appropriate joint venture

Licensing is the simplest route, but it is suitable only where a proprietary technology has been created that will not be rapidly superseded by later developments. This situation tends to be limited to areas like pharmaceuticals and chemicals, where patent protection is strong. And because the originator does not build a genuine business around the technology, it is unable to promote the use of the technology in different applications markets.

In-house development offers the greatest degree of control. However, it is rather slow, and large businesses usually have difficulty providing the independence that a new business needs. A partial spinoff, in which outside equity is introduced, can sometimes be used to provide a more entrepreneurial culture, but this is appropriate only if the new market is unlikely to constitute an important part of the future core business.

Acquisition is, in principle, an attractive means of obtaining the resources required to enter new markets. However, the cost is often high (especially if the missing resource is an effective global marketing network), and integration of resources is usually more difficult than expected. Also, there may not be a suitable acquisition candidate available.

Joint ventures frequently provide the quickest and most cost-effective means of market entry.

So joint ventures frequently provide the quickest and most cost-effective means of market entry. They can help companies that possess sufficient technology but lack adequate manufacturing or marketing skills to acquire what they lack. They can help companies combine technologies to enter new applications markets, and they can help companies with little or no relevant technology to diversify into new markets. In some cases, the venture constitutes a carefully planned move to change the core business portfolio; in others, it is an opportunistic move to exploit proprietary technology that would otherwise lie fallow.

As markets become more international, it becomes essential for companies to have an effective marketing presence in all of the world's major markets.

Exploiting an Overseas Market — As markets become more international, it becomes essential for companies to have an effective marketing presence in all of the world's major markets. The principal ways in which companies can sell into export markets are by:

- Exporting from the home market base — either directly or through OEM contracts organized through a local marketing subsidiary
- Establishing a wholly owned manufacturing or marketing facility
- Joint venture with a locally based company
- Acquiring a local partner or obtaining an equity position
- Manufacturing under license by a local company, with income obtained from royalties and the possible sale of components

In most national markets, it is essential to have local management, and this can make the creation of a wholly owned overseas subsidiary difficult and time consuming. A joint venture provides a means of accelerating market entry and reducing entry costs, though often it is seen as merely a temporary strategy—a prelude to outright acquisition or the establishment of a separate wholly owned operation.

Overseas marketing is particularly difficult where a "systems sell" is involved, requiring substantial local engineering input to meet individual customer requirements and strong aftersales service. Building up this capability from scratch through a green-field site investment is usually out of the question. Setting up the operation through an equity joint venture (as opposed to a straight distribution or VAR relationship) provides a way in which the supplying company can participate in the locally generated value-added items.

One reason for using joint ventures to set up assembly or production in major overseas markets is to diffuse political pressure from local companies that wish to share in the manufacturing value-added.

One reason for using joint ventures (as opposed to wholly owned companies) to set up assembly or production in major overseas markets is to diffuse political pressure from local companies that wish to share in the manufacturing value-added. Often, in the developing countries, local participation is expressly required by law, but there and elsewhere more subtle forms of commercial and political pressure can also be brought to bear.

Manufacturing in a Local Market — A local company can team up with an overseas supplier by:

- Acting as a straightforward distributor
- Selling imported products under its own name as an OEM customer
- Forming an equity joint venture
- Manufacturing and marketing under license

The share of added value that the local company enjoys increases with its degree of involvement in the venture. A company with a strong local brand or distribution network is an ideal OEM customer for the overseas supplier. However, a local manufacturing joint venture may provide the opportunity to negotiate greater participation, especially if it has government backing. The J2T joint venture is a good example of this. When Thorne EMI and Thomson consented to act as OEM customers for JVC's VHS videorecorders in Europe, it was agreed that a European manufacturing joint venture would be created if sales reached a certain level. The joint venture gave Thorne EMI and Thomson the opportunity to participate in some of the manufacturing profits from VCRs as well as in the marketing profits.

Equity joint ventures are of particular value in giving partners the opportunity to learn from one another.

Acquiring Knowledge or Technology for the Core Business — Equity joint ventures are of particular value in giving partners the opportunity to learn from one another, since they provide direct access to technologies that have reached or will soon reach commercialization. They usually provide access not just to the hard technology of the product, but also to the product planning and design skills that go with its development, the manufacturing skills that enable it to be made efficiently, and the management skills involved in setting up a new business operation. Once a company has learned new skills and technologies, it can usually apply them to businesses outside the joint venture.

Technology transfer is an important objective of many joint ventures, though generally this is a long-term goal, which sits alongside the shorter-term financial and marketing objectives. Increasingly, in industries like consumer electronics and semiconductors in which Japanese companies

have obtained supremacy, joint ventures are being created to transfer know-how from East to West. NUMMI is a good example of a two-way flow: in this joint venture Toyota is gaining the experience of operating in the United States, and General Motors has the opportunity to learn Japanese manufacturing methods—besides giving GM the opportunity to experience Toyota's management approach.

Commercial and Financial Relationships with Parents

Joint ventures must yield financial as well as strategic benefits. Whatever the strategic context of the venture, the direct financial impact it has on the parent is a key yardstick of the joint venture's performance. And the answer is seldom simple, for joint ventures involve companies in varied and intricate commercial and financial relationships from which different partners benefit in different ways, with conflicting objectives being inevitable.

Financial benefits can flow directly from the joint venture to its parent through —

- Dividends on profits
- License royalties on designs or technologies developed by the parents
- Purchases of raw materials, components or assemblies from the parents
- Consultancy or management fees
- Growth in the capital value of the joint venture's assets
- Economies of scale in the parent (through sales of components or raw materials to the joint venture and the resulting reduction in unit costs)
- Profits made by the parents from marketing products produced by the joint venture

In choosing among the possible commercial and financial relationships, each parent needs to evaluate the tax implications and assess the impact of the aforementioned factors on its balance sheet and in its income accounts. For example, dividends are often the least important financial consideration. Many of the joint ventures we studied had never declared one, as profits accrued directly to the parent companies by way of transfer prices, royalty payments and commissions.

Joint ventures between Western and Japanese companies have special problems.

Joint ventures between Western and Japanese companies have special problems. Japanese companies are used to paying only modest dividends. Moreover, there are also different attitudes toward the treatment of manufacturing and marketing profits. Western companies usually regard both as important profit centers; Japanese companies tend to see manufacturing as the principal source of profits. The function of marketing, in their view, is to achieve maximum market share. Prices may also be set in a way that takes account of anticipated learning-curve improvements in manufacturing costs. It is then up to manufacturing to ensure steady cost improvements. These differences in attitude can cause partners to have different financial expectations of joint ventures, although the conflict may become apparent only when circumstances change.

Anticipating Strategic Developments

Parents involved in a joint venture will be continually developing their own strategies.

Parents involved in a joint venture will be continually developing their own strategies; each must understand how the relationship between the joint venture and its own business is likely to evolve. The joint venture may gradually become more or less important to a company's core business.

Also, technological developments will create new opportunities, perhaps rendering the role of the joint venture's business irrelevant. For example, within the next ten years many of the functions presently fulfilled by complex electronic systems will be carried out by simple devices or even single components, optical storage technology will take over from magnetic storage, and the computer manufacturers of the future are likely to lean heavily on the skills of the consumer electronics companies of the present. Parents in electronics joint ventures have the choice of exploiting these opportunities directly or in collaboration with their partner through the joint venture. The balance of power between the partners will change, depending on who has the strongest technology, is best financed, and is best organized to exploit these strengths.

One of the most important factors in successful joint ventures is trust.

It is essential for a company to try to understand the aspirations of its partner, particularly if the partner is an actual or potential competitor. Each joint-venture situation raises a whole series of such questions, which must be tackled at the outset when the possibility of a joint venture is being considered and potential partners are being evaluated. The answers should influence not just the selection of partners, but also the structure of the agreement and indeed the decision as to whether a joint venture is the appropriate vehicle. Ultimately, one of the most important factors in successful joint ventures is trust; and trust can be easily destroyed by surprises.

Preventure Planning

Having examined the strategic framework within which the joint venture is likely to operate, the next step is to carry out detailed preventure planning. Two main aspects of this effort are outlining a business plan for the joint venture and identifying and screening potential partners. In practice, these two activities are carried out simultaneously and exert constant influence on each other. The precise form of the relationship will depend on what the parties have to contribute, and this may become clear only during negotiations.

Our study disclosed that a lack of planning is surprisingly common in strategic alliances.

Our study disclosed that a lack of planning is surprisingly common in strategic alliances. As with any other initiative requiring a major commitment of assets and management time, companies considering undertaking a joint venture should first prepare an outline business plan describing the rationale for the initiative and defining its objectives. This plan should also indicate the anticipated resource requirements as well as describe the venture's operations. It should take into account the overall operation, not just the inputs of one particular parent, and it should cover the related inputs and activities of the parent companies. It should also evaluate alternative means of achieving the business objectives, such as through licensing or acquisition.

The main topics to be covered by the venture plan are listed in Exhibit C. Very little may be known about some of these topics at the early stage, and it may be necessary to commission external consultancy studies—on technology, market characteristics, competitors or financial matters.

These will help pinpoint those areas where information on potential partners must be gathered later on.

At the same time it is important to have a flexible strategy, especially when it comes to joint ventures created to exploit novel technologies. In this kind of business, adaptability is generally a vital ingredient, since the most lucrative applications and the best means of marketing will become clear only over time.

Preparing the Ground Internally

One of the jobs of the sponsor is to ensure that all the key people on whose success the venture will depend get a chance to have their views heard and to participate fully in the planning process.

Widespread support can be best guaranteed if the venture is sponsored at a senior level in the company — either by the chief executive or by a director who is able to obtain the CEO's wholehearted backing. One of the jobs of the sponsor is to ensure that all the key people on whose success the venture will depend get a chance to have their views heard and to participate fully in the planning process. The failure of one of the joint ventures we examined was clearly attributable to a lack of effective consultation.

Internal consultation will reveal early on the interests of the individuals concerned regarding the proposed venture: the potential allies for the venture and the misgivings of potential dissenters. This is particularly important for companies undertaking a very extensive collaboration program where the impact of each new move on existing relationships must be evaluated; some companies with extensive partnership programs have set up special internal mechanisms to assist this process.

Partner Selection Criteria

In drawing up a profile of the ideal joint-venture partner, it is necessary to consider both the resources which it will be required to contribute and a variety of less easily measurable characteristics. Many of the characteristics of an ideal partner are in practice rather difficult to define. But provided the major selection criteria are established at the outset, the partner search and screening exercise will reveal the key sensitivities and stumbling blocks.

The venture plan should indicate what resources the venture will require over all.

The venture plan should indicate what resources the venture will require over all. Preparing a simple table of key resource inputs, as in Exhibit D, helps identify what the initiating company can contribute to the joint venture, and what resources are required from the other partner(s). The resources required must be defined in some detail. For example, having "strong marketing skills" is not the same as having relevant distribution networks in target markets.

EXHIBIT C — THE VENTURE PLAN

INTRODUCTION	— Background — Business need or opportunity — Objectives of business initiative
PRODUCT(S)/ SERVICE(S)	— General description — Circumstances of use by purchasers — Research and development (current status and work to be undertaken) — Patents, licenses and other intellectual property rights — Future development plans, including follow-up products
THE MARKET	— Market size and anticipated changes — Market segments — Prospective customers and their needs — Nature of the purchase decision — Distribution chain — Dependence on third parties — Impact of new technologies — Assessment of competition

BUSINESS STRATEGY	— Means by which it is proposed to secure and retain competitive advantage
	    — Technology
	    — Marketing
	    — Cost
	— Project phasing

RESOURCE REQUIREMENTS	— Product range (in-house and bought-in products or components) — Research and development — Production capabilities — Facilities — Marketing skills — Market access/distribution networks — Systems-engineering capabilities

EXHIBIT C — **THE VENTURE PLAN (continued)**

RESOURCE REQUIREMENTS (continued)	— Aftersales capabilities — Management — Finance — Resources to be contributed
STRATEGIC OPTIONS	— Structure of commercial and financial relationships under alternative means of implementation (acquisition, joint venture and in-house development) and in each case: — P&L and balance-sheet projections from the alliance — Financial flows to parents — Impact on balance sheet of parents — Financial requirements — Return on parent's capital — Analysis of alternative strategies — Strategic and financial impact
KEY ISSUES	— Principal risks and problems — Proposals for meeting the identified risks and problems
FUNDING	— Amount of startup funding required — Projected return on capital
APPENDICES	— Technical reports — Market surveys — Additional detailed information

EXHIBIT D — KEY RESOURCES AVAILABLE

	VENTURE REQUIREMENTS	KEY FACTORS FOR SUCCESS	INITIATING COMPANY CONTRIBUTION	IDEAL PARTNER CONTRIBUTION
Technology				
Product				
Market Access				
Marketing Capacity/Expertise				
Manufacturing Capacity/Expertise				
Customer Support				
Management				
Finance				
Other				

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