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Criteria for Selecting Joint Venture Partners

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by

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ABSTRACT

Selecting partners with compatible skills is not necessarily synonymous with selecting compatible partners. This paper identifies and discusses several criteria executives may employ when evaluating the suitability of prospective partners, including complementarity of technical skills and resources; mutual need; financial capability; relative size; complementarity of strategies and operating policies; communication barriers; compatibility of management teams; and trust and commitment between partners.

CRITERIA FOR SELECTING JOINT VENTURE PARTNERS

A small technology company, let's call it Alpha Corporation, developed an advanced design for a computer peripheral. Lacking the manufacturing and marketing acumen, as well as the financial muscle, necessary to rapidly commercialize this breakthrough, Alpha's managers decided to seek assistance via a joint venture (JV). They approached several firms and, after spending much time analyzing the technical compatibility between their own and prospective partners' companies, agreed to venture with one of the industry's dominant firms. Their decision was announced amidst great fanfare--press releases, a company-wide celebration, champagne. Analysts lauded the decision and predicted spectacular results. Alpha's stock nearly doubled in value.

Another success story from the Silicon Valley, right? Wrong! Within a year the venture had been dissolved, Alpha's stock price had tumbled, and the executives who helped set up the venture had departed for greener pastures. What had happened? According to the survivors of this debacle, the JV confronted problems almost from Day One. Because of differences in the partners' sizes and management styles, venture teams constantly complained of an inability to work together. Managers from Alpha, used to making quick decisions and then acting upon them, were frustrated by the slow moving bureaucracy of their larger partner. Alpha's designs were repeatedly, and their employees thought unnecessarily, subjected to modifications by the partner's researchers. Product introduction was delayed by several months when the partner unexpectedly transferred several critical personnel to another project. Complaints to the partner's headquarters frequently appeared to be ignored. To make matters worse, the delays enabled a competitor to beat them to the market with a similar product.

Alpha's managers did not adequately consider the differences between selecting a partner with compatible skills and selecting a compatible partner. They wanted to establish a venture which would achieve corporate objectives, but this meant different things to the two companies. The Alpha Corporation example is especially insightful because a surprising number of managers do not probe deeply enough into the issue of compatibility between their own and prospective partners' companies. They want very much to believe that they are building a lasting relationship with their partners--but they're not. Establishing a lasting JV relationship is a complex process, and the degree of compatibility between partners is only one of the variables influencing that process. Yet, although selecting a compatible partner may not always result in a long-lived and successful joint venture, selection of an incompatible partner virtually guarantees that the venture's performance will be unsatisfactory.

Previous studies have devoted most of their attention to motivations for forming a JV, as well as managing the venture once it has been established. In contrast, this paper identifies and discusses several critical criteria which executives may employ when evaluating a company's suitability as a JV partner. The discussion is based primarily on a series of interviews with corporate executives regarding the joint venture experiences of their companies. These executives, almost exclusively from senior levels of their management hierarchies, had been intimately involved in identifying and selecting partners for one or more JVs.

CRITERIA FOR SELECTING PARTNERS

Defining a set of criteria for selecting the "right" partner would be roughly analogous to telling a person how to pick the "right" spouse--

certainly a difficult, if not an impossible, proposition. Selection of a partner who will be compatible in the long term is a complex and individualistic endeavor. Each joint venture is unique in its own way, and must be approached accordingly. Yet, there do seem to be common elements to many JVs. As a result, the experience of other managers may provide guidelines for selecting a JV partner. Several considerations regarding selection criteria--including complementarity of technical skills and resources; mutual need; financial capability; relative size; complementarity of strategies and operating policies; communication barriers; compatible management teams; and trust and commitment between partners--are discussed below.

Seek Complementary Technical Skills and Resources

The primary selection criterion is generally a partner's ability to provide the technical skills and resources which complement those of your company. If prospective partners can not satisfy this criterion, then formation of a joint venture should be a questionable proposition, at best. Therefore, technical complementarity should be viewed as a minimum qualification for selection of a partner.

Technical complementarity is determined by analyzing the key success factors--those few areas strongly influencing competitive position and performance--confronting the proposed venture. Once this is done, you must evaluate your company's current and anticipated future competitive position relative to these factors. Those areas where deficiencies exist can serve as the basis for assessing the technical complementarity of a partner. However, the analysis should identify more than merely a financial deficiency--such resources may often be accessed via other options which will not entail the extensive managerial involvement of a partner. Although initially appealing, a JV based solely on a partner's financial contributions is unlikely to foster long term compatibility.

Technical complementarity can assume many forms. A common alliance consists of one parent supplying technology and the other furnishing marketing and financial capabilities. For example, an American medical equipment company wanted to expand sales of its product line in Europe. However, because of its small size and limited name recognition, the company was hesitant about increasing penetration of the European market on its own. Instead, it sought assistance from a JV partner. Strategic analysis of the proposed investment suggested that the partner must be a recognized player in the medical supplies industry and have sufficient financial and marketing resources. The partner would also need to evidence the technological sophistication necessary to demonstrate the technical advantages of the American firm's products. Companies not satisfying this set of criteria were rejected as possible co-venturers.

Seeking a partner with complementary technical skills and resources can permit each partner to concentrate resources in those areas where it possesses the greatest relative competence, while diversifying into attractive but unfamiliar business arenas. Rather than intensifying weaknesses, JVs can thus be a means of creating strengths.

Mutual Dependency: A Necessary Evil

Many managers have viewed dependency upon other organizations as undesirable, and have avoided such situations whenever possible. However, in identifying suitable JV partner prospects, there should be some identifiable mutual need, with each partner supplying unique capabilities or resources which are critical to the venture's success. Proper matching should result in both partners perceiving that they have a vested interest in keeping the venture working, rather than resorting to some non-JV form of investment. By having one partner strong where the other is weak, and vice versa, mutual respect will be fostered and second-guessing and conflict can be mitigated.

Prior experience suggests there should be a "middle level" of dependency between partners. If the level of dependency is too small, the JV is unlikely to survive difficult times. On the other hand, too much dependency may prove unstable because of fears of the consequences of loss of a partner. The latter case commonly occurs when small firms JV with much larger partners. A small firm may feel insecure, since it would not be able to fully exploit a market opportunity by itself, or only at a much slower rate and at a greater risk than in a shared endeavor. The smaller firm tends to be hungrier, and may need revenues from the JV more than a larger partner. In addition, as discussed earlier with the Alpha Corporation example, association with a prominent partner may influence the smaller concern's stock price. This is particularly worrisome if later termination of the venture is attributed to unsuccessful commercialization of the smaller firm's technology. While the larger firm may emerge relatively unscathed, JV termination may severely disable the small firm by causing customers, employees, and Wall Street to question the firm's viability. The resulting damage to its reputation may cause a precipitous decline in its stock value, harm morale, and limit the available strategic options.

Painful lessons regarding dependency between partners were experienced by many companies which, in the late 1970s and early 1980s, formed ventures with Asian firms as a means of rapidly accessing cheap labor or new markets. Frequently, American corporations contributed the initial technology and some of the financing, and they trained their partners in the intricacies of running the business. Once this was accomplished, several of the ventures were dissolved and the partners later used technology obtained from the JV as a weapon against their former U.S. allies.

Several options are available for helping insure that JV partners will continue to perceive themselves as mutually dependent. One method of reinforcing mutual dependence is to establish some means of "exchanging hostages." For instance, it is often possible to insert conditions into a JV agreement whereby a unilateral decision to prematurely break up the corporate marriage will result in a substantial charge of some sort, "alimony" payments if you will, as well as covenants against engaging in competing activities within a specified time period. It may also be possible to guarantee cross purchases of specified volumes of products or services by the partners. This option can help reduce the potentially devastating impact of a break-up upon a more-dependent firm by guaranteeing access to critical raw materials or sales revenues during the painful readjustment period. By employing techniques such as these, the threat posed by dependency on a partner can be reduced substantially.

Avoid "Anchors"

When contemplating a JV, be sure that your prospective partner can generate the level of financial resources necessary for maintaining the venture's efforts. Managers frequently note their avoidance of potential "anchors"--partners which are likely to slow venture growth and development due to an inability or unwillingness to provide their share of the funding. As the vice president of a major manufacturing concern remarked, "Partners will almost always have differences of opinion regarding expansion. A small company may have fewer financial resources available for shouldering its portion of an expansion, or have to pay a higher financing rate than does the larger partner. This can not only cause operating problems, but may also result in some bruised egos, which can further intensify the difficulties."

A partner's inability to fulfill its financial commitments--whether due to small size, financial difficulties in its other operations, or the existence of different discount rates and time horizons--can create turmoil for the venture and its managers. Particularly in the early stages of a JV, when large negative cash flows are more likely to be encountered, the presence of an "anchor" can jeopardize an entire project. Commenting on his company's experiences, one senior executive commented that, "The joint venture was functioning quite smoothly and was meeting or surpassing both companies' projections until the financial demands exceeded (the other company's) capabilities .... The resulting animosities ultimately caused the venture to be dissolved."

Although it is not always possible to identify potential "anchors," several tell-tale signs may suggest the need for further inquiry. As one executive suggested, "You have to look at the partner's balance sheet and ask: 'Is it a financially solid company?' You have to look at their plans for growth and their profit orientation. Is there a difference in the strategic importance placed on the JV's activities? Is the partner likely to confront financial problems in one or more divisions? If so, what will be the effect upon other activities of the partner, especially the JV?"

A prospective partner's resource constraints can constitute a significant hurdle to the establishment of a successful JV. However, if proper precautions are observed, the presence of a partner with meager financial resources need not prevent JV formation or a premature buyout or termination. Especially when insufficient financial contributions are not due to financial insolvency, it may be possible to reduce noncompliance. For example, the agreement may include penalties if either partner attempts to back out of the relationship or otherwise sidestep its financial obligations. The agreement might also stipulate that the companies can not engage in similar activities for a specified period of time. Furthermore, the agreement might be structured such that shareholdings or payouts are contingent upon the level of each partner's contributions, thus minimizing perceived inequities which might result from disparities in financial contributions. The use of these and similar mechanisms can reduce the undesirable effects of an "anchor" upon JV activities.

Relative Company Size: The Elephant and the Ant Complex

Relative company size is often of paramount concern when evaluating a prospective partner. Although exceptions are numerous, joint ventures often have the best chance of succeeding if both parents are comparable in sophistication and size, preferably large. When a small company decides to JV and chooses a similarly-sized partner, the companies frequently magnify each other's weaknesses. This is less often the case between two large firms, which are likely to have similar values and control systems, similar tolerances for losses, and similar appetites for risk. Crises are less common in large firms, particularly in regard to short term cash flow. Thus, larger companies typically offer greater "staying power," being able to commit a greater volume of resources over a longer time horizon.

Yet, sometimes ventures between firms of different sizes seem warranted. Size differences may yield synergies for the partners. A smaller company with innovative technology may venture with a large corporation which offers the financial and marketing clout necessary to commercialize that technology, as was the case with the Alpha Corporation example. Similarly, Nike, an innovative designer of athletic shoes, teamed up with Nissho Iwai, Japan's sixth-largest trading company. And in 1978, Advanced Micro Devices, with $62 million in sales, formed a venture with Siemens, West Germany's largest electrical company, to produce a line of microcomputer systems and related products.

When partners evidence significant size discrepancies--dubbed "the elephant and the ant complex" by one executive--managers must be aware of the problems which may result. One frequently voiced concern is the possible domination of one company over the other, as addressed earlier during the discussion of mutual need. A related problem is that the different operational environments and corporate cultures of the partners may appear incompatible. For instance, the typically bureaucratic environment of many large firms, with a relatively slow decision making apparatus and a voracious appetite for information gathering and analysis, sharply contrasts with the more entrepreneurial and quick-response orientation characteristic of small firms. A small business, accustomed to reacting within short time frames, may feel paralyzed by the seemingly glacial pace at which the larger company operates. Yet, the small company's prodding and sense of urgency may make the larger partner nervous. The large company may interpret its smaller partner's spartan environment and informality as indicative of a fly-by-night, shoe-string operation that may not remain in business for long. Furthermore, the larger firm may perceive that most or all of the risk is being borne by itself--educating a sales force and customers about a new product's features; assuming responsibility for warehousing, distribution, and sometimes production; lending credibility to the product, along with enhancing the prestige and financial status of the smaller firm. In response to its partner's impatience, the larger firm may exercise even greater caution in its activities, further exacerbating the problem.

As the above suggests, differences in management style, decision making orientation, and perspective on time may effectively result in corporate culture shock, frustrating management from each partner and hindering the development and maintenance of good rapport. Therefore, a JV between companies of widely disparate sizes often necessitates creation of a special environment in order to foster successful venture development. For instance, it might be possible to reduce the effects of partner size differences by giving the JV virtually a free hand in product development or other activities, minimizing administrative red tape and permitting quicker response time. This emphasis on autonomy might be particularly appropriate when a venture's environment is characterized by rapid change, and slow response might be akin to a kiss of death. The willingness of a partner to allow this autonomy might be a critical consideration in the partner selection decision.

Even if managers express a strong desire for working with partners with similar "systems" orientations, that need not dictate ventures between same-size corporations. On the contrary, the relevant measure often is not absolute corporate size, but the relative size of the respective business units. Therefore, managers may seek partners evidencing similar size at the business or division level. Another possibility for minimizing the effect of size differences is for a small firm to try to identify a large firm which is both hungry and has the marketing, financial, or technical muscle necessary for a successful venture. This may require greater diligence in identifying and contacting partners, however, since these are attributes which tend to be found in certain individuals or business units rather than in an organization as a whole. Yet, their presence helps ensure that the larger partner will be sufficiently aggressive to maintain respect from customers and competitors, and there is a greater likelihood that both partners will have similar perceptions of time as a vital component in the venture's success.

Strategic Complementarity: A Prerequisite for Long Term Success

Although partner size is an important criterion for many companies, it is commonly asserted that relative size is not as important as complementarity among the partners' strategic objectives. Achieving a fit between companies' objectives for the joint venture is necessary for maintaining long-term commitment. From the outset of discussions, each partner must strive to clearly understand what the other participants desire from the union. As one seasoned veteran commented, "It is remarkable how many joint ventures are consummated where one or both partners do not clearly state their objectives. Under these circumstances, venture failure is almost inevitable."

Different objectives in forming a particular JV, including the timing and level of returns on their investments, frequently produces conflicts of interest between partners. For instance, one executive reflected upon a previous JV involving his company and an Asian firm. He noted that the venture evidenced a lack of strategic fit between the partners' objectives: his company sought rapid market access and a high rate of dividend repatriation so its stock price would be maximized, enhancing an expansion strategy based on exchanges of stock. The partner, on the other hand, sought transfer of technology and long term market development, rather than rapid financial returns. As a result of these differences, the JV performed poorly and was abandoned within a couple of years. The partner was reported to have used the acquired technological expertise to expand its own market position in Asia.

As partners' objectives diverge, there is an increasing risk of dissatisfaction and associated problems. This risk may be heightened when the venture's environment is characterized by a high level of uncertainty, since changes in a JV's operations are more likely under these circumstances. Unexpected events can cause problems because of the difficulty of formulating a mutually acceptable response to change. A power game can result, and the venture can collapse if the partners cannot reach an agreement on an appropriate course of action.

However, divergence of corporate objectives can lead to a venture's downfall even if performance is satisfactory. For example, Dow-Badische was formed in 1958 as a 50/50 joint venture between Dow Chemical and BASF of Germany, and it achieved good profitability over much of its life. Nevertheless, despite $300 million in annual sales, the venture was ultimately dissolved. BASF wanted to expand the venture, but Dow was reluctant to contribute additional capital since the venture's activities did not seem to fit within the firm's strategic focus. The gap between corporate objectives prompted BASF to buy out Dow's shares in 1978 and transform the venture into a wholly-owned U.S. subsidiary.

Although determining a prospective partner's objectives is often difficult, it is an essential task nevertheless. Failure to do so may significantly increase the prospect of later problems. The analysis needs to address not only the company's current situation and objectives, but also scenarios of its likely future position. The rationale for this is that JVs frequently encounter changes in their operating environments, and it is essential that companies anticipate how their partner is likely to be affected by, and respond to, these changes. JVs only tend to work as long as each partner perceives that it is receiving benefits or is likely to benefit in the relatively near future. Because of differences in objectives, what is good for one company may be a disaster for the other party. Therefore, a compatible partner would ideally be one with similar values and objectives, in both a short and a long term sense. Such a situation will enhance the ability of managers to interpret one another's estimates, such as sales forecasts, development schedules, and cost estimates. This is particularly critical as the strategic stakes--the size of investment, potential effect on corporate image, or relationship to the organization's core technologies--increase in scale.

Evaluate Compatibility Between Partners' Operating Policies

Another consideration during partner selection is the similarity of partners' operating policies. Executives related several instances where differences between partners' policies had caused significant problems for JVs. For instance, one venture was nearly dissolved because inconsistencies between partners' accounting systems repeatedly produced disagreement regarding timing of purchases, allocation of costs, and so forth. Since the JV was only marginally profitable, the method of reconciling disagreements could determine whether or not the venture would appear on the parents' books as a profitable operation, an important consideration for the division-level management teams. Another executive reported that differences in vacation policies between his firm and his European partner created serious difficulties for their JV because the latter company shut down virtually all operations for a month each summer, whereas the U.S. firm allowed employees to schedule their own vacation time. As a result, the venture repeatedly encountered difficulties.

Partners should be clear regarding the types of policies they will be comfortable working with. For example, U.S. and Western European firms are typically accustomed to operating with lower debt-to-equity ratios than is the case in Japan. Such policies should be addressed thoroughly before the venture is formed. Differences in operating approaches often result from cultural biases, and managers may not be conscious of their existence. They may take for granted that there is a "right" way to do certain things. As one Japanese manager stated, "Many American executives attempt to force their Japanese partners to adopt American methods of operation, in disregard of the distribution structure and other financial and management methods which have prevailed in Japan for a long time. For this reason, many JVs in Japan ultimately fail." As these examples illustrate, the compatibility of partners' operating policies may need to be considered before forming a venture.

Be Aware of Potential Communication Barriers

Communication is another potential problem area. By nature, JVs tend to be fragile agreements, and communication problems make their operation even more difficult. Such problems may occur as a result of differences between national or ethnic cultures, including language, as well as differing corporate cultures. Cultural differences can impede the development of rapport and understanding between partners. You should not overlook the importance of a partner with adequate English-language capability, or your firm's facility with the language of the partner. The simple ability to communicate with one's counterpart in the partner firm often makes a significant difference in a venture's prospects for success, and the absence of this ability has caused more than a few disasters.

Because of cultural or language differences, subtle nuances may be more difficult to communicate. This can require greater expenditures of time in negotiations, possibly delaying JV formation or major post-formation decisions. The use of buzzwords common to many industries tends to compound language problems. When buzzwords are used, misunderstandings can arise regarding each company's role in a JV. Especially in technology-oriented fields, commonly used terms may not have the same connotations for each partner. For example, specifications for the Boeing 767 jetliner called for fuselage panels to have a "mirror finish." Boeing's Japanese partners interpreted that specification too literally and engaged in excessive polishing efforts. As a result, labor costs for the initial panels were excessive, necessitating further discussions to resolve the misunderstanding. Because of risk of misinterpretation, it may be advisable to attempt to substitute simple, "Dick-and-Jane"-type terminology for technical jargon during negotiations and follow-up discussions.

The existence of different cultural perspectives implies value systems that are not necessarily compatible; you cannot assume that promoting interests from one perspective will necessarily promote interests from another. However, managers should avoid the alternative assumption that different value systems will necessarily be incompatible. Values associated with different perspectives may be similar, even if only slightly, or they may be irrelevant to each other; it is not common for them to be in complete opposition.

Prior experience suggests that language and culture tend not to be insurmountable barriers, particularly for partners from industrialized nations, although they can be an important handicap. Therefore, although cultural barriers are often considered when evaluating prospective partners, and especially when choosing between two otherwise equivalent partner prospects, they seldom function as the dominant selection criterion.

Compatible Management Teams Help Reduce Problems

It may be desirable to select a partner whose management team is compatible with one's own. Personal rapport between the principal decision makers is often an important factor in the selection decision, and the inability of management to "take to each other" has frequently been cited as the basis for rejecting a prospective partner or for terminating a venture. Close personal relationships, particularly among the senior operating-level managers, helps to nurture the level of understanding necessary for a successful JV relationship. Managerial compatibility can enhance partners' ability to achieve concensus on critical policy decisions and to overcome the frequent roadblocks encountered during joint venture formation and operation.

Though building relationships between partners' managers takes time--a commodity many executives perceive to be in short supply when pursuing JV formation--it is an invaluable element of most successful ventures. This particularly characterizes JVs with Japanese firms, for whom establishment of close personal rapport is customarily a requirement before business negotiations can be concluded.

In many ways, it may seem unfortunate that JVs are so heavily dependent on personal rapport between a few individuals. Because of the informal nature of these relationships, including extensive utilization of unwritten "gentlemen's agreements," reliance upon executive rapport may lead to unnecessary disputes and conflicts of interests at a later date. To reduce prospects for such turmoil, an additional consideration when selecting a partner may be the likelihood of continuity among the critical personnel within a partner's management team. Such continuity can help minimize the incidence of misunderstandings between partners. In this regard, several managers commented that Japanese executives had expressed hesitancy about forming JVs with U.S. companies, because the typically higher levels of management turnover in American firms hindered establishment and maintenance of close relations among partners' managers.

Trust and Commitment: Essential Elements of Long Term Relationships

Forming and operating a successful JV may not be synonymous with the maintenance of friendly and cordial relations between partners' management teams. The perceived trustworthiness and commitment of a partner has been a pivotal consideration when selecting many JV partners. Human chemistry is essential to development and maintenance of trust and commitment, and interactions between managers helps provide the necessary foundation for their establishment. These interactions permit partners to better understand the people they will be working with, including their values, concerns, and needs, thus helping to assuage potential suspicions. One executive, noting the importance of mutual trust and commitment in the partner selection decision and the process for evaluating these traits, likened the process to a "mating dance." He envisioned the prospective partners as cautiously approaching each other, trying to "strut their stuff" and create favorable impressions, engaging in an often lengthy ritual of evaluating mutual attraction and compatibility before either would commit itself fully to the JV. Without full commitment by both parties, JVs tend to become short term relationships, or "flings," often followed by divorce and parent-less "children." For this reason, great emphasis is typically placed on selection of partners evidencing trustworthiness and commitment to the venture, particularly by executives with more extensive JV experience.

The need for trust and commitment is especially critical if the JV involves activities closely related to your firm's technological core. The technological core of many firms is the essence of their corporate strategies and competitive advantage. A manager may understandably react with some level of initial distrust regarding potential partners' motives. It is useful to recall the inherent fragility of joint ventures when choosing partners, since today's partners could become tomorrow's competitors. As one CEO noted, "You've got to be sure you're working with earnest and ethical people who aren't trying to undermine your company. Usually, a partner will have access to your trade secrets. He might attempt to complete a few projects, learn what you do, then exclude you from future deals."

Exposing your technological core to a partner who is unable to adequately protect this knowledge from technological theft or bleed-through can threaten your company's competitiveness. As a result, an intuitive response may be to seek majority control, if not full ownership, of any venture, and then to hover over every decision the child might make--particularly if you do not trust a partner's intentions. Yet, such a response is unlikely to promote compatibility.

Many managers take the position that, given the likelihood of some misunderstanding between the partners, the JV agreement should address every conceivable contingency. In contrast, managers experienced in JVs emphasize the building of mutual trust and understanding, which make the formal written agreement more a symbol of a commitment to cooperate than an actual working document. As one C.E.O. commented, partners generally "don't start looking at the specifics of the venture agreement until the relationship starts breaking down and you're contemplating getting out."

Regardless of protections written into the JV agreement, no legal document is fail-safe. "You can write all sorts of legal contracts and other formal agreements, but the partners must trust each other and be committed to the venture in order for it to work," noted an executive. "A partner may be able to muster a virtual battalion of lawyers, making it very expensive for you to take a grievance to court, much less to win it." Therefore, you must be comfortable that the partner will honor the spirit, not just the letter, of the agreement. Often, particularly for ventures involving the Japanese, demands to develop extensive formal contracts dealing with every conceivable dispute will be viewed as evidence of mistrust. Managers are to be reminded that a JV relationship is delicate at best and complicated at worst. Without fundamental trust and commitment by each party there is little hope for a working partnership.

Although the preceeding discussion presents a rather long list of criteria, managers with JV experience may be able to add others. Admittedly, these suggestions constitute an ideal set of conditions, and there may be few situations where each of these will be fully achieved. Nevertheless, the above provides a foundation for the identification and evaluation of potentially compatible JV partners.

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