DEPARTMENT OF STATE
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THE JOINT VENTURE FORM OF INTERNATIONAL INVESTMENT

FOREWORD

This report, based on a survey questionnaire sent to 138 companies during the summer of 1963, was written by Roger Feldman, a summer intern who has since returned to the Yale Law School, and by Janet Haase, A.I.D. Management Intern. We owe thanks to them and to all of the international executives who spent time completing the questionnaire. We particularly appreciated the willingness of many executives to answer additional questions in personal interviews.

The Joint Venture Form: Attitudes and Experience

General Introduction

In recent years, many United States firms have entered into foreign enterprises in which they shared control of equity with nationals of the country in which the investment was made. According to a recent study by Booz, Allen and Hamilton, Inc. over 550 such investments took place in 1961 and 1962. The size of a firm does not seem to be related to the decision to use the joint venture approach to investment overseas. According to the Booz, Allen, and Hamilton report, during the 2½ year period from July 1960 to December 1962 a total of 81 joint ventures were entered into by companies with over $500 million sales as compared to 85 joint ventures entered into by companies with less than $50 million in sales.

A.I.D. states in its booklet "Aids to Business" that it favors joint-venture type investments because they are most likely to result in a transfer of entrepreneurial, technical and managerial skills in the less developed countries. A.I.D. has also suggested that it is wisest in the long run for U.S. investors to identify their interests closely with those of the citizens of the country in which they operate.

This outlook has not met with uniform agreement in the business community In a recent article in the July 1963 issue of "Foreign Affairs," for example, Emilio Collado criticized the policy sharply. He suggested that while the availability of a local partner may sometimes encourage an investment from abroad, an investor might well wish to avoid the managerial problems, financing difficulties, disagreements on dividend and reinvestment policies, tax burdens and political fovoritism that are sometimes involved in joint ventures.

The following report is based on a study of U. S. business attitudes towards and experience in operating joint ventures. It is an attempt to collect and analyse actual experiences which U. S. companies have had with joint ventures and is based on information received in response to a circulated questionnaire, personal interviews, and existing literature on the subject.

For the purpose of this study, a "joint venture" has been defined to mean only those foreign operations of a company in which it holds a minimum of 20% of the equity. Pure licensing and management contracts as well as portfolio investments are explicitly excluded.

In carrying out this study, a questionnaire seeking information on the actual experiences of companies was sent to 138 United States firms known to have international investments. The companies to which the questionnaire was sent either had participated in a private sector development program of A.I.D. (Investment Survey, Investment Guarantee, Cooley Loans, Dollar Loans) or were clients of Business International, a private weekly report to management on business abroad. The great majority of firms to whom questionnaires were mailed had over $100 million in sales. Eighty-six companies replied to the questionnaire. Fifty-three of them had joint ventures, and returned a total of 135 completed questionnaires. Only ten of the respondents had total corporate sales of less than $100 million; five of these were in India. Personal interviews were held to gain a greater understanding of the joint venture form of investment. Seven interviews were conducted with executives responsible for international operations of their respective companies. To gain some understanding of the support of the less developed nations for joint ventures, interviews were held at the Indian Investment Center and with the Counsul-General of India, and questionnaires were sent to A.I.D. missions in general developing countries. An overall perspective of the subject was sought through interviews with Professor George Kalmanoff of Columbia Law School, co-author of a book on Joint International Business Ventures and with an editor of Business International. Assistant Secretary of Commerce, Jack Behrman and several Commerce Department officials also provided valuable comments in the course of preparing the questionnaire.

Any conclusions drawn or policy suggestions made in this report are attributable solely to the author's and do not necessarily represent the views of A.I.D.

Evolution of Joint Ventures

The joint venture is a comparatively new business form in international investment. Although almost all of the persons interviewed in the fields of business, consulting, academic research and government maintain that the number of joint ventures is increasing, it is difficult to gather statistical evidence to support this general belief. Of the 86 companies that responded to the questionnaire, 32 firms, or almost 40%, did not have any joint ventures.

The joint venture type of investment seems to be the product of the merging of two factors: corporations in the capital-exporting nations wish to expand or protect markets for their products by investing abroad and the governments of developing countries wish to reserve their economies for their own nationals, insisting on participation in foreign investments. Many U.S. corporations have come to the realization that:

> "While in general it is desirable to have complete control (of a foreign investment), this cannot be a precise answer considering that the method of operation must vary depending upon changes in local laws, the ability to continue with a partner and many other factors."

Some executives state bluntly that nationalism is a rising wave around the world and that U.S. firms simply must recognize it and learn to deal with it.

Government Regulations and Pressures

United States companies are essentially realists and pragmatic in their approach to foreign investment. The most important factor in encouraging joint ventures has been foreign political pressures and circumstances. Several governments have legislation which officially or in practice requires foreign investors to enter a joint venture if they wish to invest in the country and operate profitably.

Companies reported that in Japan, profits cannot be taken out of the country in dollars without the "validation" of the operation by the government, and only joint ventures are validated. In India, U.S. firms found they could not gain entrance unless they had a local partner because the government virtually prohibited total foreign ownership. In Mexico, U. S. manufacturing firms indicated that they entered joint ventures in order to facilitate the import of needed components, to insure favorable tax treatment, and to convince the Mexican government that the border ought to be closed to competitors.

This expression of nationalism exists in many countries. Firms with investments in Pakistan, Thailand, and the Philippines reported that they had been strongly advised or required by the local government to enter joint ventures. Companies that complied sometimes have been rewarded by ease of local financing and improved government relations. The governments of Venezuela, Jamaica, Brazil and Colombia also urged U. S. companies to enter into joint ventures. Government pressure also exists in European countries. In France government approval must be obtained in order to make an investment and several firms reported that the French government placed pressures upon them to enter into a joint venture form of investment before they would approve the enterprise. One firm reported that its reason for entering a joint venture was that "Exchange and other controls make it nearly impossible to operate alone."

One example of government restrictions placed on completely foreign-owned investment and enterprises both in economically developed countries such as France and in less-developed countries such as Mexico, is that government contracts for consumer as well as military products usually are awarded only to those firms which are essentially owned and operated by local country nationals. Occasionally long-established foreign firms are exempt from these restrictions but most young foreign-owned firms are not. One U. S. company stated:

> "Joint ventures continued to be recognized by the local governments as local companies, managed by local nationals, and as such are deriving certain benefits which would not necessarily be available to wholly-owned American subsidiaries."

Because local governments are frequently more favorably disposed towards U. S. investments which are in the form of joint ventures than towards those which are 100% foreign owned, U. S. businessmen associate joint ventures with long-term staying power within a country. Several companies have indicated that although they do not feel that the improved government relations resulting from taking on a local partner will necessarily avoid Cuban-type expropriation, they do feel that it will help the company continue to operate within countries which are subject to économic and political fluctuations.

<u>Advantages of Joint Ventures</u>

United States firms have different opinions regarding contributions a local partner brings to a joint venture. Several large firms that have operated abroad for many years, see nothing to gain from joint ventures except entry into the country and, therefore, prefer a "silent" partner who provides capital, some business contacts, and local coloration but otherwise keeps out of the actual operation of the business. On the other hand, the survey indicated that many companies deliberately search for partners who will provide capital, access to raw materials, or plant facilities, management skills, technical knowledge, entrance into a competitive market, or local business contacts.

U. S. companies cited capital as the contribution most frequently made by local partners in joint ventures. By entering into a joint venture, the U.S. firm is able to stretch its dollars further. A small company can begin international operations although it has limited capital and risk capacity. A large company can reduce the time and capital required to establish an international network of operations. However, because U.S. companies usually have access to a variety of sources of capital, the other contributions and advantages offered by local partners frequently are key factors in inducing a U. S. firm to enter into a joint venture.

Joint ventures may provide a means of breaking into limited or saturated markets. The emergence of a sophisticated consumer economy in many countries has resulted not only in the development of greater market demand but also in the development of greater competition. While it is difficult for a firm to start from scratch, entrance into a competitive market may be possible by forming a joint venture enterprise with an experienced local partner. One firm which has done this several times in Latin America explained:

> "Our partner was already engaged in the manufacture of competitive products similar to those manufactured by (our company) for (its) prospective markets in Brazil... Market was not sufficiently large to make competition attractive. Partner was desirous of obtaining technical assistance. Difficult economic and political climate in Brazil made joint venture approach attractive..."

Joint ventures can also provide a means of retaining markets formerly supplied by U.S. exports. With the development of nationalistic tendencies or the creation of regional organizations, U. S companies have encountered problems in retaining former export markets or find they must now operate under the penalty of import restrictions One large American corporation commented in connection with its European investments that:

> "With the development of the European Free Trade Association and the European Common Market, it became evident that we would lose a major portion of our U S. export participation in certain high volume high investment requirement ... products. The decision to build in certain areas was made with the intention of supplying the same areas as had previously been exported to. The local venture's line was to be supplemented by imports of more sophisticated products to the United States. The joint venture form was hit upon as best suited to the ascertained needs because: a) branch operation would have involved permanent establishment of a United States company overseas with the concommittal undesirable legal and tax implications; b) the most important fact was the United States company did not have the available technical and marketing personnel to accomplish the job."

This firm decided to enter joint ventures with sophisticated, experienced firms in the U K. and Japan as well as the common market in order to successfully meet the challenge of local competitiors which had "become fully integrated from raw materials to finished consumer products "

Knowledgeable management and technical skills are other important contributions made by local partners to joint ventures. In European as well as in Latin American and Asian countries management and ownership tend to be synonymous and the capable businessmen who have developed management skills are precisely those men who have access to the capital to invest in joint ventures. They have an understanding of the way business is conducted within the country and often have contacts in the government and business community. As one company stated, it entered into joint ventures in order "to have foreign partners with their contacts and knowledge of foreign business, as well as to share in the investment." Another company which has investments in Latin America and the Middle East emphatically stated that:

> "(Our company) prefers native managers and investors as it has found that they understand fully how to do business economically and politically so that lengthy, expensive training is avoided."

Several U.S. firms indicated that their local partners had connections with the government and even had staffs of lawyers, accountants, etc., specifically to facilitate their joint venture's operations.

One company stated that in many instances its joint ventures which operate under local management are better able to deal with local problems such as labor relations. Native managers are able to adapt operations in order to utilize local facilities and methods to full advantage, and thus are better able to compete with local competitors. As one U.S. firm said in discussing the contributions of its local partner in a Latin American venture:

> Due to the small scale of operations the transfer of American facilities and methods was not practicable. Local management with technical capabilities was able to produce a satisfactory product using labor rather than machinery more extensively than in larger scale operations."

Equity Participation and Position of Control

The percent of equity participation by U.S. companies in a joint venture varies considerably. Although U.S. firms frequently would prefer to control the majority of the equity, many hold either 50% or less of the equity of the joint venture. Very few of the companies responding to the questionnaire took a minority position deliberately because they felt that the local partner had sufficient understanding of the enterprise and that there was compatability of interests. Local government pressures are most often the major factor influencing the particular equity position the U.S. firm assumes. Another important factor is the availability of a partner to purchase a particular amount of equity. It is unclear how often government pressure is responsible for the "availability" of the partner, or how often the government supports the negotiations of a powerful local partner.

Several U.S. firms believe they can get the maximum value from a joint venture if they assume a minority equity position, and, therefore, have made this a corporate policy. They contend that when local partners hold a majority of the stock they have a vested interest in the success of the enterprise. One U.S company said that its Brazilian joint venture had been successful because:

> "We have capable partners with demonstrated integrity. The difficulties of operating in an inflationary climate have shown that partners with a financial stake in the

business and who also have good management ability can do a job that might not be possible by a management with less at stake in the success of the business."

U.S. companies reported different methods of maintaining a position of control in a joint venture in which they hold a minority equity position. One of these is to retain control of the Board of Directors or the selection of the Chairman of the Board. Sometimes the American partner is given a class of stock which is worth more votes per share than that which is given to the local partners. Other times minority control is assured by selling shares of the joint enterprise to the public, a practice which is encouraged by the governments in certain countries such as India.

U.S. corporations reported various other regulatory devices which they use to ensure effective minority control over joint ventures. For example, when a U.S. firm provided the technology and understanding of the basic industrial principles necessary to set up and maintain a plant, it frequently retained veto power over the appointment of the plant manager and other key personnel, and control over the plant's operations. In other cases, companies exercised leverage because the responsibility for product and methods development rested with its U.S. laboratories and management. In several instances the U.S. firm required that the products of the joint venture be distributed solely by its wholly-owned sales subsidiary in the country. Businessmen also reported that in countries not too distant from the United States where import regulations and shipping costs are not prohibitive, the U.S. partner sometimes supplied machinery or product components and in this way established still another means of control.

Management Contracts and Licensing

Most companies indicated that they negotiated and signed management contracts or licensing agreements with their local partners to define and protect their position in the joint venture. Some companies reported using management contracts which put the U.S. firm in direct control of the actual management of the joint venture. Other companies placed U.S. personnel only in the key positions. The majority of the U.S. firms entered into a "technical assistance" or "licensing" agreement to specify the terms on which the U.S. partner makes available his patents, trademarks, and other technical knowledge, the ways in which the joint venture may use the information, and the royalties to be paid.

These agreements are also used to stipulate certain conditions concerning the production or final product of the joint enterprise, to establish uniform specifications for the components of a product which is made in several parts of the world so that they will always be interchangeable, or to guarantee that the quality of the product meets the criteria established by the U.S. firm for goods sold under its brand name.

Selection of Local Partner

Many of the advantages which the American company derives from the joint venture depend on the partner selected. In the majority of cases, it is the U.S. company who decides to enter into a joint venture and initiates the search for a local partner. Most U.S. firms appeared to buy into existing companies or search for local partners within the country. Companies which are already present in a country but which must assume joint-venture form because of pressure by the local government will frequently invite their local sales representative to become their partner. On the other hand, it has been the experience of several U.S. corporations to be invited by foreign nationals to enter a joint venture.

This has happened particularly with many joint ventures in India.

All companies responding to the questionnaire agreed that the selection of an appropriate local partner is one of the key factors to assure success of the joint venture. Virtually all respondents stressed the need to select potential partners with great care before making any commitment. A company runs into difficulties when it is more concerned with the benefits to be gained than with carefully selecting a partner who will honor agreements. After the initial screening of proposed partners for credit rating and honesty, the most important factor seems to be that the local partner has parallel policies and goals for the development and operation of the joint venture. As one company expressed it, the American firm should be able to feel that its future plans for the enterprise and those of the potential local partner are in accord. In the words of another U.S. company:

> "The critical aspect is the selection of the partner. If one has good partners, the equity proportion becomes relatively insignificant. Regardless of the proportion, we always try to operate on a basis of mutual respect and equ equal partnership."

Problems Encountered

American and local partners encounter problems of varying magnitude in the course of doing business together. The U.S. companies responding to the questionnaire cite various examples of disagreements resulting from a conflict of interest between U.S. and local partners. The greatest source of strain between U.S. companies and local partners often seems to be a fundamental difference of interest and outlook concerning the joint venture. Divergent intests are reflected in the different policies desired by each partner. For example, most U.S. firms focus on capital gains and prefer to reinvest the bulk of profits into the business to stimulate growth and development instead of paying taxes on high dividends while having to invest more dollars from outside. However, a large number of local partners are primarily concerned with immediate profits and high returns in order to increase the value of the joint enterprise stock in the capital market as well as to get a quick return on their investment.

Frequently they attempt to achieve this by means of the very dividend policy which the American counterpart seeks to avoid. Situations such as these have led one company to state that it only enters joint ventures when it knows it will have complete control over disposition of earnings. Another company which presently has no joint venture states that it might consider entering an overseas investment with another U.S. partner but not with host country nationals because "the way of thought in other countries is so different from the American concept of healthy growth and plowing back profits into a business". An executive of a very large company which has avoided joint ventures wherever possible explained the problem as follows:

> "Local joint venture partners do not trust the stability of the social situation or the currency of their country and as a consequence do not trust the long-run profitability of the joint venture into which they have entered. The exorbitant interest rates which prevail in many less-developed countries is further evidence of this psychology."

In some instances, U.S. and local partners have clashed directly as a consequence of their difference of interests. Disagreements occur when the U.S. company must invest more money than was originally anticipated in the joint venture and, therefore, it demands a greater equity position than was stipulated in the original agreements. In one such case, the local partner was adverse to changing the equity ratio between the original partners and surrendering his equity position despite the change in percentage of capital contribution. A slightly different situation is illustrated in the case of a U.S. company which entered into a joint venture with an enterprise which was teetering on bankruptcy and restored it to sound health. The American company has found that although its public relations in the country have heretofore been superb, there is now a clambering for the revitalized enterprise to distribute greater profits and there are bitter denunciations of the American partner's unwillingness to provide them. On occasion, especially when a joint venture has a very narrow profit margin, royalties and fees to the U.S. partner have been challenged by the foreign partner as draining the profits from the enterprise.

Another area of disagreement occurs over the pricing of products and services bought from or sold to the parent company. Also, foreign partners are sometimes disgruntled when the U.S. partner suggests that a given market be served by another affiliate of the U.S. company or when the U.S. partner establishes a new plant in a market being served by the joint-venture enterprise. Disagreements also occur when a U.S. firm gives comparatively greater emphasis to a plant other than the one in which the local partner is involved, even if the favored plant is in another country.

Another group of difficulties arises in the day-to-day operations of the joint venture. One U.S. company summarized its problems as "not being able to get prompt enough or aggressive enough action on matters we felt needed improvement." Companies cited other specific examples and disagreements arising from a basically different approach to operational activities: local partners prefer high prices rather than low prices coupled with high volume; local partners consider adequate maintenance of facilities as an unnecessary expense; locals prefer paying wages at a level beneath that necessary to produce good quality workmanship and to maintain a stable work force in order to avoid labor turnover costs; as long as there is a demand for the goods, local partners are not concerned with maintaining the high quality which the American companies insist be associated with products sold under their brand name.

Varying attitudes and concepts of "business ethics" can create difficulties between U.S. and local partners. The American corporation is accustomed to the institutional controls and the standard business practice of the U.S. It keeps one set of books. It pays taxes. It does not use bribery as standard operating procedure. It generally respects the terms of the contracts which it enters.

One U.S. executive characterized this faith in the efficacy of a contract as an Anglo-Saxon cultural phenomenon. He asserted that Americans think that by writing something down they are going to define the way things happen. Non-Anglo-Saxons generally feel that the eventual shape which the joint venture will take depends on circumstance and not on the signed document. This can be a source of friction between partners particularly if the U.S. firm finds itself unable to enforce the terms written into the contract.

American businesses overseas are in a particularly vulnerable position. The foreign partner is secure in its position and less accustomed to institutionalized controls. It is willing to cut corners in its dealing with the government as well as with its American partners. Comments from American firms with joint ventures in Latin America, the Near East and Europe all indicate that the U.S. company has not always felt comfortable with the activities of its partner. Sometimes it has been pleased that its partner has known the right man to deal with and the right way to do it, but in other cases it has been embarrassed by the positions in which the partner's policies have put the joint venture. In some instances, it feels that the local partner has stretched the contract terms to suit his own interests. For example, one firm reported a

> "problem related to the declaration of a dividend and capitalization of surplus needed in one year for the benefit of the consolidated profit picture of our partner's corporate organization. This resulted in higher taxes to our joint company than would have been the case otherwise. However, we agreed to proceed according to our partner's recommendation."

Because of such activities, one executive went so far as to suggest that U.S. firms could project a better image of the U.S.--and get better personnel--by staying out of joint ventures. He argued that personnel in the less developed countries understands the skull-duggery that goes on in local businesses and prefers to avoid operations in which local businessmen have a say. A wholly-U.S.-owned firm has a clearer corporate image, and will get the best young men.

In general, U.S. firms resolve real differences of opinion by discussion and negotiation with the local partner. United States companies cite firmness and presuasiveness coupled with a large dose of tact as the salesmanship qualities essential to deal effectively with a local partner. Although several of the 85 U.S. firms that responded to the questionnaire indicated that they had bought out their local partner, not one indicated that this was because of inability to work out problems. Companies indicated that most difficulties and disagreements were resolved to the satisfaction of all parties.

Conclusion

The increase in the number of joint ventures in international investment seems to indicate that U.S. companies consider the rate of return realized on the investment to far outweigh the risks involved. However, it is the responsibility of each U.S. corporation to carefully weigh the factors and to make its own decision about entering a joint venture. Objectives and interests vary with each company, and among the various joint ventures entered into by the same company. The decision depends entirely on the particular case and must be made according to the merits of the specific situation.

Participation in a joint venture can provide many advantages to the U.S. firm, such as capital, entrance into a competitive market, management and technical skills, knowledge of local business conditions and contact with business and government circles. However, there can also be disadvantages resulting mainly from differences of opinion concerning financial policies, distribution of profits, production and operating methods, product pricing and distribution, and variations in what are considered business ethics.

Most U.S. companies indicated that in order to reduce the difficulties and successfully solve problems, they maintained some method of control; sometimes by holding a majority equity position, but most frequently by indirect means such as control of the appointment of key personnel or the supply of equipment or product components. Almost all companies had negotiated and signed a management contract or licensing agreement with their local partner before entering the joint venture in order to delineate the respective privileges, responsibilities, and positions of control.

The consensus of opinion, however, was that the key to the success of a joint venture lies in the careful selection of the local partner. When the United States company and the local partner have comparable aims and interests in the joint venture, they are able to work out any problems and conflicts which might arise. As one U.S. corporation summarized:

> "Depending upon the nature, qualifications and interests of the partners, and the mutual understanding and respect which can be developed, a joint venture can be rewarding to both parties".