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# **Internationalisation Strategies For Small and Medium-Sized Enterprises**

**A Study of UK and German Joint Ventures in the  
People's Republic of China**

Dipl.-Kfm. Stefan H. Kaiser

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Thesis submitted in fulfilment of the Degree of  
Doctor of Philosophy

University of Durham, Business School  
October 1998

**23 AUG 1999**

*To my family and my friends*

# **Internationalisation Strategies For Small and Medium-Sized Enterprises**

## **A Study of UK and German Joint Ventures in the People's Republic of China**

Thesis submitted in fulfilment of the Degree of Doctor of Philosophy

Dipl.-Kfm. Stefan H. Kaiser

October 1998

### **Abstract**

This thesis studies internationalisation strategies for small and medium-sized enterprises (SMEs). For most SMEs internationalisation means, predominantly, exporting. Only a few SMEs are involved in foreign direct investment. However, growing pressure from globalisation increasingly means that SMEs must extend their business activities beyond sole export strategies.

Internationalisation imposes an above-the-average financial and managerial resource burden upon SMEs. This is particularly true in the case of foreign direct investment which requires the highest resource commitment of all market entry strategies. Frequently, thus, SMEs cannot commit the resources necessary for success in international markets. Not without reason internationalisation, in the form of foreign direct investment, is often considered the domain of large multinational enterprises.

This thesis regards the joint venture strategy as a means to overcome the resource scarcity of SMEs and so make foreign market entry in the form of a direct investment commitment feasible for these firms. Joint ventures can open doors to markets that otherwise would not be open to SMEs. The joint venture strategy can be a vehicle for SMEs to penetrate a foreign market with only a reduced financial and managerial resource commitment.

The results of this investigation suggest that joint ventures are a feasible strategy for UK and German SMEs to enter the vast market of the People's Republic of China. The joint venture strategy permits SMEs to establish a market presence in the Chinese market and so better reap the benefits of the impressive economic development of the country.

The UK and German joint venture entrepreneurs studied expressed overall satisfaction with their joint investment projects in China. However, the study has also detected various size-related resource scarcities which restrict the SMEs in their joint venturing efforts. Short cut planning procedures and partner selection processes are resultant from that, as well as a weak bargaining position in negotiations and less influence in the control and management of the investment project.

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## Glossary of terms

AG	Public limited company (Aktiengesellschaft)
APA	German Asia Pacific Committee
ASEAN	Association of South East Asian Nations
BCC	British Chamber of Commerce (in China)
BDI	Federation of German Industry
BfAI	Bundesstelle für Aussenhandelsinformationen
BMWi	German Economic Ministry
BMZ	German Ministry of Economic Cooperation
BoD	Board of directors
BOT	Build-Operate-Transfer
CBTG	China-Britain Trade Group
CBTR	China-Britain Trade Review
CCPIT	China Council for the Promotion of International Trade
CEC	Commission of the European Communities
CJV	Contractual joint venture
CoC	Chambers of Commerce (in Germany)
DIHT	German Association of Chambers of Industry and Commerce
DM	Deutschmark
DTI	Department of Trade and Industry
ECIP	European Community Investment Partners
EJV	Equity joint venture
EOSME	European Observatory for SMEs
ETDZ	Economic and Technological Development Zone
EU	European Union
FAZ	Frankfurter Allgemeine Zeitung
FDI	Foreign direct investment
FSA	Firm-specific advantage
FT	Financial Times
GDP	Gross domestic product
GmbH	Company limited by shares (Gesellschaft mit beschränkter Haftung)
GONE	Government Office for the Northeast
GSFB	German Federation of Small Business
HSBC	Hong Kong Shanghai Banking Corporation
HWWA	Institute for Economic Research Hamburg
IMF	International Monetary Fund
IoD	Institute of Directors
IoE	Institute of Export
JV	Joint venture

KfW	German Development Bank (Kreditanstalt für Wiederaufbau)
KG	Limited partnership (Kommanditgesellschaft)
LDC	Less developed country
MBA	Master of Business Administration
MNE	Multinational enterprise
MOFTEC	Ministry of Foreign Trade and Economic Cooperation
NAFTA	North American Free Trade Agreement
NDC	Northern Development Company
NPC	National People's Congress
OAV	Asia Pacific Business Association (Ostasiatischer Verein)
OECD	Organization of Economic Cooperation and Development
PPP	Purchasing Power Parity
PRC	People's Republic of China
RMB	Renminbi (Chinese official currency)
ROI	Return on investment
R&D	Research and development
SBA	Small Business Administration
Sbfd	Small Business Foresight Digest
SEZ	Special Economic Zone
SME	Small and medium-sized enterprise
SOE	State-owned enterprise
SSB	State Statistical Bureau
SWOT	Strengths and weaknesses, opportunities and threats
TEC	Training and enterprise council
UK	United Kingdom
UNCTAD	United Nations Conference on Trade and Development
USA	United States of America
US\$	United States Dollar
VobaRaiba	Volksbank-Raiffeisenbank (public bank)
VW	Volkswagen
WFOE	Wholly foreign-owned enterprise
WTO	World Trade Organisation

### **Exchange rates used**

1996 averages DM:£ = 2.35:1

1996 average US\$:£ = 1.56:1

1996 average RMB:£ = 13.48:1

Thus

1996 average RMB:US\$ = 8.64:1

Information from Barclays Bank, Durham of 24.6.98.

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# Chapter One

## Introduction

### 1.1 Introduction

#### 1.1.1 Globalising businesses

Globalisation has been a major trend of the 1990s. The world is shrinking at a speed that was unthinkable only ten years ago (Teltschik, 1998). Companies, which a decade ago felt secure inside national borders, are now facing ever-increasing international competition. In fact, a recent survey of European businesses (Jackson, 1997) has shown that global competition is the major challenge for Europe's business leaders. These companies now recognise the need to pursue global strategies in line with the argument of Porter (1980) and Harrigan (1984) that competition can no longer be confined to national boundaries. Although globalisation has frequently been declared a threat to national businesses, it equally holds plenty of opportunities for them (Gundlach and Nunnenkamp, 1998).

New international horizons - including the creation of the single European market, NAFTA, the opening up of the former eastern bloc, the creation of ASEAN and now the emergence of the countries of East Asia - offer endless opportunities for globalisation. In the words of the German ministry for economic co-operation (BMZ, 1995), fresh momentum to new economic areas has been emerging. Developments in information technology and telecommunications that have reduced the costs of communication and transportation, interacting governments, and the move towards freer trade under the auspices of the world trade organisation (WTO), have fuelled this move towards globalisation (Gibb, 1995).

Whereas in the early 19th century only about 1 per cent of all goods manufactured in the world were traded internationally, in the 1990s this share has grown to about 15 per cent. Worldwide production in the 1990s is 44 times higher than in 1820 and worldwide trade, 600 times higher. In recent decades, growth in world trade has been consistently higher than growth in production (EOSME, 1993). According to International Monetary Fund (IMF) data, in the mid-1990s world economic output grew at an average annual rate of 3.7 per cent and worldwide trade at more than 8 per cent.<sup>1</sup> Trade between industrialised and less developed countries (LDCs) grew even faster - at more than 11 per cent (FT, 27.9.96, p.xv).

Trade barriers across much of the world have declined sharply and estimations suggest that the average tariff by 1990 stood at about 7 per cent, less than 20 per cent

of the level four decades earlier (Tait, 1997).<sup>2</sup> Worldwide production and worldwide trade are closely interconnected: the freer international trade, the more the production of specific products shifts to countries specialising in the manufacture of those products. Similarly, the more intense is international job sharing, the faster the growth of worldwide production.

The markets of many western companies are saturated and no longer demand outputs of sufficient size to secure growth and competitiveness. Western economies are growing only moderately. In 1996, the UK economy was growing at 1.1 per cent (Office for National Statistics, 1998) and the German economy grew at 1.4 per cent in 1996 and 2.2 per cent in 1997 (FAZ, 28.2.98, p.13). As a consequence, companies are making great efforts to globalise their operations. As many companies now recognise the need to establish market presence to ensure efficient servicing of customers, globalisation has become particularly important for traditional export economies, including the UK and Germany. In 1997, the UK was the fifth biggest exporter in the world and Germany the second largest, with export volumes of US\$280bn (£179.5bn) and US\$511bn (£327.6bn), respectively (FAZ, 24.3.98, p.17).

The term globalisation has become synonymous with internationalisation. However, Buckley (1997) draws a clear demarcation line between these two concepts: globalisation suggests that firms can reach similar foreign markets simultaneously; internationalisation implies a gradual approach to entering also dissimilar markets.

When authors suggest that enterprises are becoming increasingly committed to global markets (Barkema et al., 1996), this applies in the main to large companies rather than small and medium-sized enterprises (SMEs). Large firms have long been regarded as global players, whereas SMEs reportedly have been reluctant to engage in global business activities. However, the necessity for them to engage in global business activities is becoming more and more important as increasingly they are experiencing saturated home markets, global competition, high labour costs, punitive taxes and bureaucracy (Lloyds Bank, 1996; FT, 10.10.97, p.3).<sup>3</sup> This is substantiated by some authors (Gibb, 1995 for the UK; BMZ, 1995 for Germany) who argue that as SMEs make up a large proportion of the total number of companies in an economy, they will be affected by globalisation and internationalisation. According to Reynolds (1997), as much as 80 per cent of all SMEs will be affected by, or involved in, international trade by the year 2005.

In fact, SMEs not only constitute the bulk of firms in all economies in the world,<sup>4</sup> but they also contribute considerably to private sector output,<sup>5</sup> exporting<sup>6</sup> and employment<sup>7</sup> (Storey, 1994; Dawson, 1995; Buckley, 1997; Reynolds, 1997).<sup>8</sup>



As a norm this study adopts the definition of SME as proposed by EUROSTAT:<sup>9</sup> accordingly, an SME has a workforce not exceeding 500 employees (see DTI, 1995; BMWi, 1995; Buckley, 1997). An extensive evaluation of UK, German and European academic literature as well as the UK, German and European official opinions of what constitutes an SME indicates a variety of approaches towards defining an SME (see Appendix I). The EUROSTAT definition is the most appropriate for the purpose of this study. It ignores the turnover criterion distorted by factors, such as exchange rates and inflation. Critics could argue that, to refer to "an SME" is linguistically incorrect since a company is either small **or** medium-sized, but not small **and** medium-sized.

Internationalisation by SMEs helps reinforce economies at home by securing existing jobs, creating new ones and establishing new, more efficient organisational models (VobaRaiba, 1996). As has been pointed out (SBFD, 1995), diversity is one rationale for the existence of SMEs. As a consequence they are able to play an increasingly important international role as providers of solutions to diverse needs since they are able to adjust more quickly to differences in standards and statutory regulations than their larger counterparts. Foreign markets offer SMEs opportunities for long-term growth and profitability (Calof, 1993). Simon (1996), for instance, insists that *his* 'hidden champions' (German world class SMEs) have to cross borders if they are to grow since their markets in any one country are too small. In fact, many SMEs have turned to foreign markets because their home markets have turned sour (Economist, 3.7.93, p.59). However, SMEs frequently lack the necessary resources to internationalise effectively and participate in globalisation.

Conversely, other sources document an unexpectedly large international presence of SMEs (eg VobaRaiba, 1996). Evidence of the increasing recognition of SME participation in international business has been found in Germany.<sup>10</sup> This was evidenced by the adoption by the Volksbanken and Raiffeisenbanken (public banks) of 'SME internationalisation' for their *Award Innovative SMEs 1996*.<sup>11</sup> The accolade was awarded to SMEs that had successfully entered international markets and in so doing had contributed to the protection and development of their domestic operations.

Businesses of different size display different degrees of globalisation (and internationalisation), as do businesses in different industries. According to the German Association of Chambers of Commerce (DIHT) (1995), SMEs understand internationalisation predominantly as exporting and importing. This finds support from an examination of business literature databases (Kaiser and Griffen, 1996), which established that exporting is the most frequently used internationalisation strategy of SMEs (chapter two, section 2.3.1). Market servicing strategies which demand higher

resource commitment, such as foreign direct investment (FDI), tend to be neglected. SMEs only rarely invest abroad (Berger and Uhlmann, 1984) and investment activity correlates positively with company size (Kayser and Hauser, 1990).

FDI has long been seen as the domain of large multinational enterprises (MNEs) which manufacture in locations offering low costs and vast markets. This is due to the long-term financial and managerial resource commitment and the consequent need for risk taking which is too often a barrier to SME FDI (Laughton, 1995). However, increasingly SMEs are recognising the necessity to extend their thinking on internationalisation beyond exporting and importing. This has been observed by OECD (1981), Rennie (1993) and Mulhern (1994), though SME direct investments are still only small in volume (Berger and Uhlmann, 1984; DIHT, 1996). The German research institute HWWA<sup>12</sup> (1996) found that 7 per cent of all German SMEs are internationally active whereas only 1 per cent of SMEs undertake FDI projects.

Various sources have suggested that SMEs follow their corporate clients abroad (Schüller, 1994; Delegation of German Industry and Commerce Hong Kong, 1995; DIHT, 1996) in an effort to maintain existing business relationships. For instance, Technoplast GmbH of Germany, an SME supplying Siemens AG of Germany, set up operations in Malacca, Malaysia, when its multinational customer shifted semiconductor production from Regensburg, Germany, to the Malaysian location. The fact that Siemens could not find a qualified supplier was both the challenge and the opportunity for the German SME (Handelsblatt, 14.6.95, p.18). The resource attractions of foreign markets - low cost production and advantageous legal and administrative environments (DIHT, 1995; DIHT, 1995b) - are also suggested as motivations for SMEs to engage in FDI.

### **1.1.2 Participation in the 'Chinese miracle'**

Three decades ago, Myrdal (1968) painted a bleak picture of 'massive misery' and 'insuperable underdevelopment' in the Asian economies'. Yet 25 years later, the World Bank (1993) pointed out that all 23 countries within that area<sup>13</sup> had enjoyed a faster growth rate than all other world economies and as a result almost all of them had experienced a reduction in poverty.

In Asia, the economy of the People's Republic of China (PRC) enjoys an outstanding position as a target for foreign businesses. Since its opening up to the outside world in late 1978, China has been the focus of international business activities. Since 1978, it has increased its economy by an average 9 per cent a year and its foreign trade

volume has grown from US\$20.6bn (£13.2bn) to US\$325bn (£208.3bn) in 1997, making the country the tenth largest trader worldwide (World Bank, 1997).<sup>14</sup>

China's increasing importance for the economies of Europe has been recognised both on the supra-national level of the EU<sup>15</sup> and at a national level within the UK and Germany (Wilson, 1990). Following the 1996 UK trade mission to China, it was noted that the country was "very important for Britain" (Heseltine<sup>16</sup>), "the greatest challenge in the next century" (Campbell<sup>17</sup>) and "a country nobody can afford to ignore" (Leitch<sup>18</sup>).

The growing bilateral importance of business between the UK and China and Germany and China, respectively, is evidenced by the number of reciprocal senior government ministerial visits. These included the then UK deputy prime minister Heseltine's visits to China in 1995<sup>19</sup> and 1996,<sup>20</sup> German chancellor Kohl's four visits to China since 1982 and the visits of Chinese president Jiang and then premier Li to the UK and Germany, as well as Qian's and Wu's visits to Germany in 1993 and to the UK in 1994 and 1996, respectively. China's new premier Zhu was expected in Germany in spring 1998 and in June 1998 Kohl was to pay a return visit to China. Whereas China's relationship with Germany has been successfully maintained on an even footing for many years,<sup>21</sup> China's relations with the UK were soured by the question of democratic reforms in the former British crown colony, Hong Kong (DTI, 1995).<sup>22</sup> However, friction between China and the US over intellectual property and human rights has seen a gradual tilting in favour of the UK and Germany.

China's importance to the UK and German economies is further illustrated by a considerable expansion of both nations' support networks in the PRC, including chambers of commerce and, on UK side, the China-Britain Trade Group (CBTG). Germany by the end of April 1998 had opened two further delegation offices, one in Beijing and the other in Guangzhou. The first, in Shanghai, had been operational since autumn 1994 and had spawned a German Centre in the city's Pudong district, providing enhanced support to German companies, predominantly SMEs (FAZ, 28.4.98, p.19). A final step will be the establishment of a chamber of commerce similar to the 1920s when several German chambers of commerce existed in China.

The necessity to establish a local presence in order to improve market access as opposed to cutting production costs has been suggested on an Asia-wide basis (Arthur Andersen, in FT, 6.2.96, p.5; Federation of Swedish Industries, in FT, 25.6.96, p.3)<sup>23</sup> as well as specifically for China (Klenner, 1986; Schüller, 1994; Grimm, 1997b). An FDI presence facilitates closer company-to-market proximity than exporting. This improves competitiveness. Unilever's China chairman has already warned that UK companies which do not move into China now "will miss the boat, because competition is already

there" (Sunday Times, 15.1.95, p.2.6). Similarly, the Siemens chief executive officer and chairman of the German Asia-Pacific Committee (APA) has called upon German companies to engage in FDI in China to capture the benefits of China's dynamically developing economy (Welt, 16.9.95, p.22).

UK and German companies are to a large extent already aware of this and are looking to China as a feasible location for overseas investment (Glaister and Wang, 1993; Far Eastern Economic Review, 1.6.95, p.46; Delegation of German Industry and Commerce Hong Kong, 1995). The two nations' enterprises are eyeing China's vast domestic market as a supplement to saturated home markets and, in the case of Germany, the slowly emerging markets in Eastern Europe (Schüller, 1994). UK and German companies enjoy special investment opportunities in China due to Chinese efforts to resist dependency on Japanese investment and China's high regard for UK and German products.

Within Europe, the UK is the biggest direct investor in China, ahead of Germany which ranks second. On a worldwide scale the UK ranks sixth as a direct investor in China and Germany ninth.<sup>24</sup>

### 1.1.3 Weak SME FDI presence in China

International sections of daily business papers, such as the UK's *Financial Times* or Germany's *Handelsblatt*, comprehensively cover the FDI moves by large MNEs. It is difficult, however, to detect investment companies outside the top 100-plus private enterprises (Cahill, 1997). One possible reason is that projects undertaken by SMEs are usually only small in size and individually unimportant to China's economic development. For this reason they escape coverage by the media. Another reason is that many SMEs prefer details to remain confidential (Simon, 1996). This was confirmed in an interview with the Consul Commercial at the British Consulate General in Shanghai who suggests that the bulk of all UK FDI in China comes from industrial giants, though smaller, specialist UK companies have also invested in China (Steve Smith interview, 17.8.95). A similar explanation is also offered for the relatively low commitment of German SMEs in China (MTC, December 1994, p.6; Manfred Holthus interview, 9.5.95). However, this is not the case for Japanese, Hong Kong and Taiwanese FDI. Evidence indicates their SMEs entered China initially as direct investors (Shenkar, 1990; Fujita, 1993; Kelly, 1994; Duffy, 1995).

The SME interest in the Chinese market in the UK and in Germany is considerable. Of 82 SMEs in Northeast England that targeted the Asia-Pacific region, as many as 34 targeted also, or exclusively, the Chinese market (Kaiser and Kirby, 1996). The 1996

Heseltine trade mission to China confirmed this interest on a nationwide basis, suggesting that "many SMEs attended" [the trade mission] (Heseltine, 6.6.96). Elsewhere (Keenlyside, 1996) 'many' was defined as 40 per cent of all firms participating in the trade mission. Evidence is also available from Germany where in excess of 500 SMEs expressed interest in the acquisition of an FDI guide for China.

There is no definite figure indicating the number of SME projects in China. According to the Shanghai-based British Commercial Consul, "there are only very few"<sup>25</sup> (Paul Davies interview, 11.11.96). It has been suggested that SMEs are under-represented in China (CHINA-INFO, July 1995; Handelsblatt, 29.5.95, p.14). However, there is no evidence given to support such statements. Although in 1996, the Delegation of German Industry and Commerce Shanghai estimated the number of German SMEs involved in FDI at 180 to 200,<sup>26</sup> this figure seems to be rather speculative: there was neither a methodology provided nor a basis given for this estimation.

The reasons for the weak presence of UK and German SMEs in China are:

- SMEs face fundamental problems when it comes to internationalisation and, in particular, FDI. These include a weak financial standing, insufficient managerial capacity, a lack of relevant information for decision-making and a relatively risk-averse attitude towards internationalisation. The German economic ministry suggests another impediment to SME FDI: while large MNEs have sufficient bargaining power to create special contractual frameworks for the treatment of their direct investments, SMEs do not (HWWA, 1996). Even though an SME investment - such as the application of a new technology with spill-over effects for the domestic economy - should qualify for the kind of preferential treatment awarded to large MNEs, the reality is they do not;
- there are various obstacles to FDI in China that large companies are confronted by and struggle with, including a foreign language, cultural differences, logistical difficulties, lack of qualified employees, lack of managerial staying power and renunciation of a long-term strategy (Thiess, 1994). It is further suggested (Delegation of German Industry and Commerce Hong Kong, 1995) that many companies are insufficiently accustomed to the procedures of establishing co-operation projects with local companies. In the case of SMEs, however, these barriers to FDI are even harder to surmount. In a recent study, Wilpert and Scharpf (1990) highlighted the psychic distance between Germany and China and Geissbauer (1994) suggested that German companies are reluctant to invest due to the political risk and lack of reliable market data;

- further reasons for the weak presence of German SMEs in China are the country's weak legal system, bureaucracy, the economic situation, inefficient infrastructure and personnel/management difficulties (Wu, 1993; Delegation of German Industry and Commerce Hong Kong, 1995);
- reasons put forward by the British Consul Commercial in Shanghai include the cost of doing business in China, insufficient knowledge about the China market, a certain reluctance of SMEs to go to China, a negative (or problem-rich) perception within SMEs of Chinese market entry and the absence of a proactive attitude towards the Chinese market (Paul Davies interview, 11.11.96);
- according to CBTG, the majority of SMEs are not strong enough to support such a remote market. CBTG suggests companies need at least 50 to 100 employees and experience of business with Hong Kong, Singapore, etc. if they are to enter the Chinese market successfully (Raymond Yang interview, 21.10.96).

That SMEs face considerable difficulties when setting up an FDI project in China was gleaned from the de-briefing of the 1996 Heseltine trade mission to China (Dougan, 6.6.96),<sup>27</sup> although SMEs were able to identify market niches (Michael Heseltine interview, June 1996). Many SMEs have dropped plans to engage in FDI projects in China due to the long duration of negotiations. Lengthy absences of owner-managers, or other important decision-makers, plus the high cost of travel and accommodation in China were simply not palatable to them. Also, the successful development of the Chinese market demands patience (Kraus, 1989) - a condition that the majority of SMEs is simply unable to afford.

A team of experts from the Economic Research Institute of China's State Planning Commission recently demanded increased government support for FDI by foreign SMEs (Business News, 3.3.97, in German Centre China Newsletter, 14.3.97, p.3). However, despite the Chinese central government having recognised the importance of a healthy SME sector, concrete signals from Beijing, in the form of additional tax concessions, preferential financing opportunities and non-bureaucratic establishment procedures have not been forthcoming (Grimm, 1997b). Earlier, Professor Wang (1996) of the Research Institute for International Economic Cooperation with the Chinese Ministry of Foreign Trade and Economic Cooperation (MOFTEC) demanded support for SMEs entering the Chinese market.

Overall, the FDI climate in China is too difficult and alien for many SMEs. Thus, UK and German SMEs invest in locations which seem familiar to them, less troublesome and secure. According to the German Federal Bank, more German investment is

directed to Eastern Europe than to Southeast Asia (FT, 27.7.95, p.19; FT, 19.7.96, p.2)<sup>28</sup> and Schmidt et al. (1995) found nearly 90 per cent of all German FDI directed towards Europe and NAFTA countries.

## 1.2 Problem and aims of the thesis

As has been outlined above, establishing a permanent market presence becomes increasingly important for western companies wishing to develop the Chinese market efficiently. However, FDI appears to be widely neglected by SMEs as a market servicing strategy for reasons of resource limitations and an unwillingness to take risks. When adopting a wholly foreign-owned enterprise (WFOE) as its FDI strategy, the SME is exposed to severe limitations, including lack of finance, managerial capacity and adequate information. The argument advanced in this thesis is that another FDI strategy, the joint venture (JV), serves as an alternative means for SMEs to service the Chinese market, ie meeting the strategic requirement of maintaining a local presence and utilising the resources of a local partner. The JV strategy allows the SME to benefit from the contributions that a partner can make, such as the investment of additional capital, local managerial expertise and knowledge of procedures peculiar to the Chinese market and business conventions. With the establishment of a JV, SMEs side-step many of the limitations associated with WFOEs. In other words, servicing the Chinese market via a JV reduces the sum of production and transaction costs that would be incurred by going it alone.

In fact, Wu (1993) argues that the JV is the best mode for SMEs to invest in China since, compared with large firms, they are in a weaker position to cope with any unforeseen eventualities. This is due to the fact that SMEs do not have the same ready access to natural resources, finance and information as large MNEs, nor are they able to enjoy the same favourable terms. Wu's (1993) assertion is supported by an Arthur Andersen survey (in FT, 6.2.96, p.5), stating that JVs are expected to become the most popular vehicle for international expansion.

This thesis investigates whether, and to what extent, JVs are a viable strategy for SMEs as a means of engaging in FDI in China. In particular, the issues to be addressed include:

- the characteristics of UK and German SME JVs in China, using and extending Beamish and Wang's (1989) and Beamish's (1993) frameworks;
- UK and German SME JV experiences. This uses a framework based on the works of Harrigan (1984), Datta (1988) and Fan (1996). In detail, the thesis

addresses both the establishment and operation phases of UK and German SME JVs in China;

- the extent to which JV strategies ease the resource burden on SMEs engaged in internationalisation;
- the extent to which the JV strategy has been successful as a market servicing strategy for UK and German SMEs.

The study investigates UK and German SME JVs. As a consequence the experiences are differentiated in order that similarities and differences between UK and German SME practice in China can be established. This follows a notion by Ritchie (1994) that there are intra-European differences in the approach to the Chinese market.

### **1.3 Methodology**

To meet its objectives this study takes both a quantitative and a qualitative approach. A total of 21 UK and German SMEs with a JV in China participated in a questionnaire survey carried out in the summer of 1996. In addition, in-depth interviews were conducted with a limited number of SMEs that participated in the postal questionnaire survey. Overall, the examination of the experiences and strategies of UK and German SMEs with JVs in China is based on both the quantitative findings and the results of four case studies.

The body of knowledge in this thesis is supplemented by findings from various interviews carried out with representatives from the British Embassy in Beijing and the British Consulate General in Shanghai, European financial institutions in China and various Chinese organisations, mainly in Shanghai. In addition, first hand information was acquired by the researcher during two placements with the Delegation of German Industry and Commerce Shanghai in 1995 and 1997. These involved the researcher in strategic issues revolving around FDI in China and day-to-day problems experienced by foreign companies. These insights not only support the argument forwarded in this thesis, but also contributed to the production of a guide to FDI in China (Kaiser and Grimm et al., 1997).

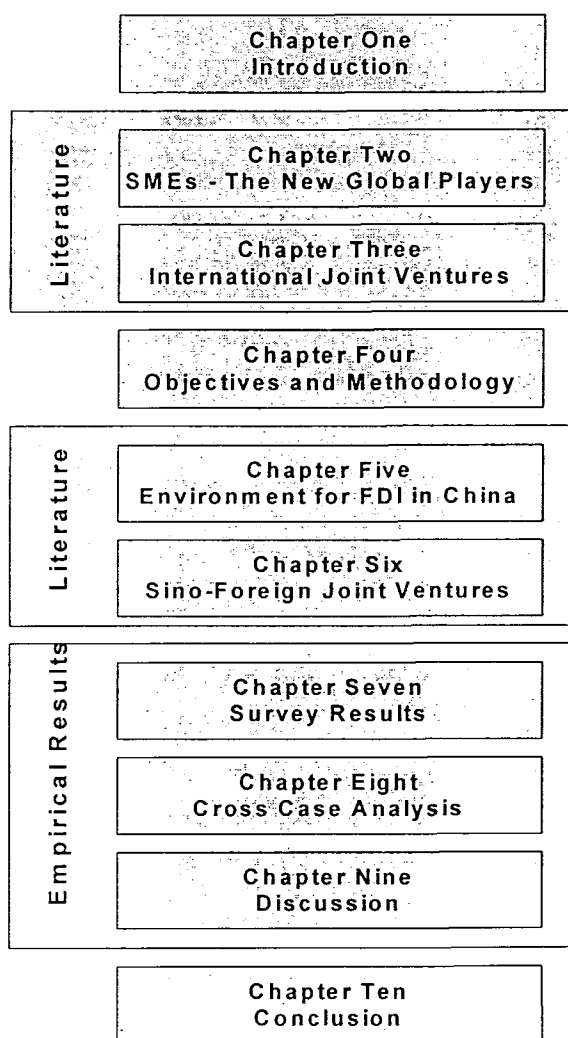
### **1.4 Structure of the thesis**

The thesis contains ten chapters. After this introduction, chapter two reviews the literature on SME internationalisation, establishes the limitations faced by SMEs when engaging in FDI, and develops a rationale for SMEs engaging in FDI, specifically JVs. Chapter three reviews the literature on international JVs and develops a framework for



analysis that is complemented and modified in chapter six. Chapter four introduces the methodology employed for gathering the essential data for this thesis and discusses the data as well as the methodological problems encountered in the course of this study. The Chinese environment for FDI is presented in chapter five. Chapter seven presents and analyses the findings of the survey that was carried out amongst UK and German SMEs and chapter eight cross-analyses four cases of UK and German SME JVs in China. In chapter nine, both the quantitative and qualitative findings are discussed using the modified JV framework established in chapter six. Chapter ten summarises the key findings, concludes the thesis and offers proposals for policy-making and further research. Figure 1-1 presents the structure of the thesis.

Figure 1-1: Structure of the thesis.



## Notes

- <sup>1</sup> In 1997, worldwide trade grew at 9.5% over 1996, despite the Asia crisis (FAZ, 24.3.98, p.17).
- <sup>2</sup> This would suggest that markets that previously demanded local production facilities because of prohibitive tariff levels can now be supplied from non-domestic sources (Tait, 1997).
- <sup>3</sup> The German manufacturing-hostile welfare state was criticised by BDI president Henkel, demanding that Germany cut taxes and social spending" (FT, 24.6.96, p.8). He repeatedly criticised the quality of Germany as an investment location (Economist, 13.9.97, p.99).
- <sup>4</sup> In 1992, the EU accounted for approx. 15.7m enterprises in the non-primary private sector. Of these, 13,000 have over 500 employees and 13.5m have less than ten employees (Stanworth and Gray, 1991; EOSME, 1993; Lloyd, 1994; Storey, 1994; Gibb, 1996). The breakdown for the UK and Germany is similar (Kayser and Hauser, 1993; Storey, 1994; BMWi, 1995).
- <sup>5</sup> European SMEs provide 66% of all sales of the non-primary sector, 50% of all manufacturing sales, 67% of services and even 90% of the construction and trade sectors (EOSME, 1993). Stanworth and Gray (1991) suggest that, in 1986, large enterprises with over 500 employees were responsible for 29.4% of the turnover of all enterprises, and enterprises with 100 or more employees were credited with 53.7% of the aggregate turnover. Bearing in mind that SMEs constitute the biggest share of enterprises and employment, this clearly demonstrates their disproportionate role in the UK economy. In 1991, the UK SME sector's contribution to GDP was only 32% (Mulhern, 1994). The IoD (1992, in Dawson, 1995, p.7) suggests that the UK SME sector accounts for 56% of the UK economy output. Germany's SMEs constituted 40% of investment and 46% of GDP (Lauder et al., 1993). Kayser and Hauser (1993) found that German SMEs, in 1990, contributed some 45.8% of all liable sales tax turnovers and 52.4% to the gross value added of all companies. Equally, they contributed 41.1% of all gross investments in the same year.
- <sup>6</sup> The importance of SMEs as exporters has been emphasised by Simon (1996), Ali and Swiercz (1991), Economist (3.7.93, p.59) and Walker (1994).
- <sup>7</sup> Authors are also in agreement with regard to the importance of SMEs as job creators (Lauder et al., 1993; Kayser and Hauser, 1993; GSFB, 1994; BMWi, 1995). According to EOSME (1993), in 1992, European SMEs employed 62m people or 70% of the European workforce in the non-primary private sector. Between 1990 and 1995, Germany's SMEs had a net growth in jobs of around 1m, while the big firms showed a decline (BMWi, 1995; FT, 16.9.96, p.2).
- <sup>8</sup> The literature agrees that the SME sectors of virtually all economies in the world are important economic contributors. It is also agreed that the German 'Mittelstand' is a complex network of values shared by thousands of German firms (Simon, 1996). A recent report by Lloyds Bank (8.5.96) stressed the non-existence of a UK equivalent of the German 'Mittelstand' due to differences in culture, motivation of owner-managers and capital markets. However, Smith (1997) recently challenged this year-long belief in the strengths and power of the German 'Mittelstand'. Instead, the 'Mittelstand' would be "labouring through a period of weakness and retrenchment" (p.128) and its UK equivalent, the so-called 'middle market' (firms with an annual turnover of between US\$7.8m (£5m) and US\$312m (£200m) has been consistently achieving annual sales growth of more than 10% and annual profits growth of more than 20%, alongside strongly rising employment and capital investment.
- <sup>9</sup> EUROSTAT is the statistics department of the Commission of the European Communities.
- <sup>10</sup> In the German states of Hesse, Rhineland-Palatinate, Thuringia and Saarland.
- <sup>11</sup> 'Förderpreis Innovativer Mittelstand 1996'.
- <sup>12</sup> HWWA - Institute for Economic Research, Hamburg.
- <sup>13</sup> The Commission of the European Communities defines the region Asia (26 countries) as: East Asia: China, Japan, North/South Korea, Mongolia, Taiwan, (Hong Kong), Macao. Southeast Asia: Brunei, Indonesia, Malaysia, Philippines, Singapore, Thailand, Cambodia, Laos, Vietnam, Burma. South Asia: India, Pakistan, Bangladesh, Sri Lanka, Nepal, Bhutan, Maldives, Afghanistan.
- <sup>14</sup> As an exporter, China ranked tenth in 1997, with exports worth some US\$182bn (£116.7bn) (FAZ, 24.3.98, p.17).

<sup>15</sup> In 1995, the Commission of the European Communities released its China strategy stretching beyond traditional trade relationships, after emphasising, in 1994, the need for Europe to adopt more pro-active policies towards the whole of Asia in order to protect its economic interests against competition from the US, Japan and others (FT, 6.7.95, p.2; FT, 13.7.95, p.4).

<sup>16</sup> Michael Heseltine was deputy prime minister of the UK from 1995 to 1997.

<sup>17</sup> Ken Campbell was a council member of CBTG.

<sup>18</sup> Sandy Leitch is chairman of Eagle Star Holdings.

<sup>19</sup> The 1995 visit of UK trade and industry secretary Michael Heseltine to China was considered the largest ever British trade mission and a very good start to a new chapter in Sino-British relations (FT, 17.5.95, p.7).

<sup>20</sup> Heseltine's 1996 trade mission to China is said to be the largest British trade mission ever, attracting some 270 entrepreneurs (Keenlyside, 1996). Although fewer deals were concluded during that mission, CBTG suggests that "the trend is still broadly on the increase" (ibid).

<sup>21</sup> Apart from temporary setbacks in the Sino-German relations due to Tiananmen Square or Tibet, the Himalayan region that was invaded by China in 1950.

<sup>22</sup> For a review of the Sino-UK and Sino-German relations see Kampffmeyer (1990), Winckler (1991) and Schüller (1994).

<sup>23</sup> The survey is based on responses of 260 managers and business experts in the US, Europe and Asia.

<sup>24</sup> In terms of trade, Germany is China's most important partner within the EU. However, according to EUR-OP News (1997) Germany's 1996 exports to China decreased by 0.1% to Ecu5.96bn compared with the previous year. The UK's export volume to China shrank by 7.6% even to Ecu0.9bn in 1996.

<sup>25</sup> Explicitly, the Consul could name three SMEs.

<sup>26</sup> This figure was also suggested in International Business Daily (3.9.96, in German Centre China Newsletter, 6.9.96, p.3). It can be assumed that the source for this statement was the Delegation of German Industry and Commerce Shanghai.

<sup>27</sup> Sir Alan Cockshaw, chairman of AMEC, led the 'mission business team' and emphasised the difficulties of SMEs with a presence in China. Patrick Dougan, chief executive of Mackie International, stressed that SMEs do not get credibility, unlike large companies and that finance is a problem.

<sup>28</sup> This is approx. 10% of the country's total FDI, DM4.2bn (£1.8bn) in 1995 against DM2.4bn (£1.0bn) in 1993.

## Chapter Two

# SMEs - The New Global Players

### 2.1 Introduction

This chapter introduces the internationalisation strategies available to small and medium-sized enterprises (SMEs), classifies them into a framework of market entry strategies and reviews the internationalisation experiences of multinational SMEs. In addition it addresses the question of where the foreign direct investment (FDI) strategy is positioned within the SME internationalisation literature and identifies the difficulties faced by SMEs when internationalising their activities, in particular in relation to FDI. The chapter also establishes the theoretical underpinning for the decisions taken by SMEs to engage in FDI and, in particular, in a joint venture (JV) strategy.

### 2.2 Internationalisation strategies<sup>1</sup>

Internationalisation is a comprehensive plan taking into account the objectives, resources and policies that guide a firm's international marketing operations (Root, 1987).<sup>2</sup> The selection of a market servicing strategy is an institutional agreement that is necessary for the entry of a company's products, its technology, as well as human and financial capital into a foreign market (Lopez-Gonzalez et al., 1995). A firm's international competitiveness depends upon the adoption of an appropriate set of strategies and their effective management (Davidson, 1982; Killing, 1982; Root, 1987; Terpstra, 1987; Naumann and Lincoln, 1991). Various authors have highlighted the importance of selecting a servicing mode with the utmost care (Rugman, 1985; Contractor, 1985; Davidson and McFetridge, 1985; Young et al., 1989; Lopez-Gonzalez et al., 1995), albeit the choice is limited by the constraints imposed by a firm's products, financial and managerial limitations and host market conditions (Buckley et al., 1991). The various entry modes differ greatly in their mix of advantages and drawbacks (Anderson and Gatignon, 1986).<sup>3</sup>

Each market servicing strategy is characterised by a set of dimensions. Commonly, authors (Hill et al., 1990) feature three determinants for servicing strategy: resource commitment, control and risk of know-how dissemination. Young et al. (1989) have added time and space limitations as a further dimension while Laughton (1995) takes into consideration the degree of learning required by the particular type of market servicing. These attributes constitute the dimensions of a market servicing decision-making framework. A firm chooses the strategy which best satisfies the factors that influence its decision-making. However, this decision is frequently a compromise since securing long-term goals often impacts on short-term decision-making.<sup>4</sup>

Foreign market entry has become a frontier issue in international research. Researchers have elaborated extensively on international market servicing (Pavitt, 1969; Stopford and Wells, 1972; Carstairs and Welch, 1982; Rugman, 1985; Rugman et al., 1985; Parry, 1985; Anderson and Gatignon, 1986; Brockmeyer, 1987; Root, 1987; Young et al., 1989; Robock and Simmonds, 1989; Hill et al., 1990; Kaufmann et al., 1990; Wu, 1993; Laughton, 1995; Lopez-Gonzalez et al., 1995). Comprehensive continuums of market servicing strategies can be found in the works of Carstairs and Welch (1982), Root (1987), Young et al. (1989), Erramilli and Rao (1990), Laughton (1995) and Lopez-Gonzalez et al. (1995).

To establish a hierarchy for market servicing modes, writers (Pavitt, 1969; Root, 1987; Brockmeyer, 1987; Young et al., 1989; Robock and Simmonds, 1989; Shenkar, 1990; Erramilli and Rao, 1990; Lopez-Gonzalez et al., 1995; Laughton, 1995; Schmidt et al., 1995) use various patterns including the application of dimensions such as risk, control or resource commitment or combinations thereof. Accordingly, they arrive at differing enumerations (see Appendix II).

The literature on foreign market servicing displays additional divergences: first, some authors suggest that a JV is one form of FDI (Parry, 1985; Brockmeyer, 1987; Young et al., 1989; Dutta and Merva, 1990; Wu, 1993; Erramilli and D'Souza, 1993; Braun, 1996). This is also the view taken in this thesis. It is, however, in sharp contrast to the ideas of authors, including Rugman et al. (1985), Anderson and Gatignon (1986), Endres (1987),<sup>5</sup> Robock and Simmonds (1989), Hill et al. (1990), Williamson (1991), UNCTAD (1993), Laughton (1995), Lopez-Gonzalez et al. (1995) and Schmidt et al. (1995), who, implicitly or explicitly, exclude JVs from FDI. This can have far-reaching implications since it suggests, as is the case with Rugman et al. (1985), that the (original) theory of internalisation would **not** apply to JVs. As section 2.4.3 of this chapter will show in detail, the internalisation theory was subject to criticism for failing to explain the reasoning for JV formation.

Secondly, whereas a variety of authors (Rugman, 1985; Rugman et al., 1985; Robock and Simmonds, 1989; Young et al., 1989; Laughton, 1995) include exporting as one principle option for companies to service markets, some (Hill et al., 1990) do not consider exporting from the home country to be such an option due to tariff barriers, transportation costs or variants thereof. Thirdly, market entry modes, including licensing, franchising and contract manufacturing do not require the physical presence of a company in a foreign country. Thus, to refer to multinational enterprises (MNEs) when discussing companies that apply such entry modes (eg Tan, 1993) is misleading.

This suggests the basic definition of the MNE as an enterprise with **assets** in at least one foreign country (Vernon, 1971; Caves, 1971; Buckley and Casson, 1976; Hood and Young, 1979; Teece, 1985; Rugman, 1985; Young et al., 1989; Dunning, 1993).

Finally, SMEs are not just smaller versions of large companies, but deal with unique size-related issues and behave differently in their analysis of, and interaction with, their environment (Welsh and White, 1981; Wu, 1993; Baird et al., 1994). However, the majority of authors (Rugman, 1985; Rugman et al., 1985; Root, 1987; Robock and Simmonds, 1989) discuss the market servicing framework from the perspective of large companies, excluding SMEs. At first glance, Young et al.'s (1989) contribution is an exception. However, the study does not prove to be of specific value for SMEs embarked on internationalisation since it is still too general – unlike Wu's (1993) study of 75 European firms entering the Chinese market. He makes it clear that SMEs are different from large MNEs in terms of, for instance, financial standing.

The literature on market entry has produced various strands of interest, including market servicing theorising (Rugman, 1985; Parry, 1985; Hennart, 1982; Anderson and Gatignon, 1986; Hill et al., 1990; Buckley et al., 1991), choice of market servicing (Contractor, 1985, 1990; Davidson and McFetridge, 1985; Anderson and Gatignon, 1986; Beamish and Banks, 1987; Contractor and Lorange, 1988; Hill et al., 1990; Erramilli and Rao, 1990; Wu, 1993; Lopez-Gonzalez et al., 1995) and managerial decision-making (Tan, 1993; Lopez-Gonzalez et al., 1995).<sup>6</sup> An examination of the literature suggests that a number of scholars (Teece, 1977, 1981, 1985; Hennart, 1982; Hill and Kim, 1988) have linked the choice of strategy to transaction cost theory, whereas others (Buckley and Casson, 1976; Rugman, 1985; Casson, 1982) have based their discussions on internalisation theory. Others (Stopford and Wells, 1972) make reference to bargaining power, focusing on behavioural constructs rather than economic and strategic dimensions. A growing body of literature takes a holistic approach towards market entry explanation (Buckley and Mathew, 1979; Anderson and Gatignon, 1986; Hennart, 1988; Hill et al., 1990; Contractor, 1990; Buckley et al., 1991) since transaction cost logic does not take into account strategic considerations. This is addressed in the strategy literature (Killing, 1983; Contractor, 1985; Harrigan, 1988; Contractor and Lorange, 1988).

### **2.3 SME internationalisation**

International business has long been the domain of large companies (Delacroix, 1984; Kaufmann, 1995; Berra et al., 1995). A United Nations study (UNCTAD, 1993, p.38) has criticised this, pointing out that internationalisation is "by no means the exclusive

province of large firms". Also Simon (1996, p.1), investigating German SMEs, insists that "many of the mid-sized champions were global long before the term 'globalisation' was coined".

### 2.3.1 Predominance in SME market servicing

According to Acs and Preston (1997), very little is known about the processes by which SMEs participate in the global economy, although there is overwhelming evidence in the literature that points to exporting as the pre-dominant international activity of SMEs (Cavusgil, 1980; OECD, 1981; Brockmeyer, 1987; Stratos, 1990; Walker, 1994; Mulhern, 1994; Schmidt et al., 1995; Vatne, 1995). There is also a large degree of agreement that SME commitment to FDI is rather limited (Buckley, 1983; Kaufmann et al., 1990; Dunning, 1993; Acs and Preston, 1997; Acs et al., 1997) both in comparison with large firm FDI and relative to the export activities of SMEs (Albaum et al., 1992). Acs et al. (1997) speculate that the SMEs' disproportionately low share of FDI might be exaggerated. However, there is supportive evidence that relatively fewer SMEs engage in FDI than large MNEs as the likelihood of firms engaging in FDI grows with firm size (Braun, 1982; Berger and Uhlmann, 1984; Oman, 1984). This is due to the fact that there is a strong correlation between firm size and the possession of monopolistic advantages, the *sine qua non* of FDI (Oman, 1984).<sup>7</sup>

Between 1986 and 1993, worldwide FDI grew at 14.6 per cent (Schmidt et al., 1995) and FDI continues to be a driving force of the globalisation process (UNCTAD, 1997).<sup>8</sup> However, it seems that large firms, as opposed to SMEs, have gained in importance in FDI (Fujita, 1995). This corresponds with later findings by Buckley (1997) and Eden et al. (1997). Summarising the key issues involved in the international transfer of technology by SMEs, these authors found that SMEs are not the major players in the transfer of technology in the world economy. Moreover, Buckley (1997) discovered that SMEs show a strong preference for non-equity forms of technology transfer, such as licensing. This is the tenor also of Kumar and Neyer's (1992) research examining 13 German firms with technology transfers to less developed countries (LDCs).

Although the limited participation of SMEs in FDI is well documented in the literature (Buckley, 1979, 1993: UK FDI; Braun, 1982: German FDI; Menke et al., 1995: German FDI; Acs et al., 1997: US FDI), there is also evidence to suggest increased FDI activity by SMEs (UNCTAD, 1993; Mulhern, 1994; Fujita, 1995; Kohn, 1997; Reynolds, 1997). In their early study of 3,153 large and small and medium-sized manufacturing German firms, Berger and Uhlmann (1984) discovered that 95 per cent were involved in export activities, whereas only 21 per cent were engaged in activities abroad on top of their

export commitment. On the other hand, Fujita (1995) points out that SMEs account for a large proportion of the number of investment projects. From data obtained from 443 firms in developed countries, he found that the make-up of SMEs<sup>9</sup> is becoming increasingly multinational and, when compared with large MNEs, represents an alternative and additional source of FDI and non-equity resource transfer to LDCs (UNCTAD, 1993). However, in subsequent research, surveying 735 multinational SMEs from 18 developed countries, with investment projects in LDCs, Fujita (1995) discovered they do not play a role in FDI to the same extent as in their home economies. He also found they are still minor players in the introduction of capital, technology and management into LDCs. Exceptions are SME investors from Japan and Australia,<sup>10</sup> the former accounting for the largest number of active multinational SMEs worldwide (Fujita, 1995).<sup>11</sup> This supports earlier findings by Ozawa (1985) who investigated the international transfer of technology by Japan's SMEs to LDCs.

However, if measured in terms of value, large investors still account for the bulk of FDI. Fujita's (1995) confident statement contradicts Buckley (1997) who argues that global figures for SME FDI are not available. Conversely, UNCTAD (1997) supports Fujita's large firm-FDI concentration statement, suggesting that for six out of nine developed countries, 25 MNEs account for more than half of their countries' outward stocks.

Equally interesting is occasional evidence that challenges the perceived importance of SMEs as exporters. Although Simon (1996) praises the export contribution of the German 'hidden champions' which generate more than 50 per cent of their sales outside their home markets,<sup>12</sup> others, including Acs et al. (1997), argue that the SME export share is disproportionately lower than its share of home economy sales: Samuels et al. (1992) in their study of 70 UK SME exporters found more than 60 per cent of the exporters generated less than 25 per cent of their annual turnover from exports. Reynolds (1997) points out that 10 to 20 per cent of manufacturing SMEs acquire 10 to 40 per cent of their sales from exports. Within OECD countries, for instance, 26 per cent of direct exports were provided by SMEs, whereas this figure was 35 per cent among the Asian countries (Reynolds, 1997). Berger and Uhlmann (1984) have shown that, although 95 per cent of their German sample firms were involved in exporting, only one third had an export ratio<sup>13</sup> exceeding 20 per cent. Further, Smallbone et al. (1995) studying European SMEs in the food processing and clothing industries in the UK and Portugal found that only 8 per cent of the food processing firms exported more than 10 per cent of their turnover. The high-number-low-volume phenomenon of SME exporters has also been observed by Kean (1989), Ali and Swiercz (1991), Naumann and Lincoln (1991) and Moskowitz and Menzies



(1995) who suggest that between 80 and 90 per cent of US exporting activity is performed by 1 per cent of the firms, mostly large companies.<sup>14</sup>

Other studies not only question the high-number argument of the SME export phenomenon: Cavusgil (1980) observed that nearly 90 per cent of the manufacturing firms in the US are non-exporters and Edmunds and Khoury (1986) studying 32 small, California-based firms, found SMEs were greatly under-represented in export markets.

The weak presence of SMEs in FDI, relative to large companies, is reflected in the literature (Buckley, 1979; Buckley et al., 1983; Clifford and Cavanagh, 1985; Parnell, 1993; Vatne, 1995).<sup>15</sup> Wright and Ricks (1994), who reviewed the business literature of the past 25 years, observed that the internationalisation of SMEs is a new thrust of research activity. Samuels et al. (1992) also discovered a substantial volume of literature on SME exporting activities. For instance, Laughton (1995) in a compendium on international business, devoted a whole chapter to the international business of SMEs, shedding light on the problems they experienced and offering a strategic framework to facilitate international success for SMEs. However, he did not specifically discuss strategies to enable SMEs to overcome resource shortages or the market entry modes available to them. SME licensing and SME FDI were not considered at all. Instead, the author devotes more than 50 per cent of the volume of his compendium to SME exporting. Equally, Young et al. (1989) claimed to be SME-specific and considered their work a 'study must' for the student of SME internationalisation, as well as the international SME itself. However, the compendium is no more than a generalised piece of work on internationalisation, addressing large MNEs equally.

A quantitative investigation of international business literature carried out by Kaiser and Griffen (1996) covering the 15 year period 1981 to 1995<sup>16</sup> found the vast majority (98%) of research studies on the concept of internationalisation do not deal explicitly with SMEs. The study further revealed that, although the absolute volume of literature on SME internationalisation has steadily increased during the past 15 years, the relative interest in SME internationalisation has decreased at a rate of 14 per cent. The study also shows that of the total contributions on SME internationalisation issues (international business, internationalisation, exporting, licensing, FDI), exporting accounted for 62 per cent of research interest.<sup>17</sup>

### **2.3.2 SME foreign direct investment<sup>18</sup>**

Compared with the literature on SME exporting, contributions on SME FDI are rather limited (section 2.3.1). Little research has discussed the FDI activities of SMEs (Buckley, 1979, 1989, 1997; Braun, 1982, 1996; Buckley et al., 1988; Kaufmann et al.,

1990; Simon, 1992, 1996; Kaufmann, 1995). Scholars from the UK, Buckley, Mathew and colleagues, and from Germany, Braun, Berger and Uhlmann, Kaufmann and colleagues, Simon, Schmidt and colleagues, have advanced the understanding of SME FDI considerably. Work on SME FDI has also been carried out by Japanese (Yoshihara, 1978; Ozawa, 1985), Italian (Onida et al., 1985; Berra et al. 1995) and French (Bertin, 1986) researchers. In a number of volumes, UNCTAD<sup>19</sup> has investigated FDI patterns of SMEs on a worldwide scale (UNCTAD, 1984, 1993, 1995).

Most notably, at a conference in October 1995, experts on 'SMEs and the global economy' - including Kogut, Gomes-Casseres, Kohn, Buckley and Reynolds - presented their ideas on SME FDI. Though these authors elaborated on various aspects of SME FDI, no ground-breaking wisdom was voiced by the contributors. Moreover, most of the data presented at the conference originated from the 1993 UNCTAD study on multinational SMEs.

According to Gomes-Casseres (1997), students of international business traditionally believe that success in foreign markets is dependent on size. Campbell (24.10.97, p.16) argues that, at first glance, the global small company appears an inherent contradiction since many of the traditional drivers of globalisation (notably economies of scale) simply would not apply to SMEs which are faced, instead, with a constant battle for scarce resources. The reason for this appears to be deep-rooted: organisational industrialists, including Williamson (1975), Hymer (1976), Buckley and Casson (1976), Dunning (1977), Teece (1981) and Rugman (1985), have long insisted that commitment to FDI has resulted in the emergence of the MNE. It has also been suggested that an MNE is different from an SME (Rugman et al., 1985; Robock and Simmonds, 1989; Young et al., 1989). Implicitly, it has been argued that:

- an MNE is a large-size company and
- vice versa, an SME can never be a multinational.

SMEs are not just smaller versions of big businesses, but they deal with unique size-related issues and behave differently in their analysis of, and interaction with, their environment (Baird et al., 1994). As a consequence, the implications cited provide cause for criticism. Frequently, research on firm internationalisation too readily separates the concepts of SME and MNE, as can be seen in the works of Caves (1971), Rugman et al. (1985), Robock and Simmonds (1989), Young et al. (1989), Tsang (1994), Leung and Yeung (1995), Smallbone et al. (1995) and Cafferata and Mensi (1995). Buckley (1979, p.12) is the exception. While arguing that "the vast

majority of writing on FDI has concerned the behaviour of **large** MNEs", he implicitly admits the existence of **small** MNEs.

Contradicting the views of other scholars on SME and MNE (Rugman et al., 1985; Robock and Simmonds, 1989; Young et al., 1989), this thesis argues that SMEs can be MNEs, as long as they meet the definition of MNEs as outlined below. On the other hand, it is recognised that the concepts of multinationality and large size have more in common than multinationality and being an SME.<sup>20</sup>

According to Robock and Simmonds (1989), there is no universally accepted definition of MNE. Early approaches focus on performance characteristics such as the absolute amount – or relative share – of earnings, sales, assets, or employees derived from, or committed to, foreign operations.<sup>21</sup> Definitions further focus on the concept of ownership, looking at whether a foreign business is owned by nationals from many countries.<sup>22</sup> Additionally, definitions consider structural criteria such as the composition and behavioural characteristics of top management, eg 'thinking globally'.<sup>23</sup>

Most of the definitions of MNE stress the possession and control of assets and operation in foreign countries without further specification (Buckley and Casson, 1976; Teece, 1981) or with a specified number of foreign countries, ranging from 'at least one' (Rugman, 1985; Robock and Simmonds, 1989; Dunning, 1993) to 'at least two' (Teece, 1985) and even 'more than six' (Vernon, 1971; Rugman et al., 1985).<sup>24</sup> Definitions characterise an MNE by the fact that it produces abroad, rather than by company size criteria (Caves, 1971; Buckley and Casson, 1976; Hood and Young, 1979; Teece, 1981, 1985; Rugman et al., 1985; Robock and Simmonds, 1989; Dunning, 1993). The above authors all require the establishment of foreign manufacturing facilities for a firm to qualify as an MNE.<sup>25</sup> Dunning (1993) adds to this enumeration of distinctive criteria the extent to which a company's higher value activities, for instance research and development, are internationalised - a measure which is intended to capture the quality or depth of foreign production.

The conclusion from this is that an SME can be an MNE, as long as it owns or controls income-generating assets in production and/or marketing operations in more than one country. Thus, the concept of the MNE and that of the SME are in fact consistent.

Interestingly, the UK and German SME FDI research reveals a distinctively similar pattern. Both strands of research into the FDI commitment of SMEs have focused on those geographic investment areas that were culturally close to the home countries of

the SMEs under investigation. This was a consequence of the influence of psychic distance on FDI by SMEs.

The concept of psychic distance was introduced into the context of a firm's internationalisation by Johanson and Wiedersheim-Paul (1975). It is a function of the differences between any two countries in terms of their level of development and education, culture, business and everyday languages, political systems and the extent of commercial connections which prevent or disturb the flows of information between firms and target nations. The concept suggests that firms not familiar with foreign countries, and whose limited information does not contribute to reducing the perceived risk in doing business with, or in, a particular country, do business with, or invest in, first neighbouring countries or those countries, that are as similar as possible to their home countries. This is seen as a way of minimising the risks arising from 'foreignness' (Buckley, 1989).

Johanson and Wiedersheim-Paul (1975) point out that psychic distance is correlated with geographic distance, ie the further a market is from the home market geographically, the greater is the psychic distance between this market and the home market. However, Buckley (1989) argues that often, psychic and physical distance are negatively correlated, ie countries that are physically distant are psychically closer (UK vs. Australia) than physically close countries (USA vs. Cuba).<sup>26</sup> However, to underestimate psychic distance between two ostensibly 'close' countries would be unwise as is shown by the studies about UK FDI (Buckley et al., 1988) and UK FDI in Australia (Mathew 1979; Buckley and Mathew, 1979, 1980). More recently, Lau (1992) analysing the development process of Hong Kong garment manufacturing companies, found that ethnic bond and geographical proximity seem to be the most salient location-specific factors.

According to Carlson (1975) and Buckley and Mathew (1979), for smaller firms political, cultural, and language barriers are more formidable than physical distance. This corresponds with findings by Schmidt et al. (1995) who emphasise that perceived psychic distance to the home country correlates positively with firm size. Based on findings from a study of 43 UK first-time investors, Buckley (1979) suggests that the rate of success of UK SMEs is higher in the 'white dominions'. Further, Cavusgil (1984) in his study of 70 US SMEs found that Western Europe was the primary export market for all firms, followed by Canada and Mexico. This contrasts with initial expectations that the experimental and active exporters would concentrate on psychically close countries such as Canada. The applicability of Cavusgil's (1984) argument is limited

since he does not provide information on the markets in diversified Europe to which the companies began exporting. In their study of 141 US service firms, Erramilli and D'Souza (1993) found that, with increasing experience, firms chose countries that are increasingly dissimilar to their home country.

This confirms findings by Caughey and Chetty (1994), who investigated the pre-export behaviour of manufacturing SMEs from New Zealand. They discovered that the firms chose initially to start exporting to countries that were psychologically close, such as the UK and the US. Only when they gained confidence and experience in exporting did they begin exporting to other markets, ie in Southeast Asia and the Middle East.

Buckley and his colleagues concentrated their early interest in UK SME FDI in Australia (Buckley and Mathew, 1979; Buckley et al., 1988) and only later moved on to research European FDI in the UK (Buckley et al., 1983). Here Buckley *et al.* examined the success and problems of European SMEs<sup>27</sup> in establishing 51 subsidiaries in the UK. From their examination of the FDI of 52 UK firms in Australia Buckley and Mathew (1979) found that the companies moved to FDI in order to exploit present and anticipated market opportunities more effectively than would have been possible through exports or other market servicing modes. Whereas the manufacturing firms in their study had attempted to avoid traditional defensive measures, such as tariffs and quotas, and responded to local competition, the service firms followed on behind their UK clients. From the fact that the subsidiaries of the UK first-time investors were "generally small"<sup>28</sup> and "larger UK enterprises were excluded" (p.59), the authors indicated that the size of the UK parent companies is small or medium-sized. This is not necessarily accurate and for this reason the empirical findings of Buckley and Mathew (1979) might not be comparable with other findings on SME FDI.

In their later investigation of 43 UK SMEs with FDI in Australia, Buckley et al. (1988) looked more closely into the investment motivations of these companies. In detail the authors observed that, where there were pull factors, such as market prospects, the firms were more successful than where firms were pushed to go abroad by home country legislation or high labour costs, etc. (= push factors). Such 'pull factors' as investment motivations were also found by Braun (1982) who investigated the FDI of German SMEs in LDCs. There, it was predominantly the desire to secure access to an existing market, or to create a new one, as well as to utilise the low production costs of the host country and bypass restrictive import policies.

These main motivations for an FDI project were also observed by Berger and Uhlmann (1984). In their research of 3,153 German large, small and medium-sized companies

with FDI projects in developed countries, as well as LDCs, the authors revealed remarkable differences between the investments of large firms and SMEs. They also highlighted the economic state of the host countries. According to their research the single most important motivation of German SMEs for choosing an investment location within an industrialised country was market proximity. However, the market motive is less important to SMEs than to large firms when the host country is an LDC and SMEs intend to develop additional markets to a lesser extent than large firms. Berger and Uhlmann's two groups of firms correspond with regard to import restrictions and production and transportation cost advantages. These are more important when entering LDCs. Perceived as important by both groups of firms (in developed countries and LDCs) were security of raw materials supply and investment support by the home and host countries. However, SMEs attached greater importance to them than large firms. This suggests that SMEs more frequently look for means to compensate for their weak resource position when engaging in FDI.

The company size-related differences observed by Berger and Uhlmann (1984) substantially contradict later findings by Schmidt et al. (1995). In their study of the market entry modes open to German SMEs, they could not find any such differences with regard to investment motivations. Although Berger and Uhlmann's (1984) early research was of considerable value in its time, it is now obsolete. The Berger and Uhlmann study was published more than 14 years ago and consequently was unable to track new trends and increased globalisation forces. Instead, included in Schmidt et al.'s (1995) motivations are marketing and market, production and cost, and sourcing. The interesting finding in this research is that motivations to engage in FDI were stable over time and generally more than one motive was necessary for the decision to engage in FDI.

Interestingly also, in contrast to the market motivation that dominates the FDI process of western SMEs (Buckley and Mathew, 1979; Braun, 1982; Buckley et al., 1983; 1988; Berger and Uhlmann, 1984; Onida et al., 1985; Bertin, 1986; Schmidt et al., 1995), Japanese SMEs were investing in LDCs (of Southeast Asia) to make use of offshore production advantages and export production back to Japan (Ozawa, 1985).

Another theme authors focused on was the distribution of ownership in subsidiaries of SMEs. Scholars, including Buckley et al. (1988) from their research on UK SMEs in Australia, Kaufmann et al. (1990) from their examination of cross-border co-operation<sup>29</sup> strategies applied by 79 German SMEs co-operating in the EU, Simon (1992, 1996) discussing the strategies of German SMEs for expanding abroad,<sup>30</sup> and Schmidt et al.

(1995), all found that SMEs prefer the establishment of wholly foreign-owned enterprises (WFOEs) to JVs or majority equity positions to arrangements where they would have a minority position. Buckley et al. (1988) derived a distinct relationship between control and success: firms with absolute control were more successful than their counterparts.

In contrast, Berger and Uhlmann's (1984) research and the UNCTAD (1993) study observed an SME tendency towards the establishment of JVs. UNCTAD (1993) discovered that multinational SMEs are more likely to jointly own affiliates than large firms, although this does not apply to those SMEs with proprietary technologies. This corresponds with the later findings of Acs et al. (1997) from a study of US SMEs. They argue that SMEs tend to have partially-owned foreign affiliates, whereas large firms have WFOEs. Also Kohn (1997), exploring the FDI strategies of US SMEs highlighted a tendency for SMEs to form minority-owned affiliates, as opposed to large MNEs. In a survey of seven US SMEs, Kohn and Gomes-Casseres (*forthcoming*) reveal a much lower share of JVs and licensing than expected. Of the 36 FDI projects undertaken by these firms, only five were JVs. However, to what extent Kohn's (1997) and Kohn and Gomes-Casseres's (*forthcoming*) findings are applicable is questionable as the upper margin of the size criterion 'number of employees' is pitched at 1,000 employees, as opposed to 500 staff in other studies. For example, Berra et al. (1995) defined an SME as a firm with a workforce up to 200 employees and found amongst Italian clothing firms a high propensity for contractual ventures and FDI in the period 1987 to 1991.

### 2.3.3 SME FDI barriers

SMEs face considerable barriers in their efforts to internationalise and even more stringent ones when engaging in FDI (Braun, 1982, 1996; Berger and Uhlmann, 1984; Brockmeyer, 1987). Authors (Buckley et al., 1988; Acs et al., 1997; Eden et al., 1997) have found that SMEs are more likely to fail in their international expansion and transfer of technology than large firms. Frequently stated constraints are the high costs, management requirements, market intelligence needs, risks and uncertainties associated with identifying foreign market opportunities and subsequently executing them. In short: finding a location for manufacture (in case of an FDI project) or the right partner (when the FDI project is a JV), adapting to a foreign culture, with a different administrative and legal system, foreign language difficulties etc. (Oman, 1984; Acs et al., 1997). Also, and this is an aspect which is regularly overlooked in the literature, host government investment policies often focus on the strategic or high-profile sectors of their economies rather than on SME industries (Braun, 1982; Oman, 1984). This

affects SMEs' bargaining power with regard to factors such as a minimum local stake, financing problems, location regulations and local content. According to Acs et al. (1997) these are regarded as the highest, economically most damaging and most difficult to overcome entry barriers for SME FDI.

An interesting insight from Braun's (1982) investigation of German FDI in LDCs is that internal as well as external problems were regarded as more taxing by smaller (up to 200 employees) than by larger (200 to 1,000 employees) firms. Braun's (1982) research provides considerable insight into the different perceptions companies of different sizes have of barriers to FDI. However, since Braun (1982) includes firms of sizes up to 1,000 staff and distinguishes them only by applying a 200-employee workforce margin, the applicability of his findings is limited. In accordance with Braun (1982), Berger and Uhlmann (1984) contend that the perception of difficulties correlates with firm size and that they are regarded as more severe by SMEs than by large companies. Interestingly, non-investors perceived nearly all difficulties to be more important than investors, reflecting the higher risk-aversion of non-investors. Brockmeyer (1987), from his research on selected cases of German SMEs with business operations in Japan, highlighted the problem of recruiting sufficiently qualified personnel for an FDI operation as one of the most important reasons for German SMEs not entering the Japanese market on their own.

The international marketing literature suggests a broad range of areas where SMEs are at a disadvantage compared with large firms when engaging in internationalisation. This is because it requires resources which SMEs often do not have (Penrose, 1956; Buckley, 1979; Oman, 1984; Cavusgil, 1984; Contractor and Lorange, 1988; Edmunds and Khoury, 1986; Buckley et al., 1988; Stanworth and Gray, 1991; Peridis, 1992; Bonaccorsi, 1992; UNCTAD, 1993; Erramilli and D'Souza, 1993; Walker, 1994; Donckels and Lambrecht, 1995; Schmidt et al., 1995; Laughton, 1995; Kaufmann, 1995; Gibb, 1995; Braun, 1996; Gomes-Casseres, 1997; Acs et al., 1997; Eden et al., 1997). Especially higher forms of market servicing are *a priori* excluded from the portfolio of many SMEs. Various scholars have argued that SMEs must execute internationalisation strategies that are consistent with their capabilities and that they should avoid market servicing strategies that require large financial and managerial resources (Contractor and Lorange, 1988; Kean, 1989; Calof, 1993; Wu, 1993; Tsang, 1994; Baird et al., 1994).

The four areas where SMEs are at a disadvantage when it comes to FDI, compared with large MNEs, are:



- financial resources,
- managerial resources,
- information shortages, and
- attitude to risk.

In addition, SMEs display a high degree of naivety and lack the public relations skills and lobbying power of larger MNEs (UNCTAD, 1993; Gomes-Casseres, 1997; Buckley, 1997). Also, according to Kohn (1997), in foreign environments only large firms can afford the product customisation and marketing modifications required.

However, it must also be noted that problems can be overcome. Buckley (1979) insists that difficulties facing SMEs in FDI are most acute for first-time investors. The risks are perceived to be great and the firms have no international experience on which to draw. Many firms in the study by Buckley et al. (1988) had unsuccessful first foreign ventures but subsequently went on to undertake successful foreign investments. By engaging in an FDI project for the first time and making mistakes, the firms learned and could avoid many pitfalls in subsequent investment projects.

#### ***Limited financial resources***

The high financial burden of foreign market servicing for SMEs has frequently been referred to in the literature (Edmunds and Khoury, 1986; Peridis, 1992; Hall, 1992; UNCTAD, 1993; Caughey and Chetty, 1994; Schmidt et al., 1995; Berra et al., 1995). Some (eg UNCTAD, 1993) consider financial constraints as the largest problem for SME FDI. The limited access to financial resources plays a crucial role in the internationalisation process of SMEs since, as Buckley (1979) and Buckley et al. (1988) suggest, failure often puts the enterprises' home bases at risk. Multinational corporations raise capital from a variety of sources at home and abroad. These include commercial banks, local and international equity markets and their own corporate systems in the form of internally generated profits for reinvestment (UNCTAD, 1997). SMEs are considerably disadvantaged in this respect as they are less able to raise risk capital from the public. Buckley (1997) also cites the problem faced by SMEs of 'selling' investment opportunities to potential investors. This is compounded by a tendency to hang on to (family) control. From the SME financing literature it is known that SMEs face a so-called "Catch 22" situation when trying to raise funding for projects (Buckley, 1979).

#### ***Limited managerial capacity***

International activities and, in particular, FDI are highly management-intensive because of the high risks involved in moving abroad and the necessity to collect and crucially

channel information (Buckley et al., 1988; Buckley, 1993). The shortage of managerial capacity is an equally important barrier to SME internationalisation, although according to UNCTAD (1993) it ranks second after financial restrictions. However, Buckley (1979, 1997) and Buckley et al. (1988) insist that in most cases, managerial constraints leapfrog financial constraints since, due to management shortages, SMEs are forced to take short cuts in decision-making, often with disastrous results. Often, however, management and financial constraints are correlated since a lack of funds often results in a lack of investment in human capital. Managing at a distance was found by Buckley (1979) as the most frequent difficulty with the operation of an SME FDI project.

When the literature discusses the problem of limited managerial resources, it frequently ignores that this comprises numerous strands. Elements such as management time, management expertise, ambition and motivation, and contacts are all part and parcel of the problem. This is supported by VobaRaiba (1997) suggesting that the managements of SMEs have, predominantly, to combat two bottlenecks: scarcity of time and problems with information gathering. Whereas Cavusgil (1984) argues that management time is the single most influential constraint on the capacity of SMEs to grow internationally, Walker (1994) considers the ability and willingness of management teams to adapt to changes and environmental developments as the major limitation.

#### Management expertise

Internationalisation requires a range of skills (Moini, 1995). For instance, Simon (1992, 1996) revealed that the skills of general managers were important assets for Germany's 'hidden champions'. Frequently SMEs do not have specialist executives to manage their international operations, nor a hierarchy of managers for complex decision-making. Instead, decision-making is much more likely to be personalised involving *ad hoc* short-term reckoning based on individual perceptions, prejudice and ignorance (Buckley, 1979; Stratos, 1990; UNCTAD, 1993). This is considered as a major problem for SME internationalisation (Cavusgil, 1980; Peridis, 1992; Hall, 1992; Smallbone et al., 1995) and explains, for instance, a firm's ignorance of government assistance towards exporting or FDI activities, as found by Edmunds and Khoury (1986) in their examination of Californian SMEs which had targeted a greater role in exporting. Further, a lack of management expertise manifests itself in insufficient internationalisation know-how (Gibb, 1995), though various authors (eg Schmidt et al., 1995) list this aspect separately. Buckley (1997) points out that SMEs with inexperienced managers can behave in a naive fashion.

Donckels and Aerts (1992) in their research on the internationalisation of Belgian SMEs have shown that internationally active business managers speak significantly more languages than internationally non-active managers. Equally, from the research of Belgian small businessmen, Lambrecht (1992) has established that the number of business dealings with LDCs increases in accordance with the managers' level of education and knowledge of languages. Accordingly, Caughey and Chetty (1994) who investigated the pre-export behaviour of small New Zealand manufacturing firms,

discovered that exporters had more management education than non-exporters. Overall, the characteristics of the decision-maker within a company may determine how internal and external stimuli are perceived and interpreted. For example stimuli such as: the goals of the firm and the expected fulfilment of those goals, fortuitous orders from foreign customers, market opportunities, competition, economic integration and government stimulation measures (Olson and Wiedersheim-Paul, 1978).

In a subsequent study investigating 480 Belgian SMEs with business connections with LDCs, Donckels and Lambrecht (1995) found that JV entrepreneurs are significantly older than non-JV entrepreneurs and that they are more frequently university graduates than non-JV entrepreneurs. However, these results contradict earlier findings by Caughey and Chetty (1994) which suggested that younger (and better educated) decision-makers were more likely to respond positively to export stimuli than older ones.

#### Restricted management time

Management time becomes more important the deeper the international involvement of the SME: large amounts of management time are needed to collect, collate, sift and evaluate relevant information. Not only is management expertise as a qualitative component a scarce resource, but so also is the management time made available to their international undertakings within SMEs (Gibb, 1995). VobaRaiba (1997) points out that SMEs do not have expensive experts with the corresponding expertise.

Frequently, this leads to short cuts with limited global scanning of opportunities (Buckley, 1979, 1997; Schmidt et al., 1995). Managerial talent is often pre-occupied with day-to-day problems, leaving insufficient time for long-term planning (Cavusgil, 1980; UNCTAD, 1993). Understandably, the actual time spent on the exploration of additional business abroad and FDI opportunities is negligible. This "fire-fighting" mode of operation was detected by Peridis (1992) in 30 per cent of the senior managers surveyed in a study of various forms of strategic alliance involving 16 Canadian technology-based SMEs. Eden et al. (1997), in their comparison of large firms and SMEs as producers of technology, suggest the latter are likely to lack the managerial resources available to large firms and are therefore less likely to use formalised methods to send technical experts abroad, or to provide formal training.

The limited global scanning of opportunities within SMEs is verified in the data of Buckley et al. (1988). From their study of 43 UK investors in Australia, the authors discovered that only 15 firms at any stage considered an alternative country for their investment. When searching for alternatives, the companies spent, on average, two to six months, with 12 months being the longest period. However, Buckley et al.'s (1988) comparison of search periods is misleading since some firms are more sophisticated in country scanning than others. A clearer statement on this aspect would have been possible if Buckley et al. (1988) had provided details on the search processes applied by the firms.

#### Lack of contact networks

Limited management time exacerbates the problem of restricted contact networks. Given constant quality of management staff, the size of a contact network is likely to be

more extensive in a company with greater management resources. Having extended global networks is vital for the establishment of international business. However, building international networks requires a positive attitude towards different cultures and at least a basic understanding of international languages. Thus, the management criterion 'networks of contacts' is correlated with the issues, expertise, ambition and management motivation.

#### Management ambition and motivation

The values and attitudes of (top) managers influence the behaviour and development of firms. In other words, a manager's values in respect of change, risk, innovation, growth etc. determine – directly or indirectly – the choice of objectives (Stratos, 1990). According to Gibb (1995), ambition and motivation of a firm's management is an important determinant of internationalisation success.

This includes, for instance, the mobility of managers (Braun, 1982). If the key individual within an organisation cannot be convinced of the need to devote resources to develop an international orientation, the internationalisation of a company can be affected seriously (Olson and Wiedersheim-Paul, 1978). Samuels et al. (1992) point out that there are small firms that have been in existence for a long time and have remained small due to the owners not seeking growth. Both personality and the objectives of the decision-maker are of basic importance for internationalisation behaviour (Schmidt et al., 1995). Simon (1996), for instance, considers the determination of the 'hidden champions' to become number one in their markets as being crucial to their success. It is frequently overlooked in the literature that critical issues such as the ambition and motivation of a manager are correlated with education and expertise.

In their study of German SMEs with cross-border co-operations in Europe, Kaufmann et al. (1990) found that in nearly 90 per cent of all cases, the idea of co-operating with another enterprise in Europe was initiated from inside the company. Had this not been the case, many of the 122 companies out of 474 German SMEs in this study, would still be operating on their own.

#### ***Information scarcities***

Becoming 'international' implies entering complex terrain (UNCTAD, 1993). Accessible information about foreign cultures and markets is essential to success (Kean, 1989; McDowell and Rowlands, 1995; Belich and Dubinsky, 1995). It plays a crucial role in risk reduction (Buckley, 1979). The importance of the availability of information cannot be over-emphasised (Buckley et al., 1988) since lack of knowledge of a host country, for instance, can frequently lead SMEs to make inappropriate decisions (UNCTAD,

1993). Whereas some authors (Deloitte Touche, 1992) argue that information problems are a major obstacle to SMEs, others (Berger and Uhlmann, 1984) have suggested that insufficient know-how of operating abroad is the least of a firm's worries. The need for high quality information to support decision-making becomes even more crucial for the switch from exporting to FDI. This is demonstrated in various models (Vernon, 1966; Hirsch, 1976; Buckley and Casson, 1981) based on the different costs involved in these methods of market servicing and – in the case of the Buckley and Casson (1981) model – the demand and conditions in the market and host market growth. This is confirmed by Cafferata and Mensi (1995) who argue that the need for information, communication and other support services increases as SMEs shift from simple to more complex internationalisation paths.

However, SMEs are often at a disadvantage, because of the fixed costs involved vis-à-vis larger firms in collecting and analysing information about the environment, the legal, economic and political aspects of operations and methods of doing business abroad, market opportunities, sources of finance, government regulations etc. (Buckley, 1979; Delacroix, 1984; Kean, 1989; Stanworth and Gray, 1991; Smallbone et al., 1995; Schmidt et al., 1995). Delacroix (1984) argues that obtaining information about little known environments, and interpreting and acting upon that information is more costly than doing the same at home. SMEs are not usually able to send their personnel to foreign countries for a lengthy period (UNCTAD, 1993). This results often in less than perfect information for SMEs (Acs et al., 1997). Buckley (1993) argues that shortage of information reinforces the impact of uncertainty on decision-making.

In their study of UK firms in Australia, Buckley et al. (1988) found that, often, information is both readily available and free with most countries providing a service to prospective investors and giving large amounts of free information on their economy, laws, aids to industry, labour conditions and costs, etc. In most cases, however, this type of information is rather general in nature and needs to be tailored first before it can be used for decision-making. The limited availability of adequate information within SMEs embarked upon internationalisation, both qualitatively and quantitatively, is confirmed by findings of a Stratos (1990) study that looked into the internationalisation pattern of European SMEs.

### ***SMEs' attitude to risk***

Due to their financial resource restrictions, a commitment to FDI means SMEs put more at stake than large firms. SMEs are highly vulnerable (Buckley, 1979). Their risks are highly concentrated due to poor diversification, changes in supply and demand, technological improvements and governmental policy decisions that can easily leave them in an unenviable position. The risk is perceived to be greatest when the firm has

no international experience to draw on (*ibid*). Since SMEs normally do not have ready access to long-term credit, the desire for a quick recovery of the investment outlay is higher for SMEs. This restricts the goals of SMEs to the short term (UNCTAD, 1993). SMEs are more risk-aware and cautious with their investment, though usually they do not carry out risk assessments, etc. As a consequence, they are often greater risk takers than more 'managerially-minded' entrepreneurs (Buckley, 1997).

## 2.4 The need for SME FDI

The initial decision to engage in FDI is critical for the MNE (Rugman, 1985). Consequently, the explanation of why MNEs undertake FDI has concerned researchers for some 60 years, commencing with Coase's (1937) contribution on the 'nature of the firm'. Since then, scholars have been trying to explain FDI against the background of international trade theory (Mundell, 1957; Heckscher & Ohlin; see Mookerjee, 1958; Vernon, 1966; Hirsch, 1976), theory of location (Calvet, 1981), investment theory (Barlow and Wender, 1955; Aliber, 1970, 1983), theory of the firm (Penrose, 1956; Kindleberger, 1979), and industrial organisation theory (Hymer, 1976;<sup>31</sup> Williamson, 1975; Buckley and Casson, 1976; Dunning, 1977; Rugman, 1985). The vast majority of FDI theorising has been carried out on large rather than small MNEs (Vatne, 1995). However, as SMEs face size-related constraints on internationalisation (Baird et al., 1994), theorising on SME FDI requires particular attention. It has taken scholars another forty years to consider the specific case of SME FDI following Coase's first FDI theory. Ten years after establishing the criteria for success for SME investors in the late 1970s (Buckley, 1979), Buckley (1989) proposed theories for SME engagement in FDI, including the 'evolutionary approach', the 'economics of the firm's growth approach', the 'gambler's earnings hypothesis' and the 'corporate decision-making approach'. Subsequently, Buckley (1997) has restated his ideas drawn from a wide range of theoretical concepts, including the ideas of incremental international involvement (Johanson and Wiedersheim-Paul, 1975; Johanson and Vahlne, 1977), the economic theory of the firm (Penrose, 1956) and the investment decision-making process (Aharoni, 1966). All strands, he suggests, adopt different perspectives, although they have a common theme: the importance of management and the constraints on SMEs, including lack of finance, shortage of managerial capacity and non-availability of essential information.

### 2.4.1 Buckley's SME FDI theorising

Internationalisation is the process of an organisation's increasing involvement in international business (Welch and Luostarinen, 1988; Young et al., 1989) or simply a process by which firms adopt international business activities (Cavusgil, 1980).<sup>32</sup>

Elsewhere (Albaum et al., 1992, p.33), internationalisation is considered to be "the successive development in a firm's export management in terms of the geographical spreading in markets, products and operation forms, and the changes in export management philosophies and organisational behaviour from the beginning of the process to the actual situation." This latter attempt to clarify the terminology demonstrates the hefty influence of the export literature in the discussion of firm internationalisation (Bilkey and Tesar, 1977; Pavord and Bogart, 1977; Cavusgil, 1980, 1984; Czinkota, 1982; Edmunds and Khoury, 1986).

According to the evolutionary model of international involvement, the internationalisation of the firm proceeds in stages, representing a process of incremental involvement with regard to managerial and financial resources (Young et al., 1989; Lopez-Gonzalez et al., 1995). FDI is perceived to be the ultimate stage of international commitment, following exporting which launches the process (Buckley, 1989). With FDI, the company has reached a stage where, in contrast to exporting, the value-adding part of the manufacturing process is carried out in a host country. Buckley (1989) breaks down the internationalisation process into a series of stages, termed the 'routes of investment' in production facilities overseas.<sup>33</sup> These start with domestic activities before moving to direct exporting, use of a foreign agent, establishment of a foreign sales subsidiary and, subsequently, establishment of an overseas production subsidiary. Throughout the process, the choice of strategy is influenced by a complex mix of both internal and external factors (Baird et al., 1994). During the evolutionary process, perceived risks decline, market opportunities are identified and managerial skills are developed.

Buckley (1989) highlights the existence of crucial interactions between internal and external pressures in the firm's development. Since all forms of international activity, and in particular FDI, are management-intensive, he stresses the critical role of management activity and awareness in the internationalisation process. Buckley (1989) equally holds that information is a crucial part of the feedback process and, thus, a critical factor impacting on progression from one stage to the next. Success in the initial stages of the process will dictate the speed of progression towards additional levels of commitment, whereas lack of success will lead to withdrawal and de-internationalisation (Cavusgil, 1980; Young et al., 1989).

The idea of incremental learning in the evolutionary model was developed at the Nordic Uppsala school of thought (Johanson and Wiedersheim-Paul, 1975) and formalised by Johanson and Vahlne (1977) as the model of the firm's

internationalisation process. It is an early attempt at classification, using the market entry form as a criterion drawing on extensive experience with Swedish firms.<sup>34</sup> Various studies provide evidence for the practical relevance of the evolutionary process of internationalisation (Gruber et al., 1967; Hörnell et al., 1973; Johanson and Wiedersheim-Paul, 1975; Bilkey and Tesar, 1977; Johanson and Vahlne, 1977; Luostarinen, 1979; Edmunds and Khoury, 1986; Buckley et al., 1988). Nevertheless, the majority of studies stem from the vast body of export literature (Bilkey and Tesar, 1977; Pavord and Bogart, 1977; Edmunds and Khoury, 1986) where authors identified four (Pavord and Bogart, 1977),<sup>35</sup> five (Cavusgil, 1980),<sup>36</sup> or six (Bilkey and Tesar, 1977;<sup>37</sup>) distinct stages throughout the internationalisation process.

The Uppsala school extended the idea of incremental international development to the entire process of a firm's internationalisation from exporting to FDI. Hörnell et al. (1973), with their case study of a Swedish pharmaceutical firm established in nine foreign countries, provide confirmation for the internationalisation process. Johanson and Wiedersheim-Paul (1975) found support for a step-wise process in the internationalisation of four Swedish firms.<sup>38</sup> Further empirical confirmation of the incremental internationalisation process has been discovered in US firms (Gruber et al., 1967), Australian firms (Wiedersheim-Paul et al., 1978), Japanese firms in Southeast Asia (Yoshihara, 1978), Finnish firms (Luostarinen, 1979), UK SMEs (Buckley et al., 1988), German SMEs in Europe (Kaufmann et al., 1990) and in China (Schüller, 1994; Commerzbank, 1995), Belgian firms (Donckels and Lambrecht, 1995) and Dutch firms (Barkema et al., 1996).

Despite Buckley et al.'s (1988) findings that companies which pursue the evolutionary model perform better than companies preferring an aggressive growth strategy, various authors (Young and Hood, 1976; Czinkota, 1982; Hedlund and Kverneland, 1983; Reid, 1983, b, 1984; Cavusgil, 1984; Edmunds and Khoury, 1986; Turnbull, 1987) have criticised the wide acceptance and popularity of the staged approach. They argue it is not consistent with the empirical evidence and is based on two significant studies only, namely the original research by Johanson and Wiedersheim-Paul (1975) and the research into Australian firms by Wiedersheim-Paul et al. (1978). This criticism is based on the argument that entry modes are more direct and rapid than those implied by the evolutionary model. The pace and pattern of a firm's internationalisation is strongly influenced by stability of market conditions, size and growth, a company's market experience, international experience in transferring technology and product lines, the present stage of internationalisation, a company's resources and its organisational structure (Hedlund and Kverneland, 1983). Turnbull (1987), reporting on



the reversal of stages, cites one case of the closure of a sales office which resulted in a company returning to direct exporting. This emerged from research into 72 UK-spawned organisational structures in France, Germany and Sweden.

Davidson and McFetridge (1985) report that their sample companies did not follow the classic pattern of 'exporting-licensing-FDI' due to the difficulty of developing export sales under Chinese state trading procedures and the reluctance of firms to license for fear of technological loss. This applies also to the Hong Kong garment manufacturers cited by Lau (1992). Unlike North American and West European MNEs, the Hong Kong firms did not use licensing as a market servicing tool prior to establishing their manufacturing subsidiaries.

Despite the general legitimacy of the arguments, the above criticism of the internationalisation process is based on large firm thinking (eg Young and Hood, 1976; Hedlund and Kverneland, 1983; Cavusgil, 1984). Large firms have the resources and managerial philosophy needed to plan expansion strategies that do not necessarily follow any strategy developed from previous experiences (Lopez-Gonzalez et al., 1995). Further, the evolutionary approach does not require adherence to a strict order of stages, but accepts leapfrogging of some intermediate steps to suit a firm's experiences or market size considerations. Companies with experience in culturally similar countries have a ready understanding of cultural characteristics which, coupled with experience of market entry strategies, streamlines the market entry process (Wiedersheim-Paul, 1975; Welch and Luostarinen, 1988). However, as Strandskov (1986) acknowledges, the literature offers only few alternative paths to internationalisation, despite the firms coming from different-sized countries, facing different technological, managerial, and environmental conditions. Critics of the model view the stages process too narrowly, solely on a one-country basis instead of adopting a multi-country perspective. Explicitly, Hedlund and Kverneland (1983) stick too rigidly to the terminology and fail to expose a wider perspective. For instance, Carstairs and Welch (1982) revealed that in all but eight of 43 cases, licensing was not the first form of international involvement by Australian firms in their study. It was preceded generally, if not by exporting to particular foreign markets, at least by exporting to *other* foreign markets.

On the other hand, Rennie (1993) in his study of the export behaviour of 300 Australian firms, highlights the growing existence of 'born global' enterprises. This contradicts the long-standing assumption that SMEs need to establish a successful domestic base before embarking on export strategies and subsequently FDI.

Elsewhere, though, it is suggested that 'born global' exporters seem to be the smaller group (Economist, 3.7.93, p.59). Nevertheless, criticism of citing Rennie (1993) to contradict the applicability of the incremental internationalisation model might be justified since this author does not question explicitly the incremental move from exporting to FDI. Implicitly, however, Rennie's (1993) reasoning could be extended to suggest that these 'born global' companies are able to establish an FDI presence without having previously exported or licensed extensively to a specific country.

Some of these critical notes (Hedlund and Kverneland, 1983; Cavusgil, 1984) give grounds for criticism themselves. For instance, Cavusgil's (1984) suggested methodology for classifying the exporting firms into three categories (experimental, active, and committed exporters) along a range of four measurable criteria was primarily judgmental and highly subjective. His entire approach promotes the belief that he measured a concept that he had already pre-determined. The purpose of this exercise and the conceptual and empirical value of Cavusgil's (1984) note is not clear.

Buckley (1989) further includes, in his discourse of SME FDI theories, the 'economics of the firm's growth approach', the 'gambler's earnings hypothesis' and the 'corporate decision-making approach'. These are promoted by Buckley as distinct approaches. In fact, both the 'economics of the firm's growth approach' and the 'gambler's earnings hypothesis' revolve around the shortage of financial resources which restrict an SME's FDI. Equally, both approaches emphasise the fact that companies, due to their inability to raise external funding in the form of loans, use retained earnings for the financing of their direct investment projects. This merely reiterates Penrose's (1956) original economic theory of the firm which suggests that firms starting with only a small investment can eventually operate on a sufficiently large basis in the foreign country to capitalise on market opportunities and to defend their position against both indigenous and foreign competitors.

Some aspects may raise concern about the applicability of the growth of the firm's approach as a rationale for SME FDI. Penrose (1956) argues that it is one of the notable characteristics of the growth of large corporations, to the extent they change the range and nature of the product as they grow. However, the difficulties of diversification and expansion out of a given sector and product are well known (Teece, 1985). So, by the same token, are the entry barriers to new areas of growth (Bain, 1956). Consequently, SMEs that are frequently one-product firms (Buckley, 1989) may find it difficult to diversify into a new product area in case competition causes profits and profitability, and future success prospects, to decline. Moreover, although the

rationales provide reasoning as to how firms grow, Penrose's (1956) theory of the growth of the firm does not offer an explanation as to why firms engage in FDI in the first place. According to the theory of the growth of the firm, a firm's expansion drive is determined by its internal resources, but fails to take environmental factors into the equation. Whereas the evolutionary approach, the economics of the firm's growth approach and the gambler's earnings hypothesis clearly emphasise the resource starvation suffered by many SMEs, Buckley's (1989) suggested corporate decision-making approach fails to capture their situation. It focuses on organisational behaviour in general. Further, the economics of the firm's growth approach, the gambler's earnings hypothesis and the corporate decision-making approach revolve around the issue of management being a major variable in the decision to invest abroad. However, it has been established above (section 2.3.3) that SMEs frequently lack the managerial resources that are essential for FDI. Thus, Buckley's (1989) SME FDI theories are constructed on a vital element which is frequently absent from the SME armoury.

This thesis also challenges the applicability of the evolutionary model. Regardless of all the empirical support and the doubt that the model has attracted, it has descriptive power - but only to suggest why firms gradually build up their international market servicing strategies and do not engage in FDI activities without prior international experience. What it fails to offer is a rationale for why firms finally make the decision to engage in FDI: what makes an SME take the final step to FDI? Why does an SME not continue exporting or licensing its technology to a customer abroad? The evolutionary model cannot answer these questions. The fact that an SME has gained experience in international business and markets is not a *sufficient* condition for it to engage in FDI, although it is necessary. The evolutionary model has no explanatory value. Neulinger and Rössl (1991) consider the evolutionary approach as classification only with no empirical relevance at all. Neulinger and Rössl's (1991) criticism sits comfortably with that of Reid (1983, b, 1984), Cavusgil (1984) and Turnbull (1987). However, as has been established, much of this criticism is in fact not well grounded.

#### **2.4.2 An appropriate SME FDI theory**

This thesis argues the application of Dunning's (1977) eclectic approach to FDI<sup>39</sup> offering a holistic framework with which it is possible to identify and evaluate the significance of the factors influencing both the initial act of foreign production by enterprises and the growth of such production. The eclectic theory draws on industrial organisation theory that stresses oligopolistic behaviour and imperfect factor markets as well as location theory.

The need for an eclectic theory for FDI was first recognised by Baumann in 1975. Subsequently, Dunning (1977) put forward the idea of the eclectic paradigm which states that the extent, form, and pattern of international production is determined by the configuration of three sets of advantages as perceived by enterprises: firm-specific, internalisation and location-specific advantages. The theory includes both home-country and host-country characteristics as additional explanatory factors. It further argues that these advantages must be sufficient to compensate for the costs of setting up and operating a foreign value-adding operation, in addition to those faced by indigenous producers. Subsequently, Dunning (1980) tested the eclectic paradigm empirically in order to evaluate the significance of ownership and location-specific variables in explaining the industrial pattern and geographical distribution of the sales of US affiliates in 14 manufacturing industries in seven countries in 1970.

The eclectic paradigm refers to firm-specific advantages (FSAs) as ownership advantages (O) and to country-specific advantages as locational advantages (L). The third set are internalisation advantages (I). Analysing the eclectic theory reveals that it has split the FSAs identified by internalisation theory into separate ownership and internalisation advantages.<sup>40</sup>

Dunning (1977, 1980) stresses the separation of the country of origin-specific inputs from those that are location-specific, because the firm possessing country of origin-specific inputs can exploit them wherever it wishes, usually at a minimal transfer cost. Moreover, unless it chooses to sell its country of origin-specific inputs, or the right to their use to other enterprises, the endowments are – for some time at least – its exclusive property (Dunning, 1977, 1980). The eclectic theory is based on adherence to a stage-by-stage procedure: a firm being able to proceed to the next stage only when the conditions of the previous stage have been fully satisfied. When FSAs exist and the first condition is satisfied, the firm must have an incentive to internalise its FSAs, such as the incentive to secure property rights over its FSAs in knowledge. This is realised through an extension of its own activities rather than by externalising them through arm's-length contracts with independent firms. Dunning's (1977, 1980) eclectic theory states further that, if the internalisation advantage condition is satisfied, it must be profitable for the firm to move its operations abroad. This, he argues, is due to at least some factor inputs, including natural and labour resources outside the home country. Otherwise, foreign markets would be served entirely by exports and domestic markets by domestic production. In accordance with Caves (1971), Dunning (1977, 1980) further argues that the more ownership advantages an enterprise possesses, the greater the inducement to internalise them. Also the wider the attractions of a

foreign, rather than a home country production base, the more likely it is that an enterprise will try to engage in international production.

However, Dunning's (1977, 1980) eclectic paradigm has been criticised by various authors (Kojima, 1978; Aliber, 1983; Robock and Simmonds, 1989). According to these critics, the eclectic theory does not take into account variations in the strategies of specific firms. Moreover, the theory pre-supposes that different firms have broadly similar objectives and respond to economic stimuli both consistently and in the same direction. Further, the eclectic theory has only a restricted applicability for analysing public policy issues. This is based on the way in which it separates the largely policy-determined characteristics of the country environments from those location-specific characteristics that are less amenable to change brought about by policy choices. Another limitation of the eclectic theory is the omission of inter-nation variables, such as foreign exchange rates (Robock and Simmonds, 1989).

As a consequence, Dunning (1988) restated the eclectic theory's main tenets and presented a number of possible extensions of the paradigm. The purpose was to ensure that the eclectic theory remained "a useful and robust general framework for explaining and analysing not only the economic rationale of international production but many organisational and impact issues in relation to MNE activity as well" (Dunning, 1988, p.24). Dunning (1988) restated that, without international market failure, there is no *raison d'etre* for international production. Without the advantages of internalisation, much of the FDI would be replaced by the international contractual transaction of resources. The higher the transaction costs of using the market and the greater the efficiency of MNEs as co-ordinators of geographically dispersed activities, *ceteris paribus*, the more international production is likely to take place (ibid). Dunning (1988) finally extended the eclectic paradigm with the incorporation of more formal modelling. This included dynamic and development aspects of international production, the explanation of different forms of international economic involvement (eg arm's-length trade, JVs, non-equity contractual agreements), locus of decision-taking, divestment by MNEs (see Boddewyn, 1979, 1983, 1985) and consequences of MNE activity.

### **2.4.3 Joint venture<sup>41</sup> rationale**

As a next logical step in theorising about the motivations of firms to engage in foreign production in the form of a JV, Dunning's (1977, 1980) eclectic paradigm is extended to encompass this aspect. Whereas the ownership-specific as well as the location-specific advantages in Dunning's (1977, 1980) paradigm need no further consideration (since they are not affected by a firm's choice of establishing a JV instead of a WFOE),

the internalisation aspect in the Dunning (1977, 1980) model needs separate examination.

Organisational industrialists such as Hymer (1976), Williamson (1975), Buckley and Casson (1976), Dunning (1977, 1980, 1988), Casson (1979), Rugman (1979, 1983), Teece (1981) and Hennart (1982) have significantly advanced the understanding of FDI and the MNE as a response to imperfect markets. However, the majority of authors (Wells, 1973; Davidson and McFetridge, 1985; Teece, 1985; Thorelli, 1986) have restricted their theorising to the formation of WFOEs. This may be because, by value of assets, or employment, WFOEs have been far more important than JVs, outvaluing them by a ratio of 2.5:1 (Contractor, 1990). On the other hand, contractual and co-operative forms of FDI are so numerous that they require an integrated theory (*ibid*). Of those, most were JVs and more were announced after 1981 than in all prior years combined (Anderson, 1990).

The literature has long excluded JVs from the arguments about the creation of hierarchies to bypass the inefficient institution of the market. JVs could not be structured in such a way as to maintain both the bargaining and maladaptation costs inherent in such arrangements. With the establishment of a WFOE, an MNE could reduce dissemination risk and in so doing economise on the transaction costs of licensing or a JV. Williamson (1975) originally suggested two modes of organising economic activity, markets (exporting) and hierarchies (WFOE). Only later did he extend this logic to encompass inter-firm relationships falling between markets and hierarchies (hybrid modes, including licensing and JVs) (Williamson, 1985, 1991).

According to authors, such as Kindleberger (1979), Caves (1982), Rugman (1983), Killing (1983), Poynter (1985), Harrigan (1985) and Rugman et al. (1985) firms have a strong economic incentive to avoid the formation of a JV since it has long been seen as inferior to the WFOE in maximising the firm's returns on its FSAs. Other frequently cited obstacles to the JV strategy include the difficulty of appreciating each other's contribution (Kindleberger, 1979) and the potential collision of the partners' interests. In many cases, the barriers are of an internal attitudinal nature which, as Harrigan (1984) notes, are more difficult to overcome than external ones. Co-operative arrangements were long seen as only the second or third best option for supplying foreign markets. They were used only under external mandates when government regulations precluded exporting or licensing or the establishment of WFOEs (Wells, 1973; Beamish, 1985; Root, 1987; Contractor and Lorange, 1988; Hamill and Hunt, 1993).

This myopic view has been criticised on various occasions (Stuckey, 1983; Beamish and Banks, 1987; Contractor and Lorange, 1988; Contractor, 1990). Beamish and Banks (1987) extended the internalisation thinking to include the JV. They established the reasons why the JV may be the preferred strategy and presented empirical conditions when this is the case. Beamish and Banks suggested the existence of two necessary conditions to justify the utilisation of the JV, namely the possession of an FSA and the superiority of the JV over other means of appropriating rents from the sale of this asset in the foreign market. Earlier, Stuckey (1983) examined the conditions necessary to establish the superiority of JVs for firms pursuing vertical FDI with the application of the transaction cost paradigm. A similar consideration of JVs in the context of horizontal FDI, however, had long been lacking.

According to Beamish and Banks (1987) the JV can provide an even better solution than the WFOE to the problems of opportunism, the small numbers dilemma and uncertainty in the face of bounded rationality. The authors suggest that when MNEs are faced with higher adaptation and information requirements than they are traditionally accustomed to, particularly in culturally dissimilar countries, the JV may be more appropriate. Kogut and Shingh (1988) found that cultural distance increased the probability of choosing a JV over an acquisition or a WFOE. Further, Davidson's (1982) early findings that JVs are more strongly associated with firms inexperienced in a particular foreign market, were later confirmed by Buckley et al. (1988) and Wu (1993). The former examined the FDI of UK first time investors in Australia. The latter investigated the entry of European firms into the Chinese market.

Eventually, the literature has brought forward substantial lists of advantages for JVs as market entry strategies. Issues raised were the ability to facilitate the partner's local knowledge of the market and politics, and to access the partner's technology and distribution network, to embark on economies of scale, to reduce venture capital costs and overheads, and to get grants and cheaper loans in foreign countries (Engelhardt and Seibert, 1981; Killing, 1983; Herzfeld, 1983; Datta, 1988; Buckley et al., 1988; Contractor and Lorange, 1988; Gomes-Casseres, 1989; Contractor, 1990; Schuler et al., 1992; Lichtenberger and Naulleau, 1993; Zahra and Elhagrasy, 1994; Laughton, 1995). JVs were also praised for providing better ways of coping with competitive challenges than WFOEs. They were singled out for increasing interdependencies between industries and global competition (Harrigan, 1985; Perlmutter and Heenan, 1986) since they provide enterprises with a wider range of strategic flexibility (Harrigan, 1985, 1987).<sup>42</sup> The JV is widely acknowledged as a strategic option when factors, such as quotas or high duties, offer only limited choices of foreign market servicing

(Harrigan, 1985, 1987; Zahra and Elhagrassy, 1994). JVs may result in greater long-term market penetration through the promotion of a local image and market proximity (Engelhardt and Seibert, 1981; Buckley et al., 1988; Hamill and Hunt, 1993).

In their statistical analysis of the foreign market entry decision of 155 US MNEs, Stopford and Wells (1972) found that the choice of JVs relative to WFOEs declined with the increasing importance of technology and marketing and product standardisation. Later, Wells (1973), while researching the determinants of 187 US investors' attitudes towards JVs, discovered that firms that did not diversify and allowed their product lines to age, did not tolerate JVs.

This is confirmed by Gomes-Casseres (1989) who discovered that the main reasons for the formation of JVs were government attempts to restrict foreign ownership, local partner assistance with the acquisition of management expertise and local connections, to facilitate fast entry into new markets, the emergence of intensified competition in the world markets and the emergence of technological capabilities and market presence. From an analysis of statistical data from the 1970s and interviews with more than 40 international executives from five major MNEs, Gomes-Casseres (1989) discovered JVs are more appropriate for, and much more common in, cases where companies are following multi-domestic, rather than global strategies. Using a sample of Japanese investments in the US, Hennart and Reddy (1997) found that the JV is primarily a device to get access to resources embedded in other organisations and is, thus, preferable to mergers/acquisitions. From 20 interviews, Berg and Friedman (1980) found that executives perceive JVs as a way to link the specialised expertise of the parent firms and, therefore, reject merger, licensing, or internal development. Similarly, Harrison (1987), examining the JV as an alternative to merger/acquisition, notes that the JV is more attractive since it costs less, requires less risk-taking and causes less organisational upheaval. On the other hand, Finnerty et al. (1986), from their research on 208 US JVs, could not observe any abnormal wealth effect for stockholders participating in a JV than for stockholders of merging or acquiring businesses.

Conversely, McConnell and Nantell (1985) have shown that the share values of over 200 firms listed at the New York stock exchange increased for those companies that had undertaken JVs. Koh and Venkatraman (1991), examining the impact of JV formation on market value, found that JVs have significant, positive effects on the market values of the parent firms. This is in cases where JVs strengthen existing product-market segments or place new products in existing markets without creating



any appreciable increase in market values in instances where they develop new customers or enter new, unrelated product-market segments. Koh and Venkatraman (1991) further discovered that only the shareholders of the smaller partners earned significantly abnormal positive returns.

Scholars, including Janger (1980), Gomes-Casseres (1987, 1989) and Chowdhury (1992) have further detected better performance in JVs compared with WFOEs.

Various arguments against the use of JVs have been developed by authors, such as Caves (1982), Herzfeld (1983), Harrigan (1984, 1985), Contractor and Lorange (1988) and Gomes-Casseres (1989). These include: anti-trust problems, sovereignty conflicts, loss of autonomy, control and competitive advantage through strategic inflexibility, the risk of dissemination of intangible assets or expertise, the free-rider problem, inadequacy, when adopted by firms pursuing global strategies, problems with transfer pricing, host government regulations, creation of new competition and damaging implications for the firm's reputation.

#### **2.4.4 Additional joint venture theorising**

The need for JVs has been reasoned also by the application of transactional value, as opposed to transaction cost thinking. Proponents of this strand of thought, including Zajac and Olsen (1993) criticised the transaction cost thinking for neglecting interdependence between exchange partners in the pursuit of a JV, as well as important process issues. These authors are in favour of transactional value thinking as it addresses both joint value maximisation (rather than single firm cost minimisation) and processes by which exchange partners create and claim value. Explicitly, Zajac and Olsen (1993) showed that transaction costs and transactional value may often be correlated so that the pursuit of greater joint value requires the use of governance structures that are less efficient from a transaction cost perspective. Strategic and learning gains often increase transaction value while simultaneously increasing transaction costs. However, expected joint gains often outweigh transaction cost considerations in inter-organisational strategies (Zajac and Olsen, 1993; Madhok, 1997). On the other hand, the shortcomings of the transactional value framework for inter-organisational strategies are its inherent abstract nature and its requirement for additional development.

Apart from transaction cost and internalisation approaches, scholars have introduced a variety of additional schools of thought when theorising on the establishment of JVs. For instance, Baran et al. (1996) consider: (1) resource dependence, (2) strategic choice, (3) transaction cost theory and (4) the eclectic paradigm of foreign investment. On the other hand, Albrecht et al. (1996) suggest three approaches towards JV

formation: (1) internalisation approach, (2) strategic behaviour approach and (3) co-operative benefits and learning approach. The latter is comparable with Kogut's (1988) organisational learning amalgam derived from a review of transaction cost theory, strategic behaviour and organisational theory. Interestingly, Albrecht et al. (1996) published their arguments on JV formation in a compendium edited by Baran et al. (1996) who proposed, as outlined, four somewhat different approaches. This suggests that JV theories are neither right nor wrong. They are simply more applicable in certain circumstances than they are in others and they share commonalities.

For instance, the strategic behaviour approach - which has attracted much research (Harrigan, 1984, 1987; Harrison, 1987; Gomes-Casseres, 1989; Lyons, 1991) - and transaction cost theorising share several of these. However, they differ fundamentally in the objectives attributed to firms (Kogut, 1988). Whereas transaction cost theory argues that firms transact by the mode which minimises the sum of production and transaction costs, the strategic behaviour approach emphasises that firms transact by the mode which maximises profits through improving their competitive position vis-à-vis rivals. Kogut (1988) points out that a common failing is the treatment of the two theories as substitutes rather than as being complementary. Schuchardt (1994) argues that the corporate goals can be better met by employing co-operative rather than competitive strategies. This occurs under certain pre-requisites such as market and environmental conditions. Schuchardt's (1994) argument is sound in part only. Co-operative strategies, such as JVs, do provide the ability to overcome political, legal and economic market entry barriers and the unfamiliarity with the foreign environment. However, they do not contribute more than WFOEs to corporate goals such as reducing industry-specific uncertainty and risk factors.

Additional JV formation theorising has been put forward with Axelrod's (1987) 'theory of game approach'. Explicitly, the theory suggests that co-operative behaviour that is based on a few, simple and transparent rules, is the best long-term strategy of survival. Axelrod (1987) formulated several essentials for successful co-operative strategies and transferred them into socio-economic systems. These include an undertaking not to covet partner advantages, not to be the first to defect, to mirror both co-operation and defection and to utilise simple, transparent rules of behaviour. The game theory crops up in various approaches, including those of Beamish and Banks (1987) and Weder (1989) who integrated the idea of game theory into business management theory. The 'theory of game' shows JV specificity although the conditions of an approach that is suitable for analysis of internal interactions and individual problems, are only partly transferable into the international context.

## **2.5 SME joint venture research**

Although there are various proponents of the JV strategy who recognised that JVs open doors into international markets for SMEs that have fewer productive resources and/or market knowledge (Connolly, 1984; Harrigan, 1985; Contractor and Lorange, 1988; Wilson, 1990; UNCTAD, 1993; Kaufmann, 1995; Donckels and Lambrecht,

1995; Osland and Cavusgil, 1996; Buckley, 1997; Gomes-Casseres, 1997), only a few have dedicated their interest to a close investigation of the joint venturing of SMEs (Connolly, 1984; Kaufmann, 1995; Donckels and Lambrecht, 1995).

For instance, Connolly (1984) examined market situations where third world MNEs and US enterprises (especially SMEs) can form JVs to combine the distinctive advantages of each for mutual benefit. The third world MNE can support US SMEs that do not have the resources, experience or personnel to "go it alone". Though Connolly's (1984) study points out the areas of synergy for both sides in the JV, it does not examine the operational difficulties of the JV itself. These involve three national systems with different legal, tax and business practices and two headquarters' managements the interests of which may conflict. Moreover, Connolly's (1984) study overwhelmingly adopts the point of view of the third world corporation rather than that of the US SME. As a result it focuses more on what the SME can provide to the third world MNE rather than vice versa. Also Connolly (1984) emphasises situations where an SME joins forces with an LDC MNE to enter a third market but not the market of the MNE (eg a US SME forming a JV with a Chinese MNE to enter the Kuwait market). The attributes of host country enterprises most frequently sought by foreign SMEs (and large firms) - such as cultural links and contacts within authorities - could not be utilised in situations as laid out by Connolly (1984).

Later, Kaufmann (1995) examined whether, and to what extent, aggressive forms of internationalisation, such as JVs are appropriate to SMEs. Eventually, he expressed concern over whether pursuing a strategy of survival through foreign expansion, as large MNEs do, is adequate for SMEs. Kaufmann (1995) who builds his construct on the concept of trust, points out that SMEs tend to avoid JVs where problems of control and governance in areas of information and research and development are observable. As an example, the author suggests a JV in distribution where loss of market share for one partner often means a gain for the other. Consequently, Kaufmann (1995) discovered that the creation of cross-border co-operation among firms already known to each other is the preferred way for SMEs to engage in FDI. Risky co-operation with unknown partners is the exception rather than the rule. Hence, the promotion of co-operation for SMEs in the form of JVs has to include the mediation of information and contacts in order to improve transparency and reduce transaction costs. Only then can the co-operation with foreign partners abroad be a basis to realise synergies and to benefit from the advantages of a location in a foreign market (ibid).

## 2.6 Conclusion

This chapter has introduced the market servicing strategies open to SMEs. The review of the literature on SME internationalisation has shown that the bulk of studies on international SMEs revolve around exporting. Less is known about SME FDI. The

common theme that was discovered in the majority of studies is that SMEs are at a disadvantage compared with large firms when it comes to internationalisation and, in particular, FDI. Financial and managerial resource limitations, a paucity of market information and the SME's 'at risk' position have been established as the main barriers to SME FDI.

Chapter two did not discuss support mechanisms available on the national and supra-national levels (eg DTI, 1995 and Samuels et al., 1992 for UK; Mulhern, 1994 for EU; Berger and Uhlmann, 1984 for Germany; O'Sullivan, 1985 for foreign investors in Ireland;<sup>43</sup> Born, 1996 on trade missions). Support mechanisms are another means of enabling SMEs to enter foreign markets, apart from the application of the JV strategy.

This chapter has rejected Buckley's (1989, 1997) reasoning to explain the FDI of SMEs since it fails to provide any rationale for SMEs engaging in FDI. Whereas the evolutionary approach is only a descriptive model, the 'economics of the firm's growth approach', the 'gambler's earnings hypothesis' and the 'corporate decision-making approach' are centred on the importance of the SME's management capacity - an asset which many SMEs do not have. Dunning's (1977, 1980) eclectic theory of foreign production is thus applied in this study. It extended industrial organisation thinking that is, according to Rugman et al. (1985), applicable to both large and small and medium-sized MNEs. SMEs have FSAs that they wish to exploit in international markets. By doing so, they use the internal structure of the firm, rather than the market mechanism. Dunning's eclectic theory has been extended to encompass also the rationale of why SMEs engage in a JV.

The predictive power of the internalisation theory which deals with Dunning's (1977, 1980) internalisation advantage, is supported by the explanatory power of the internationalisation approach. The evolutionary approach of internationalisation provides the reasoning as to why firms enter a JV instead of a WFOE, if it is assumed that both forms are strategies of FDI. Especially in markets which are geographically or culturally distant, a JV can be an advantageous entry and servicing strategy as it is less resource-intensive than a WFOE (Schuchardt, 1994; Laughton, 1995). For many SMEs, the JV is the finite strategy for servicing a foreign market. For others it is the stepping stone to a form of higher commitment - the WFOE.

This approach of combining elements from both internalisation and internationalisation thinking, coincides with the ideas of Lau (1992). He argues that internationalisation and internalisation of a firm's FSAs do not necessarily conflict, but rather complement each other. This contradicts Rugman et al. (1985) who insist that a firm involved in internationalisation is typically more concerned about avoiding exposure to an uncertain foreign environment than about losing its FSA.

The subsequent chapter builds a model framework for JV analysis.

## Notes

<sup>1</sup> A catalogue of market entry strategies is contained in Appendix II.

<sup>2</sup> The literature has also addressed the measurement of the degree of internationalisation (Bilkey and Tesar, 1977; Luostarinen, 1979; Czinkota, 1982; Cavusgil, 1984; Strandskov, 1986; Welch and Luostarinen, 1988; Albaum et al., 1992; Gibb, 1995; O'Farrell et al., 1996; Simon, 1996).

<sup>3</sup> Lopez-Gonzalez et al. (1995), along with other authors, include strategic alliances (SAs) in the range of servicing strategies. A SA exists when two or more firms combine parts of their operations, either formally or informally, in order to achieve the goal of internationalisation. However, as Lopez-Gonzalez et al. (1995) establish, and as can be found in the contributions of Welch (1992), Axelsson (1993), Hara and Kanai (1994) and Gomes-Casseres (1997), a SA can comprise any of the market entry modes, "but especially licensing and (contractual) equity JVs" (Lopez-Gonzalez et al., 1995, p.219). What Lopez-Gonzalez et al. Understand as **contractual equity JV** is not clear: the literature on JVs distinguishes between equity JVs and contractual JVs. This excludes the SA from a separate discussion in the market entry strategy framework.

<sup>4</sup> Establishing a long-term market position through a JV or a WFOE affects the short-term profit prospects of a firm since substantial funds are required which often cannot be recouped shortly.

<sup>5</sup> Endres (1987, p.374) considers the JV not as a form of FDI: "JVs as opposed to direct investments." However, he states also that "within the group of FDI [...] there is a trend to JVs."

<sup>6</sup> For a discussion of contributions in the entry mode literature see Tan (1993, pp.12-31).

<sup>7</sup> Various studies have detected a positive correlation between firm size and export behaviour (Calof, 1993; Wagner, 1995; Vatne, 1995), though others reject such a relationship (Bilkey, 1978; Ali and Swiercz, 1991; Bonaccorsi, 1992; Walker, 1994).

<sup>8</sup> While the share of trade in GDP has remained constant since 1980, that of FDI flows has risen from 1% to 2.3% in 1996 and that of FDI stock from 10% to 21% (FT, 4.9.98, p.4).

<sup>9</sup> UNCTAD (1993) defines multinational SMEs as having up to 500 employees in the home country, possessing at least one foreign affiliate and originating from developed countries. Noteworthy is the confusing use of terminology in the study: on the one hand, it is referred to "affiliates of SME TNCs" and elsewhere to "parent firms of SME TNCs" (p.205). 3,315 questionnaires were sent to multinational SMEs in 18 developed countries and 1,257 were mailed to their foreign affiliates in LDCs. Additional 862 foreign affiliates of large MNEs and 460 indigenous firms received questionnaires. 132 parent SMEs, 97 SME affiliates, 147 affiliates of large MNEs and 67 indigenous firms in LDCs returned the questionnaires.

<sup>10</sup> Also most Western European countries have more foreign affiliates than the average. Many US SMEs have not become internationalised due to their large home market (Fujita, 1995).

<sup>11</sup> In the mid-1980s, their share in total FDI by value was under 20% and if measured in numbers of investments, more than 50% of new equity FDI by Japanese MNEs was accounted for by SMEs in the late 1980s. In contrast, in the US, the share in FDI by value was only 3% in 1988.

<sup>12</sup> Although Simon's work provides insight into the relevant issues of SME internationalisation, including servicing strategies, attitudes and the characteristics of owner-managers, the results have to be applied with care: the world-class SMEs in Simon's (1996) 122 firm sample have, on average, 735 employees and, thus, do not correspond with the definition applied in this study.

<sup>13</sup> Turnover abroad/total turnover.

<sup>14</sup> The reason for the discrepancy is that Moskowitz and Menzies (1995) draw the upper size margin at 99 employees. It is not clear, however, where Kean (1989) draws the margin. Naumann and Lincoln (1991) suggest that only 10% of total US exports are conducted by SMEs.

<sup>15</sup> For the entire firm internationalisation scholars (Buckley et al., 1983; Albaum et al., 1992; Axelsson, 1993; Erramilli and D'Souza, 1993; Calof, 1993; Storey, 1994) discovered similar.

<sup>16</sup> ABI-INFORM (Proquest), ANBAR, BUSINESS DISC EBA, INSTITUTE OF MANAGEMENT INTERNATIONAL DATABASE, INTERNATIONAL BIBLIOGRAPHY OF THE SOCIAL SCIENCE, SOCIAL SCIENCE CITATION INDEX.

<sup>17</sup> The interpretation of Kaiser and Griffen's (1997) results warrants consideration: first, SMEs were defined as businesses with up to 500 employees. However, since scholars apply a variety of definitions to the term SME, it can be assumed that other authors have defined the term SME differently, eg by applying different criteria (turnover or number of employees) and/or different margins. Secondly, due to the nature of the search strategy, double counting could not be completely avoided. Thirdly, terms such as 'JVs' were not searched for. In the study, JVs were considered as one form of FDI. This suggests that the inclusion of the search term 'JVs' would have produced different results. On the other hand, within the concept of the category of 'internationalisation', 'licensing', as opposed to 'exporting', 'FDI', 'internationalisation' and 'international business' can also be dealt with on a purely domestic basis. This could possibly have reduced the number of research items found, though it would have then reduced the figure within both categories.

The literature on SME exporting has addressed various aspects, including 'firm size and export intensity' (Ali and Swiercz, 1991; Bonaccorsi, 1992; Calof, 1993; Walker, 1994; Wagner, 1995; Vatne, 1995), 'exporters and non-exporters' (Vatne, 1995; Crick and Chaudhry, 1995; Calof and Viviers, 1995), 'SME management characteristics' (Bilkey and Tesar, 1977; Edmunds and Khoury, 1986; Butler, 1993; Caughey and Chetty, 1994; Moini, 1995), 'export barriers' (Sharkey et al., 1989; Naumann and Lincoln, 1991; Kumcu et al., 1995; Crick and Chaudhry, 1995; Campbell, 1996) and 'export information' (McDowell and Rowlands, 1995; Belich and Dubinsky, 1995). However, ideas were also put forward on the strategies for successfully pursuing SME exporting: Delacroix (1984) reports on cases of US SME exporters and Kerr (1989) and Kirkconnell (1989) present guidelines for successful SME exporters.

<sup>18</sup> See Appendix V for a definition of FDI.

<sup>19</sup> United Nations Conference on Trade and Development.

<sup>20</sup> Robock and Simmonds (1989, p.3) in their discourse upon the emergence of international business, suggest that "some business firms have had FDI and foreign operations for many years [...] predominantly in the fields of mining, petroleum and agriculture." All these are product categories that have, traditionally, been in the hands of large corporations.

<sup>21</sup> One such approach to defining an MNE is the use of the ratio of foreign (F) to total (T) operations (Bruck and Lees, 1968; Rugman, 1979). According to Rugman et al. (1985), firms with F/T ratios greater than 25 or 30% can be classified as MNEs. The problem with the F/T ratio is that available data do not always permit to distinguish between exports and sales by overseas branches.

<sup>22</sup> Hood and Young (1979) allow the income-generating assets to be owned also partly by the foreign enterprise.

<sup>23</sup> The work of Perlmutter (1969) points out three types of management view: ethnocentric, polycentric and geocentric. A true MNE is geocentric.

<sup>24</sup> Why these authors advanced these figures is not clear.

<sup>25</sup> This contradicts Young et al.'s (1989) understanding of the MNE which requires the establishment of income-generating assets in the form of *either* production *or* marketing.

<sup>26</sup> This is more a matter of historical consequence.

<sup>27</sup> The parent firm should have worldwide sales of less than £50m per year and the UK subsidiary should have sales no larger than £10m per year. Size limits were chosen in order to eliminate the larger European MNEs but to leave a population from which a viable sample could be selected. The relevance of the size of the investment project is not clear.

<sup>28</sup> 18 of the distributor companies had up to 50 employees, 17 of the service firms had up to 50 employees and 12 of the manufacturing firms had up to 50 employees. In addition, three manufacturers had between 51 and 100 and two had more than 100 employees.

<sup>29</sup> As forms of co-operation the authors regard anything between co-ordination and equity JVs.

<sup>30</sup> These results with regard to Simon's 'hidden champions' can be transferred to the SME context in this thesis only to a limited degree since the 'hidden champions' have workforces in excess of 500 - the upper limit for an SME in this thesis.

<sup>31</sup> The theory was originally propounded in Hymer's thesis in 1960.

<sup>32</sup> Johanson and Wiedersheim-Paul (1975) refer to it as the 'establishment chain' and Cavusgil (1984) discusses the phenomenon under the 'stages internationalisation framework', whereas Strandskov (1986) knows the concept as 'phase process' and Turnbull (1987) as 'internationalisation process'. Similar was pointed out by Lopez-Gonzalez et al. (1995).

<sup>33</sup> Rugman et al. (1985) suggest four stages in the model dominated by the management's attitude towards expansion into foreign markets (re-active exporting, pro-exporting, assembling and packaging stage, foreign production stage).

<sup>34</sup> The Johanson and Vahlne (1977) model is based on the premise that a lack of knowledge about foreign markets and operations is a crucial obstacle to the development of international operations and that the necessary knowledge can be acquired through operations abroad. Johanson and Vahlne borrowed from Aharoni's (1966) behavioural theory of the firm which suggests that market commitment and market knowledge affect both commitment decisions and the way activities are performed. These, in turn, change knowledge and commitment. The internationalisation variables 'market commitment' and 'market knowledge' develop during the internationalisation process. Johanson and Vahlne (1977) assume that the firm strives to increase its long-term profit and to keep risk-taking at a low level, and that these objectives characterise decision-making at all levels of the firm." The model finally assumes that the state of internationalisation affects perceived opportunities and risks. These, in turn, influence commitment decisions and current activities. The role of management is crucial in the model since success in subsequent stages depends on the ability of the management team to adapt to changes and developments in both the internal and external environments.

<sup>35</sup> No activity in the export market, passive activity, minor activity and aggressive activity. However, the authors' empirical study of 138 US firms did not confirm these suggested stages.

<sup>36</sup> Domestic marketing, pre-export stage, experimental involvement, active involvement and committed involvement. Later, Cavusgil (1984) merged the first three stages of the 1980 model into one single stage, the active exporting stage. The new, three tier categorisation comprises stages such as 'experimental exporters', 'active exporters' and 'committed exporters'.

<sup>37</sup> Management is not interested in exporting; management would fill an unsolicited export order; management actively explores the feasibility of exporting; firm exports on an experimental basis to some psychologically close countries; firm is an experienced exporter to that country and adjusts exports optimally to changing exchange rates, tariffs, etc.; management explores the feasibility of exporting to additional countries that are psychologically further away. The classification of companies in the individual stages was based on criteria such as length of export experience, volume of exports as a percentage of sales and export target countries. The authors tested their model on 423 US SMEs and found clear confirmation for the stages model.

<sup>38</sup> Sandvik, Atlas Copco, Facit and Volvo. The authors suggest four stages of development: no regular export activities; export via independent representatives (agents); establishment of sales subsidiary; establishment of production/manufacturing subsidiary. Of 63 sales subsidiaries of the four companies, 56 were preceded by agents and in no case had a firm started production without having first sold to the country via an agent/sales subsidiary.

<sup>39</sup> Defined as production financed by FDI and undertaken by MNEs.

<sup>40</sup> Rugman (1985) argues that any ownership advantage has to be internalised in order to be effective. This supports Rugman's (1983) earlier argument that there is no substantial difference between the eclectic paradigm and the internalisation theory, once the assumption is made that market imperfections are exogenous.

<sup>41</sup> For a definition of the JV see Appendix V.

<sup>42</sup> Harrigan (1987) highlighted the advantages of the JV using the example of the pharmaceutical industry, where JVs are inevitable due to the involvement of technologies such as robotics and industry automation.

<sup>43</sup> From his research of foreign investors in Ireland, O'Sullivan (1985) found that market size, costs of production, and exchange rates were important for investors, whereas grants and subsidies were not found statistically significant as explanatory variables for the locational choice of FDI. This contradicts findings by Donaldson (1966).

## Chapter Three

# International Joint Ventures

### 3.1 Introduction

Chapter two has hypothesised that the joint venture (JV) is an adequate strategy for SMEs servicing a foreign market in cases where exporting is exposed to too-high transaction costs and which cannot be serviced by a wholly foreign-owned enterprise (WFOE), because of limited firm resources. This chapter moves the JV strategy into the centre of attention. It attempts to develop a framework that allows the investigation of this strategy. This framework will be modified and developed further in chapter six with the findings from the literature on Sino-foreign JVs.

### 3.2 The model framework

JVs have become a very popular tool for foreign market servicing and have been the dominant foreign direct investment (FDI) strategy compared with WFOEs (Herzfeld, 1983; Endres, 1987). Research on JVs has been popular for the past three decades (Herzfeld, 1983), the literature suggesting the 1960s and 1970s as the cornerstones of research activity (Reynolds, 1984). Import substitution policies and quota restrictions, restrictions on royalty payments and the problems of negotiating with agents and licensees prevented exporting, licensing and the establishment of WFOEs (Datta, 1988; Young et al., 1989; Laughton, 1995).

However, as several scholars (Friedman and Beguin, 1971; Raveed and Renforth, 1983; Lasserre, 1984; Beamish, 1987) argue, MNEs have not resisted entering into JVs since they have recognised their desirability. In the future, JVs may become even more attractive to MNEs (Killing, 1983; Herzfeld, 1983; Harrigan, 1987; Lichtenberger and Naulleau, 1993) since, as Raveed and Renforth (1983) conclude, WFOEs are no longer a viable form of foreign equity investments in most LDCs. In the east-west context, JVs have long been the exception, and only after enduring unsatisfactory and disappointing experiences with technology transfer through licensing in the 1960s and 1970s, have socialist countries widened the opportunities for establishing JVs (Erhardt, 1977).

An analytical JV model needs to address the question of whether, and to what extent, joint venturing is an adequate FDI strategy for SMEs. It needs to address the issue of success and the various factors that determine the success of a JV, ie its interaction with parents and environments, etc. The model that is developed here takes on the perspective of the multinational, rather than the local partner.



Harrigan (1985)<sup>1</sup> presented an early framework for JV research. In her model, she examines the relationship between the partners in a JV, between the parents and the 'child', and between the 'child' and its competitive environment. She allocates a variety of factors to the individual elements of her model determining the bargaining power of the parent firms and including benefits, costs, resources, alternatives, needs and barriers. Harrigan's (1985) model further suggests that the JV, as the bargaining agreement, covers outputs, inputs, control mechanisms and duration or stability of the agreement. It incorporates a dynamic element, so-called change stimuli that influence the stability of the JV and the timing of changes. These stimuli include changes in the parents' strategic mission, in the importance of the JV to parents, in parent firm bargaining power, in the industry (and success requirements therein), effectiveness of JVs as a competitive strategy, in the JV's need for autonomous activities and changes in patterns of parent-'child' co-ordination.

For the application in this thesis, Harrigan's (1985) model is not appropriate, for various reasons: first, although the model addresses the questions of the relationship between the different parties involved in the establishment of a JV, ie parents and JV, it does not emphasise the relevance of success. Secondly, the model in this thesis needs to apply a time aspect, commencing with the preparation of a JV and culminating in its operation, in order to identify in the later analysis chapters (seven, eight and nine) where SMEs face resource-induced joint venturing difficulties. Dissolution issues are not addressed as a component of the model, though emphasised in the literature (Fan, 1996). Harrigan's (1985) model cannot capture this aspect. Its main limitation is that it confines itself to competing in mature markets - the US market in her case. The model does not consider, and explicitly excludes, its application to situations where emerging markets are being serviced. However, motivations vary considerably depending on whether the JV is to be established in a mature market setting with a developed country partner or whether it is to be established in a less developed country (LDC) environment with a local partner. Harrigan (1985, p.1) points out that "... surprisingly ]...[ JVs are now being used voluntarily as a strategy option within mature economies ...", assuming that any motivations other than government mandate would not be relevant if a foreign firm sets up a JV in an LDC.

Killing (1983) addressed the different issues that make a JV succeed or fail, based on a review of existing JV studies and a first hand examination of 37 JVs in North America, Western Europe and in LDCs. His resultant model revolves around the issue

of control, incorporating elements such as performance, techniques of JV control, partner selection, staffing, reward systems, product flows and management. In it success is the dependent variable and control is the independent. Although this framework provides a basis for the development of an analytical model for this thesis, it needs substantial extensions: for instance, it does not address the issues of partner motivations, partner contributions and the negotiation process, although these issues are considered essential for the success or failure of a JV. Further, as was the case with Harrigan's (1985) model, Killing (1983) deals exclusively with JVs in mature market settings.

However, to be applicable to the investigation in this thesis, an international JV model must also consider those cases where MNEs form JVs with local firms from foreign countries and, in particular, LDCs since the approach to JVs in developed countries is different from that in LDCs (Beamish, 1985; Lane and Beamish, 1990). This has been shown in various studies of JVs in LDCs, including Wells (1973), Raveed and Renforth (1983), Schaan (1983, 1988), Lasserre (1984), Reynolds (1984), Stoever (1985), Beamish (1985, 1987), Franko (1987) and Lane and Beamish (1990).

From an original sample of 66 JVs in LDCs<sup>2</sup> and the results from 12 empirical JV studies from both developed countries and LDCs, Beamish (1985) demonstrated that developed countries and LDCs represent different external environments, with the latter being a more complex and difficult one in which to establish and manage a JV. Beamish (1985) examined characteristics, including reasons for JV formation, autonomy, stability, performance, frequency of government partners and ownership, while placing particular emphasis on ownership and control and their relationship to performance. He discovered that JVs in developed countries and LDCs differ in eight characteristics. Whereas 64 per cent of developed country JVs were created because each partner needed the other's skills (Killing, 1983), only 38 per cent of the JVs in Beamish's (1984) LDC sample were created for this reason with the primary skill required by the MNE being the local partner's knowledge of the local economy, politics and culture. 19 per cent of the JVs in the developed country sample were created because one partner needed the other's attributes or assets. However, only 5 per cent of the LDC sample were created for this reason.

Further, whereas 17 per cent of the JVs in the developed country sample were created as the result of government mandate, 57 per cent of JVs in LDCs were created for this reason. Many LDCs seek to maintain their national identities by protecting and

controlling economic activities within their borders (Reynolds, 1984).<sup>3</sup> Nearly half of the JVs in the LDC samples of authors, such as Tomlinson (1970), Janger (1980), Reynolds (1984), Datta (1988) and Contractor (1990) were created due to government requirement. Wells (1973) and Franko (1987) have found this earlier from their studies of 187 US firms in LDCs and 65 minority and equal equity food JVs, respectively.

Datta (1988) extended the rather narrow use of JVs to situations where they provide MNEs with an attractive strategic option where demand for local participation offers only few alternatives. His analytical framework is based on a critical examination and synthesis of the various tasks, activities and factors associated with, and influencing JVs and their performance. His model incorporates such elements as environmental forces, JV objectives and motives, JV strategies – the equivalent of Killing's (1983) control aspect –, potential JV benefits (unique opportunity of combining the distinctive competences and the complementary resources of participating firms, including economic benefits in the form of factor cost, transportation cost, overhead and tax reductions, and increased economies of scale in areas such as manufacturing, research and development, sales and marketing), and JV management and implementation. However, important JV issues, including JV negotiation, are not discussed in Datta's (1988) model. He also fails to evaluate the achieved performance, though indicated in the overview figure of his model framework.

The analytical framework needed in this thesis must be a model comprising two elements, with one tier being the formation and the second being the operation of JVs. Both tiers examine the independent variables of the model in this thesis that determine the success of the JV strategy and thus its applicability as a strategy for internationalising SMEs. The JV formation phase comprises sub-elements, including JV planning, motivations for JV formation, partner search and selection, JV negotiation and contributions towards the JV. The JV operation element of the model comprises the ownership, control and management issues of the JV process. The model in this thesis shows various links to Harrigan's (1985) dynamic JV model. For instance, the JV formation element in the model developed here reflects Harrigan's (1985) JV parent relationship and the JV operation element reflects her parent-'child' relationship.

### **3.2.1 Joint venture formation**

Research has shown that only JVs that have been carefully planned and negotiated, that have symmetric sets of motivations, complementary contributions and matching partners succeed (Engelhardt and Seibert, 1981; Harrigan, 1984; Reynolds, 1984).

First and foremost, it is important for a company to understand why it wants a JV (Lane and Beamish, 1990; Lichtenberger and Naulleau, 1993; Zahra and Elhagrasy, 1994; Albrecht et al., 1996). Subsequently, firms must develop an appreciation of industry structures, consider all options, clarify the appropriate potential partner, consider the motives of potential partners, develop a SWOT analysis for parents and the JV itself, eternal vigilance and attention to detail (Lyons, 1991).

### ***Joint venture planning***

Planning the JV process is key to the prevention of failure (Killing, 1982). Hamill and Hunt (1993), in their research of three UK JVs in Hungary discovered that potential JV partners need to pay great attention to the effective planning of JVs, ie clarifying the objectives, analysing the advantages of JVs, compared with other entry strategies, screening potential partners and constantly evaluating the individual planning steps. However, methods of strategic planning are applied only to a limited extent (Harrigan, 1985; Anderson and Gatignon, 1986; Young et al., 1989; Lane and Beamish, 1990), and especially within SMEs strategic planning, if used, is characterised by a number of short cuts (Bilkey, 1978; Robinson and Pearce, 1984; Laughton, 1995). Harrigan (1985, p.12) is critical of firms that "jump without thinking through their motivations or how the 'child' will fit into their scheme for strategy implementation." Killing (1983) discovered that some firms, excited by the prospect of entering a JV, put in a lot of effort into designing its internal operation and relationship with its parents, but are less scrupulous about examining the market, competition and the venture's strengths, weaknesses and prospects.

Despite the existence of a large volume of literature on the planning of JVs, according to Reynolds (1984), Young et al. (1989) and Hamill and Hunt (1993), the literature has not examined empirically the relationship between planning and success of a JV. What does the efficient planning of a JV look like and what kind of firms should employ what kind of planning? Is there a greater need for planning of JVs in LDCs? So far, research has not addressed these questions.

### ***Motivations for joint venture formation***

Motivations are the directions and persistence of action. They are the goals or objectives of each partner (Kim, 1996). The examination of the JV formation literature suggests it is important to distinguish among three sets of motivations, including those of the foreign and the local partners<sup>4</sup> as well as the host government<sup>5</sup> (Datta, 1988). These sets of motivations are often not congruent. Harrigan (1985) found that local partners frequently want to import sophisticated technologies and brand names,

whereas host governments and foreign firms might want to establish JVs in order to use technologies that exploit the country's low-cost labour. Harrigan (1985, p.37) established also that "many host governments want the most modern technologies, but not those that would make the most sense from the parents' viewpoints". However, this contradicts her earlier argument that host nations desire labour-intensive technologies: sophisticated technologies (her second argument) are commonly not labour-intensive.

#### Foreign partner motivations

Harrigan (1985) categorises the motivations for JV formation into internal, competitive and strategic uses. Since her dynamic JV model is developed in the mature, domestic market context, motivations such as the entry of a new and potentially profitable market appear only relatively late in her enumeration of motivations for JV formation. In Datta's (1988) international JV model, on the other hand, 'new market entry' enjoys high importance. Also, other motivations as stressed by Datta (1988), receive little or no priority consideration in the Harrigan (1985) model. These motivations include the sharing of heightened economic risks in new JVs, satisfying nationalistic demands and reducing risks of expropriation, maintaining good relations with host governments and pooling organisational know-how to realise synergistic benefits. This suggests that partners in domestic JVs attempt to consolidate existing positions whereas foreign partners in international JVs attempt to establish and extend their existence in a foreign market. There, foreign partner motivations are rather aggressive.

Too often, authors in the field of international JVs (eg Shenkar, 1990) consider *necessary* motivations for JV formation as *sufficient* motivations. 'Entry of a potentially profitable new market' and 'gaining raw materials'; for instance, are frequently suggested as sufficient for establishing a JV (eg Janger, 1980), though they are only necessary. In fact, there are various other ways of developing new markets (see chapter two) and getting raw materials. Eventually, these motivations can lead to the formation of a JV upon a host government's insistence, or when a project is financially too large for one firm, or when neither firm has all the skills required to make a success of the business on its own, or when a venture can only achieve satisfactory economies of scale in research and development, production or marketing when forces are combined (Killing, 1983). Thus, conditions do not necessarily have to be substitutional, but can also be complementary.

This argument partly pre-empts Sukijasovic's (1970) four-point enumeration that motivations for entering a JV are 'doing business in common', 'sharing of profits', 'sharing of business risks and losses' and 'longevity of co-operation'. Whereas in this thesis 'sharing of business risks and losses' as well as 'longevity of co-operation' are accepted as motivations for JV formation, 'doing business in common' and 'sharing of

profits' are rejected: why should a firm wish, *a priori*, to share its profits with another firm? Also, access to technology (Harrigan, 1985; Bleeke and Ernst, 1991) requires special consideration: while JVs, as a means of gaining skills and technologies, are relevant for the industrialised partner in a mature market context, they are of less or even of no importance to foreign, advanced partners in the LDC context (Kim, 1996). There, skills and technologies are desired by the local partner.

According to Endres (1987) and Contractor and Lorange (1988), in the international JV context, foreign firms join forces with local partners for their knowledge of business practices, consumer behaviour, distribution networks and legislation. They join forces to generate economies of scale, exchange technology, co-opt or block competition, overcome government-mandated trade or investment barriers, facilitate initial international expansion of inexperienced firms, and vertical quasi-integration advantages of linking the complementary contributions of the parties in a value chain. The partner in an international JV further facilitates better access to product, resource, labour and financial markets of the host country. The local partner is expected to bring in financial, technical and human resources that eventually reduce the foreign firm's resource commitment, its business and political risks and strengthen the impact of the JV. Foreign firms also desire the partner's ability in dealing with authorities. Endres notes the foreign firms' desire to reduce foreignness and the 'colonial character' a WFOE creates: considering the JV as a national business provides access to tax and investment incentives, to government orders and to projects of international credit and supra-national developmental aid organisations. However, analysing the international JV literature has not suggested any study that has examined whether, and to what extent, this aspect influences a foreign firm to establish a JV, instead of a WFOE.

The US MNE executives in Raveed and Renforth's (1983) study of US JVs in Costa Rica rated five motivations as "most important" for JV activity. These included (1) to obtain country-related knowledge and local management, (2) to reduce the risk of expropriation, (3) to obtain favourable government treatment in areas of taxes, protective tariffs, foreign exchange, and input permits, and (4) to keep operational control of the JV. Thereby the US managers exhibited a substantially different opinion to the local elite who considered the most important motivations for the **foreign** firm to be the maintaining of good relations with the national government, reduction of the risk of expropriation, nurturing the best attitude by the general public, keeping operational control of the venture and avoiding labour problems. Overall, however, the differences, although statistically significant, tend to be more of a degree and of emphasis, rather than a total failure to understand each other's point of view.

#### Congruity of motivations

For the success of a JV, congruity of the partners' motivations is essential (Killing, 1983; Connolly, 1984; Reynolds, 1984; Harrigan, 1985; Schaan, 1988; Datta, 1988; Gomes-Casseres, 1989). However, the partners' (and host governments') motivations

are not always so (Killing, 1983; Ruggles, 1983; Connolly, 1984; Harrigan, 1985; Datta, 1988; Gomes-Casseres, 1989; Anderson, 1990). Frequently, one partner pursues its objectives with little regard for the needs or values of the other (Reynolds, 1984).

Reynolds (1984), in his study of 52 Indian-US JVs, discovered that the Indian partner hoped to export in order to generate foreign exchange for the import of equipment, whereas the US partner aimed at entering the market with a broad product line that would have competed against products already offered by the Indian partner's sister companies. Subsequently, Habib (1987) developed and tested a research instrument for measuring manifest conflict within international JVs. Investigating 258 JVs in the chemical and petrochemical industries, he found that the greater the disparity in the partners' goals, the higher the level of conflict in a JV. Bieszki and Rath (1989) demonstrated that in socialist economies the central planning unit wished to obtain a different technology than the western partner was prepared to transfer. For instance, Hamill and Hunt (1993) examining the experiences of three UK companies that were to establish JVs in Hungary (United Biscuits, Thorn-EMI, APV), found that Thorn-EMI's proposal to establish a 50:50 equity JV was aborted due to a mismatch of the partners' objectives: the Hungarian Ministry of Education and Culture viewed the potential JV primarily as a vehicle for promoting Hungarian musicians and culture rather than as a viable business entity in its own right. This proved unacceptable to Thorn-EMI.

### ***Partner selection***

The decision for or against a JV rests also upon the availability of a suitable partner in the host country (Endres, 1987). Research has shown that the choice of a JV partner (or partners) is an important variable influencing performance because it affects the mix of skills and resources that will be available to the JV and thus its ability to achieve its strategic objectives (Tomlinson, 1970; Berg et al., 1982; Killing, 1983; Harrigan, 1984, 1985; Rugman et al., 1985; Gomes-Casseres, 1989; Geringer, 1991; Schuler et al., 1992; Hamill and Hunt, 1993). The central challenge of JV formation is to identify a qualified, reliable, co-operative and resourceful partner (Brockmeyer, 1987; Lane and Beamish, 1990).

Before a JV is formed, it is important that the potential partners recognise any differences in objectives that may exist and take appropriate action to reconcile them (Datta, 1988). Otherwise there will be inevitable conflict and misunderstanding, erosion of potential benefits and ultimately the demise of the venture (Datta, 1988). Research has further established a variety of dimensions that are related with partner selection, including cultural background, number of partners, firm size and industry, and a

company's past association with a potential partner. Firms that are to engage in a JV need to assess their potential partners according to these dimensions. However, Lasserre (1984) and Lane and Beamish (1990) suggest that partner selection is usually not given the time or the attention it deserves, though Harrigan (1987) has observed that managers are rather choosy about whom they take as their partner. This is empirically supported in the works of Tomlinson and Thompson (1977), Geringer (1991), Schuler et al. (1992) and Hamill and Hunt (1993).

From an investigation of the JV experiences of Canadian firms in Mexico, Tomlinson and Thompson (1977) found that the firms sought traits, including: the local partners' financial status, business compatibility, common goals, ability to negotiate with the government, compatible ethics, resources, technology and experience in its application, international visibility and reputation, commitment to the JV, international experience, management depth and the ability to communicate with Mexicans. The authors failed, however, to indicate the relative frequency or intensity with which the specific traits were sought, or any contextual variables which might influence the criteria employed.

Later, Geringer (1991) aimed at emphasising the identification of variables that help determine the selection criteria which firms employ when seeking JV partners. Studying 81 US firms,<sup>6</sup> he found a positive correlation between perceived importance of potential critical success factor categories and the relative weighting of their associated selection criteria categories. There was only mixed support for a negative correlation between perceived relative competitive position on a particular variable category and the weighting applied to the associated selection criteria category. Geringer (1991) found a positive correlation also between the perceived difficulty of internal development categories and the weighting of their associated selection criteria categories. Geringer's (1991) study is a potentially valuable contribution towards an improved understanding of the partner selection process and how firms proceed in selecting partners. However, it was restricted to US-based firms and limited to JVs with only two parents where partners may have held a maximum equity of 75 per cent. Hamill and Hunt (1993) showed that United Biscuits (UB), when selecting a partner for its JV in Hungary, used a number of clearly defined criteria. These included the stipulation that the target company had to operate in UB's core business, that UB would bring something to the JV, that the target had good products and management, and that the target had a large market share.



While symmetry in the partners' objectives and its commitment to, and vision for, the JV is considered stabilising, symmetry in resource contribution is a destabilising force (Harrigan, 1985; Rugman et al., 1985; Ohmae, 1989). Various authors (Berg and Friedman, 1980; Killing, 1982) warn that a lack of erosion of complementariness is the most important factor undermining JV effectiveness. The potential for joint gains is greater the more dissimilar the partners (Gomes-Casseres, 1989). On the other hand, Gomes-Casseres (1989) and Bleeke and Ernst (1991) point out that alliances between strong and weak companies rarely work: they do not provide the missing skills needed for growth and they lead to mediocre performance. Gomes-Casseres (1989) discovered that all of 'his' US firms chose a partner that could complement their capabilities.

Earlier, from a study of 895 strategic alliances competing in 23 industries, Harrigan (1988) analysed the influence of parent firm asymmetries on venture performance, including national origins of parent firms, firms' levels of venturing experience and firms' relative asset sizes. Her results suggest that ventures are more successful where partners are related (in products, markets, and/ or technologies) to their ventures or horizontally-related to them than when they are vertically-related or unrelated. Harrigan (1988) also found that ventures last longer if the partners are of similar cultures, asset sizes and venturing experience levels and when the partners' activities are related. Harrigan's (1988) findings could have advanced the understanding of partner asymmetries. However, the author does not distinguish between different types of strategic alliances, but refers to the range of market servicing strategies as one entity, which they are not. Harrigan could have categorised the various market servicing strategies in separate clusters and, for each strategy type, separately analysed the relationships between partner asymmetries and performance. The applicability of Harrigan's (1988) results is difficult and, as a result, generalised.

#### Cultural background

Killing (1983), in his study of JVs between firms in developed countries and LDCs showed that the greater the cultural gap between the partners, the more difficult it is to create cohesion. This is in line with findings by Perlmutter and Heenan (1986) and Lane and Beamish (1990) who argue that differences between national cultures, if not understood, can lead to poor communication, mutual distrust and JV termination. Often, according to Killing (1983), the difference in language can be a hindrance to the creation of a core skill.

#### Number of partners

Endres (1987) suggests that normally the foreign company has only one local partner and that with an increasing number of partners the risk of conflict increases. In a JV

with several partners decision-making might be lengthy, making the business sluggish and possibly performing worse than with one partner only. However, Beamish (1985) did not find any difference in the performance of JVs with two or more partners. Though there is fragmented knowledge on the appropriate number of partners in a JV, there is a lack of studies on this topic in either a developed country or an LDC setting.

#### Firm size

Size mismatches between parents can contribute to differences in corporate culture which may affect a venture's performance (Rugman et al., 1985). Lane and Beamish (1990) showed that large foreign parents tend to be systematic and slow in their decision-making. They have a long-term investment orientation and a willingness to reap rewards in the future. In contrast, their local partners are often entrepreneurs who manage intuitively and make decisions very quickly (ibid). On the other hand, Kogut's (1988) data suggest the reverse. However, his findings were not statistically significant.

#### Industry

Killing (1983) predicts that JVs between firms in the same industry are easier to manage than those between parents from different industries and would therefore perform better than others. In line with this, Lane and Beamish (1990) advise that industrialists of some stature are used in the same or a similar business. On the other hand, JVs between firms with similar skills and knowledge also tend to cause difficulties.

What was suggested above with regard to number of partners applies also to firm size and industry: so far, no study has been carried out to investigate closely the issue of ideal firm size and industry of partners. The issues that need to be addressed for instance include: what is to be chosen and what is to be avoided, when and why. Are there any differences when considering firm size and industry, between JVs in developed country and in LDC settings?

#### Firm type

As partners, foreign firms prefer private rather than government companies since the interests of an MNE usually correspond to a higher degree with those of local firms than those of state owned enterprises (SOEs). This has been shown by Endres (1987). SOEs are commonly criticised for being less decisive and that both the slowness and the confusion of the decision-making process at the board level can place a JV with an SOE partner at a distinct competitive disadvantage (Killing, 1982; Endres, 1987). In fact, the most common partner for MNEs in LDCs is a local private firm (Beamish, 1987), though Beamish (1985) earlier detected a higher use of SOEs in JVs with a

particularly high scale of investment, or in JVs in an industrial sector that was important to the local economy.

Raveed and Renforth (1983) from their study of various forms of US equity investments in Costa Rica revealed that both groups of respondents (39 US executives, 68 local business leaders and government officials) agreed on the usefulness, both for the MNE and the host country, of incorporating a local partner. The respondents also agreed that foreign equity investment forms excluding local participation were not very attractive to either the MNE or the host country. The two groups agreed further on the relative usefulness of JVs to the local general public and that, in most cases, the JV between an MNE and a private local firm was the optimum form both for the MNE and the host country. However, the groups of respondents disagreed strongly on the usefulness of SOEs: whereas MNE executives would avoid JVs with SOEs, host country executives proposed that a JV with an SOE perfectly meets the MNE's needs. US MNE executives believed that an SOE partner is incompetent, inefficient, slow in decision-making, and often has different objectives. Further, host government control would be much greater than their own. Raveed and Renforth's (1983) research was confined to US MNEs. Thus, the study minimises the possible cultural differences among foreign investors which is likely to reduce the differences in the attitudes of the MNE executives. This limits its scope and general applicability. Equally, the study increases the homogeneity of the more restricted sample which, in turn, should increase the validity and reliability of its findings.

The desirability of local private partners in JVs has been expressed also in performance measures. Stuckey (1983) found that JVs with government partners had an overall instability rate of 56 to 58 per cent whereas instability rates of JVs with local private partners in Beamish's (1985) study were 43 per cent. In Beamish's (1984) LDC sample only two out of 23 JVs were deemed satisfactory where the foreign firm had government partners, public shareholders or other foreign partners. In none of the 12 JVs with government partners was the foreign firm satisfied with the venture's performance. Firms with a local private partner were satisfied with performance more often than firms with other types of partners (Beamish, 1985).

#### Favourable past association with the partner

It has been suggested that selecting a partner with whom a basis of trust has been established during earlier business relations is advantageous (Endres, 1987; Lane and Beamish, 1990).

As early as 1970, Tomlinson studied the JV process of 49 UK firms in India and Pakistan and identified distinct categories of partner selection criteria. Of the six general categories examined, 'favourable past association' was found to be the single most important criterion, though it was not sufficient to ensure effective performance. Categories, including 'facilities', 'resources', 'partner status' and 'forced choice' were about equally important and 'local identity' only rarely represented a primary criterion for partner selection. Generalisation of Tomlinson's (1970) results might be constrained by several factors, including a sole focus on a convenience sample of 49 UK firms involved in 71 JVs. Further, the selection criteria categories developed were not mutually exclusive and his data's validity may also be compromised by the likelihood that some interviewees had not been involved in partner selection. Since several JVs were formed 20 years or more prior to the interviews, reliability of information regarding selection criteria might have diminished even if the executives had participated in the selection process.

Later, Lasserre (1984), studying a French-Thai and a German-Indonesian JV, suggested two pre-JV establishment phases. Phase one: the partners' attempts to assess whether the strategies of the partners are compatible with their own. Phase two: whether the resources of the partners are complementary to jointly carry out the project. According to Lasserre (1984), the get-to-know period takes one or two years before a JV is established. Most of the US firms in Reynolds's (1984) study had selected as partners Indian firms that had previously marketed their products. In the case of Marley of the UK and Davidson of the US forming the Davidson-Marley JV in Belgium (Schuler et al., 1992), the partners' long-term arrangement had given them time to get acquainted and learn about each other's management styles and philosophies.

### ***Negotiation process***

The relationship between the potential partners in a JV is one of the three elements in Harrigan's (1985) JV model. It is the confrontation of the bargaining powers of the firms involved, including the JV benefits, costs, resources, alternatives, needs and barriers. Each potential partner tries to get the most out of a deal. The more a firm has to offer, quantitatively and qualitatively (eg uniqueness of a technology) to a JV, the more it demands of the other firm or firms involved and the more equity and control it is likely to demand in the proposed business.

Blodgett (1991) examined just this relationship between contribution and ownership. Studying US JVs in OECD countries (110), Japan (81), LDCs (81), and (former)

Eastern bloc countries (7), Blodgett discovered that when technology and government requirement are combined in an international JV, the majority share of equity is more likely to go to the government partner. On the other hand, when technology and local knowledge/marketing skill are combined, the majority share is more likely to go to the technology partner. In conclusion, Blodgett (1991) argued that government requirement dominates technology more strongly than technology dominates local knowledge/marketing skill.

Equally, the more alternatives a firm has to engage in other business deals, or the less a company needs to enter a JV with a particular firm, the stronger is its bargaining position. The more successful a firm is in communicating to its potential partner and the host government how indispensable it is for the success of the JV, the stronger is its bargaining position (Endres, 1987). Often, foreign firms only agree to establish a JV if their previous export volumes are secured through supply contracts for raw materials, semi-finished goods, parts or certain finished goods (Engelhardt and Seibert, 1981). As strong bargaining positions, Hamill and Hunt (1993) propose the control over technological know-how and the operation in industries identified by host governments as priority sectors of economic development.

Contractor (1984) established a methodology for conducting negotiations between US firms with local JV partners over the nature of the arrangements, the value of technology transferred, the equity shares of both parties, and other forms of compensation to be derived by the US firm, such as licensing fees and sales of components or products. He proposed a three step quantifiable approach to planning negotiations, including the determination of the total income derivable from that country's market for the product in question, the determination of the fractions of income that ought to accrue to each partner, and the determination of the mix of ownership and contractual arrangements used to compensate the foreign firm. Contractor's (1984) underlying assumption might be misleading: when discussing the strategic purposes of auxiliary agreements, such as the licensing or trading arrangements, he bases his ideas on a positive correlation between ownership and control. However, majority ownership and dominance of a JV do not necessarily correspond as has been suggested in the literature on JV control (Killing, 1982, 1983).

Gomes-Casseres (1989) suggests that the bargaining power of the US MNEs in his study increased with the size of their planned investment. Hamill and Hunt (1993) discovered that the key to negotiating JVs is the ability to cultivate good relationships

with the authorities and the venture partners. Matching the requirements of the country for foreign currency, modernisation, technology transfer and exports, for instance, is one way of achieving this. However, attempting to meet all the host country's requirements, as suggested by Hamill and Hunt (1993), has not very much in common with bargaining. It is particularly the export requirement of host governments that foreign partners are not always willing to meet since they are, themselves, seeking a possibility to develop the domestic market (Bieszki and Rath, 1989).

### ***Partner contributions***

Firms forming JVs make contributions in the hope of adding the partner's competence and assets to their own (Beamish, 1987; Blodgett, 1991). Organisational know-how and skills or intangible assets, including patents, trademarks and reputation cannot be readily acquired through arm's-length transactions. Thus, companies seek these contributions through a JV with another firm (Gomes-Casseres, 1989). Killing (1983) distinguishes between assets, such as capital, trademarks and patents and attributes, including nationality, source of raw material or component supply. In other words, Killing's (1983) attributes are 'soft contributions' and assets are 'hard contributions'.

The foreign partner in a JV contributes its firm-specific knowledge in, and access to, technology, product know-how and patents, management expertise, technical training and management development, finance, access to international distribution channels, increased exports and improved competitiveness (Hamill and Hunt, 1993). On the other hand, the local partner contributes capital; location-specific knowledge on the political, economic and customs environments of the host country market; contacts with government officials; faster entry into the domestic market; marketing personnel; plants, facilities and land; local labour and trade union relationships; as well as access to local financial institutions (Contractor, 1984; Hamill and Hunt, 1993). Contractor (1984) also proposes risk reduction as a potential local partner contribution.

The importance of JV contributions can, from time to time, differ substantially between mature economy settings and LDC environments. Berger and Uhlmann's (1984) work has shown this (chapter two). Thus, the findings of Killing (1983) and Harrigan (1985) have to be treated with care and cannot be generalised and transferred to JV scenarios in LDC settings. For instance, Harrigan (1985) suggests access to distribution networks as the most important contribution of a partner, more important even than capital and technology, marketing experience, personnel, or physical assets, including production facilities, plants, etc. On the other hand, Beamish (1985) has found that the primary attribute required of the local partner in LDCs by the MNE is its knowledge of the host country's economy, its politics and culture. So far, research on JVs has not produced any convincing comparison between contributions sought by MNEs in mature markets and in LDC settings.

Studying 66 JVs in LDCs and 12 core ventures between US, UK or Canadian MNEs and local private firms,<sup>7</sup> Beamish (1987) examined 16 partner contributions and their relationship to performance in terms of the degree of importance (ie on a scale of 'important', 'neutral', 'unimportant'), the changes in importance (ie 'increasing', 'decreasing', 'steady') and the various perspectives (of MNE executives, local partner/JV general managers). The partner need was assessed over a time span in terms of the relative importance of each partner's contribution to the JV in a number of aspects, such as capital, knowledge and staff. Beamish's (1987) performance measure was subjective, based on whether there was mutual agreement between the partners regarding their overall satisfaction.

The MNE executives felt that speed of entry was an important partner contribution at the time of establishing the JV, whereas raw material supply, inexpensive labour supply, and technology and equipment were not important. The local managers felt that the foreign MNEs made important contributions in the areas of raw material supply, technology/equipment and export opportunities. Perceived as unimportant, were speed of entry into the local market, local political advantages, inexpensive labour supply, and general knowledge of the local economy, politics and customs. In summary, the executives in high-performing JVs looked at their local partners for greater contributions than did MNE executives in low-performing JVs. Interestingly, partner contributions that were considered unimportant tended to remain unimportant, while contributions considered important tended to vary in importance over time (Beamish, 1987).

### **3.2.2 Joint venture operation**

Harrigan's (1985) JV model also suggests the analysis of the relationship between the 'child' and the parents. This relationship covers the ownership, control and management aspects of the JV process. This is where the work of Killing (1983) finds its application since it includes just these elements. The model developed in this thesis covers this relationship in its second tier, the JV operation. The model framework also suggests that this relationship is linked with the sub-elements of the first tier, making the model dynamic. For instance, re-negotiation of certain issues that were negotiated in the formation phase, or the modification of resource contributions, or changes in the global strategy of the parent firms at a later stage, might change the entire constellation of the JV as it was in the formation and operation phases. Datta (1988) has established that the effective implementation of the JV plays a key role for JV success. However, only limited attention has been given to this dimension, with research addressing, instead, JV establishment issues (Lyles and Reger, 1993).

#### ***Joint venture ownership***

In a JV foreign firms can take majority (at least 51% of the equity), equal (50%) or minority (49% or less) positions. According to Young et al. (1989), the partners' relative

equity share holdings are commonly 50-50 or 51-49 per cent, though the authors do not specify which partner holds the majority. The partners' stakes determine where in the JV the management power lies: in functional areas such as production, marketing, research and development and finance (Young et al., 1989).

As has been established above, differences between JVs in domestic, mature market settings and LDC settings also apply to the ownership aspect. Berg and Friedman (1978) note that more than 80 per cent of two-partner, US chemical JVs formed between 1924 and 1969 had an equal equity split and Beamish (1985) discovered in developed country samples that half of the JVs were 50:50 ventures. On the other hand, in LDC samples both Reynolds (1979) and Beamish (1985) revealed that in 70 per cent of cases the foreign firm was in a minority equity position with only a small proportion (10 to 20%) of the JVs being equally owned. On the other hand, Afriyie (1988) has observed that the most common type of JV in Ghana is the shared management equity JV, based on a sample of 46 JVs in three Ghanaian industries, food, beverages and textiles. According to Endres (1987), equal equity sharing in JVs in LDCs creates the impression the foreign firm accepts the partner on equal terms.

Beamish (1985) discovered that the most common reasons of MNEs taking a minority position are existing regulations and/or local tax advantages. Often, JVs are the result of host government attempts to reduce foreign influence in their economy and to demand participation and the minimum equity holding of local partners. In some industries, LDCs demand a majority equity being held by local partners (Endres, 1987). Interestingly, MNEs that were minority or equal partners performed better than those where the MNE was the single, largest shareholder (Beamish, 1985; Lane and Beamish, 1990). This coincides with findings by Bleeke and Ernst (1991) who found, from a study of US, European and Japanese strategic alliances that 50:50 equity JVs had a higher success rate than others.

Equity share holdings in JVs of MNEs differ from industry to industry. For instance, Franko (1987) surveying the use of new forms of investment<sup>8</sup> in LDCs by the 70 leading, internationally active US corporations, discovered that minority and equal equity JVs are more common among US vehicle component manufacturers than in the auto assembly companies. 25 of the 64 subsidiaries and affiliates in LDCs of the ten leading US component manufacturers are minority or equal equity JVs and accounted for slightly more than 10 per cent of all 243 foreign operations of these ten component producers. The typical food processor's overseas operation was either a WFOE or a majority JV. Franko (1987) points out that the more important foreign sales were to a US food processing MNE, the less likely it is to have minority or equal equity ventures.



For the pharmaceutical industry, Franko could not discover the majority equity pattern. There, only the smaller companies have used minority or 50:50 JVs.

Franko's (1987) work highlights the US reluctance to enter into minority or equal equity JVs in LDCs. He further discovered minority shareholdings in firms that produce unrelated or distantly related diversified products. He shows, also, that companies producing low technology, comparatively undifferentiated products with low value-to-weight ratios (or local tariff protection) isolate themselves from 'core' company activities elsewhere. The new forms of investment were avoided by companies that were industry leaders. However, they were accepted by second rank or outsider firms attempting to match the geographical spread of their larger brethren (ibid).

### ***Joint venture control***

Control is the authority over operational and strategic decision-making (Hill et al., 1990). It is the ability to influence systems, methods and decisions (Anderson and Gatignon, 1986) and a continuing adjustment to given and changing conditions, not a one-time intervention (Ulrich, 1983; Miles and Snow, 1984). Control refers to the process by which one entity influences the behaviour and output of another through the use of power, authority and a wide range of bureaucratic, cultural and informal mechanisms. Control plays an important role in the capacity of a firm to achieve its goals (Ulrich, 1983; Davidson, 1987; Geringer and Hebert, 1989; Young et al., 1989). As the process of influencing actions, control includes setting goals, giving orders, setting up procedures, and monitoring results. It is determined by the number of parties involved in a venture (Hill et al., 1990). The actual level of control the foreign investor has, is dependent on whether or not the host country stake is held by a major company, the government or more local companies even, rather than equity traded on the stock market.

Killing (1983) established three distinctive control constellations, including dominant parent ventures, shared management ventures and independent JVs. Schaan (1988) found that, of these, the shared management ventures are the most difficult to manage. This indicates that, although shared management ventures are not consistently used for riskier business tasks, they have a higher failure rate (Killing, 1982). Shared management ventures frequently encourage deadlocks in decision-making, unless one partner trusts the decisions of the other on minor issues (Killing, 1982, 1983; Harrigan, 1985). Thus, asymmetric equity sharing has been touted as being more effective than 50:50 equity JVs (Harrigan, 1985).

Geringer and Hebert (1989) argue that domination of a JV may allow greater integration of it into the global strategy of the firm. As such it helps protect the firm from premature exposure of its strategy, technological core or other proprietary components to outside groups. A partner that exercises dominant control in a JV can reduce the risks associated with co-ordination and opportunistic behaviour and thus reduce transaction costs (*ibid*). From the MNE's viewpoint the dominant parent strategy is appropriate when it is forced to take on a partner solely in response to pressure from the host government or when the passive partner sees its involvement as a purely financial investment (Datta, 1988). If a partner is chosen for reasons other than managerial input, a dominant parent JV fits best (Killing, 1982).

How can a foreign partner get into the position of exercising dominant control? First and foremost, control is linked with ownership and is certainly highest in cases where the foreign investor holds a majority stake in the venture and where the local partner adopts a management-passive role (Young et al., 1989; Blodgett, 1991), though this occurs rather less frequently in LDCs, according to Beamish (1985). Killing (1983) discovered a high correlation between ownership and control of JVs in developed countries: 70 per cent of the dominant management JVs were majority owned and 76 per cent of the shared management JVs were equally owned by the partners.

However, control and ownership do not necessarily have to correspond (Friedmann and Beguin, 1971; Stopford and Wells, 1972; Beamish, 1985; Young et al., 1989; Lichtenberger and Naulleau, 1993). Killing (1983) proposed various strategies for controlling a JV in an equal equity or minority position even. In line with that, Harrigan (1985) notes that firms accept a minority ownership if they can obtain a majority position in managerial authority. Overall, control in a minority JV seems to require a shift from control through financial and legal structures to influence through creating relationships and through behavioural interaction (Lane and Beamish, 1990).

When it comes to measures which a minority partner can employ to control a JV, Friedman and Beguin (1971) discovered a variety of mechanisms. These included right of veto, representation in management bodies and special agreements related to either technology (eg licensing) or management (eg management services). From interviews with 48 senior executives of 23 JVs operating in North America, Mexico and Europe, Schaan (1988) discovered a variety of means which allow a foreign firm to control a JV even as a minority equity partner, including board meetings, provision of parent company services (transfer of technology, sales to, and from, the JV, provision of staff

services), key personnel appointments, organisational and structural context, informal mechanisms, and integration of the parent organisations. Schaan's (1988) findings are flawed since, at the time of the interviews, 13 per cent of the JVs had been terminated, 35 per cent were unsuccessful in the eyes of at least one parent and only 52 per cent were successful.

On the other hand, JVs that are not equally owned by the partners can be controlled and managed evenly (Killing, 1983). Shared management ventures are most common in situations in which the skills of both parents are crucial to the success of the JV (Killing, 1982).

Examining data on 74 licensing agreements and 28 JVs in North America and Western Europe, Killing (1980) considered the conditions under which a firm should try to acquire technology - via licensing or JVs. He discovered that a 50 or 55 per cent majority JV is best for a strong technology transfer relationship. 50 to 55 per cent JVs have high managerial costs and major decisions in such a JV have to be made via negotiation and compromise, and the managerial time demanded in a 50 to 55 per cent JV is very high. Thus, many firms will not enter JVs of this type (*ibid*). Only five ventures in Killing's (1980) sample were majority JVs. However, many firms with valuable technology will not supply to a JV in which they own less than 50 per cent. Killing's (1980) conclusion is that many managers, particularly in North America, will not enter 50:50 JVs since they view such ventures as too ambiguous, too inflexible, and all too likely to end in disaster. Killing warns against the use of a stronger link than necessary because the cost of the agreement to the technology-dependent firm generally goes up with increasing strength of the linkage.

JV relationships where decisions are based only on the equity and control shares of partners are frequently prone to failure. Control cannot be more than that which companies fall back on when everything else fails and when they are willing to risk the moralisation of workers and managers. Good partnerships do not work on the basis of ownership or control. Instead, it takes effort and commitment and enthusiasm from both sides if either is to realise the hoped-for benefits (Ohmae, 1989). Ohmae (1989) argues that tradition has long taught managers the incorrect arithmetic that equates 51 per cent with 100 per cent and 49 per cent with zero. Although 51 per cent buys a company full legal control, this is control of activities in a foreign market, about which it may know little (Ohmae, 1989).

The importance of creating consensus was prior to that stressed by Killing (1982) who points out that it is the manager's job in a 51:49 or up to a 60:40 JV to ensure that no decisions are forced by shareholders' vote, since this would lead to the loss of the minority partner's goodwill. However, both partners in the venture are essential to its success (Schaan, 1988). For instance, although United Biscuits had a controlling stake of 85 per cent in its Hungarian JV, which virtually would have allowed it to run the venture as a WFOE, the actual decision-making was as decentralised as possible (Hamill and Hunt, 1993). Equally, APV could have opted for 100 per cent ownership in its JV in Hungary, but preferred a 60:40 JV since it believed the long-term success of the venture required the active involvement of local partners in decision-making (ibid).

There is a popular misconception that control means a better managed company and a better chance of success (Ohmae, 1989). Tomlinson (1970), examining the attitude of UK parents toward control of their 71 JVs in India and Pakistan, found that higher levels of profitability were obtained from JV investments with a more relaxed attitude towards control. Beamish (1985) observed that when the foreign firm owned less than 50 per cent of the equity in a LDC JV, it was more likely to perform satisfactorily and even equal shareholding MNEs performed better than those MNEs that were the single, largest shareholders (Beamish, 1985).

On the other hand, there are also voices that would suggest a better performance in dominant parent JVs, including Killing (1982, 1983). Half of the shared ventures in Killing's (1982) sample had to be liquidated or reorganised. Janger (1980) gathering data from 168 JVs in developed countries and LDCs, did not find that one type of JV (dominant parent venture, shared management venture) tended to be more successful than another. Also Kogut (1988) who attempted to support statistically the argument that dominant parent ventures are more stable than shared management ventures, could not extract significant data from a sample of 148 domestic and international JVs.

### ***Joint venture management***

JVs offer companies significant economic and non-economic benefits. However, the extent to which these benefits are realised depends largely on venture implementation and management (Datta, 1988; Lane and Beamish, 1990). Compared with WFOEs, JVs are much more difficult to manage (Rugman et al., 1985) since in a JV more than one firm is involved in decision-making (Killing, 1982, 1983). According to Datta (1988), behavioural, cultural and administrative impediments make JV management a demanding and difficult task. For instance, the MNE management team might have a different attitude towards risk than the local partner or a different decision-making style. The greater the interdependencies or linkages, the greater is the possibility of conflict

between the JV partners. Datta (1988) insists it is important to recognise these interdependencies early on in the JV process and to take appropriate actions to minimise their consequences. Overall, managing an international JV might have to be considered as a mutual responsibility evolving over time (Albrecht et al., 1996).

In his JV model, Killing (1983) identified the board of directors and the management staffing issue as the two areas where problems of multiple parents manifest themselves. The board of directors aspect covers the issue of control. This has been discussed above. However, this aspect is of interest only in cases where management is shared, since in dominant parent ventures the board plays rather a ceremonial role as the dominant parent executives make all the venture's strategic and operating decisions (*ibid*). Management team staffing is a highly delicate issue: as some parent firms attempt to manoeuvre their own personnel into key managerial positions while others refrain from sending excess foreign personnel to the JV, owing to either their polycentric orientation or cost considerations. Lane and Beamish (1990) recommend committing a large proportion of local managers rather than expatriates in order to ensure that the foreign partner acquires the necessary knowledge of the local economy, its politics and culture. On the other hand, expatriate management personnel enhance and improve the communication between the venture and its parent company, because employees of the two firms know each other (Killing, 1983). Also, the more complete the information communicated by expatriates to the parent company, the better the control.

Whether a large proportion of local managers is employed (ie Lane and Beamish's argument) depends upon the control position of the foreign partner. For instance, Killing (1983) found that dominant parent ventures do not employ managers from their passive parents, whereas, in order to enhance information flow and to capture the skills of parent companies, shared management ventures between firms from similar cultures employ managers from both parents.

Often, managers in JVs are on loan and their seniority and pension rights are retained in the parent company. In his research of US JVs in Mexico, Schaan (1983) found that in two out of ten Mexican JVs, the general manager remained on the payroll of the parent, in four JVs the general manager's bonus was tied to one of the parent's results, in four ventures the general manager was required to attend the parent's worldwide management or technical meetings, and in five JVs the promotion and career plans of the general manager were clearly predicated upon his returning to the parent

company. Neither Schaan (1983) nor Killing (1983), however, established any relationship between these issues and JV success. Also Killing's (1982) earlier study did not reveal any better performance from JVs with managers drawn from either both partners or just one, respectively.

As a result, these managers may pay more attention to events taking place in their parent and to signals coming from that parent, than to the venture's general manager (Killing, 1983). To this end, Killing (1983) found that eleven of 19 shared management ventures used executives from both parents. Those shared management JVs that did not use managers from both parents were either too small to justify a full-time employee or had previously used employees from both parents, but had learned enough to be able to dispense with the expensive foreigners.

The appointment of JV general managers has seen most problems and conflicts between partners. Foreign companies display different behaviours with regard to general manager appointments. Whereas one type of company (ethnocentric), attempts to introduce one of its own employees in order to increase the company's influence on the JV operation, the other type (polycentric) opts for a general manager from the local parent company. A third type (geocentric) rejects both strategies and would appoint an independent general manager, in many cases from a third nation. The advantages and disadvantages of appointing foreign or local general managers have been discussed by Buckley et al. (1988).

Schuler et al. (1992), studying the Davidson-Marley Automotive Components JV in Belgium, investigated issues such as the assignment of managers, transferability of human resources, allocation of start-up responsibilities and conflicts of loyalty which are typical for JVs. The authors found western managers displayed greater sensitivity to cultural diversity when dealing with Asian firms than was the case with other European or US firms. This was because differences were expected. Marley recognised the importance of adjusting to the employment practices of the host country rather than just imposing parent country practices on the local operations. In conclusion, Schuler et al. (1992) suggest that companies need to consider the degree of cultural homogeneity. After drawing the picture of the Davidson-Marley JV, van Sluijs and Schuler (1994) subsequently assessed the Belgium-based JV. The authors argue that, since in a JV the general manager reports to two individuals - one from each parent - conflicts, differences and discussions are bound to occur among the three individuals. This would be even more complex in the case of the human resource manager, who reports to the general manager of the JV itself and to the corresponding

functional managers of the two parents. Thus conflicts, differences and discussions take place among four individuals.

Lyles and Reger (1993) explored the relationships between influence, autonomy and control in the US-European JV EIM. Autonomy and upward influence in JVs was found more complicated than previously believed and relationships were not simple, unidirectional or linear. The study revealed that JV managers have a variety of techniques that can be applied to influence decision-making about the JV's future. These include generating a self-sufficient resource base, cultivating a separate culture, developing multiple, distinctive products, and producing superior products. Lyles and Reger (1993) observed that JV managers utilised a variety of individually-applied techniques to influence the decisions made, including personal interactions with parent firm managers and gaining co-operation from outside the formal authority structure.

Lichtenberger and Naulleau (1993) investigated French-German JVs to study cultural issues prevalent in JVs. The data from non-specified number of interviews with consultants and executives working in these JVs revealed conflicts in the three phases of the JV life cycle. In the start-up phase, the German approach to decision-making was characterised by a higher degree of systematisation in planning all the steps, eventually leading to the JV start-up: business plan, budgets and division of responsibilities (Lichtenberger and Naulleau, 1993). Lichtenberger and Naulleau (1993) propose that cultural synergy emphasises the need for managing the impacts of diversity, rather than attempting to eliminate the diversity itself. Synergistic problem-solving is a systematic process for moving a JV from two-domestic to one-international perspective. It becomes an effective approach for making JVs successful (Lichtenberger and Naulleau, 1993).

### **3.2.3 Joint venture success**

JV success is the dependent variable in this model. The most prevalent question at this stage, however, is: what is success? How is success measured? Lyles (1987), Anderson (1990) and Geringer and Hebert (1991) could not find consensus on the appropriate definition and measure of JV performance. A variety of subjective and objective measures have been employed with the latter including profitability, growth and cost position (Tomlinson, 1970; Lecraw, 1983), survival (Franko, 1971; Killing, 1983; Harrigan, 1988; Geringer, 1991), JV duration (Harrigan, 1988; Kogut, 1988) and instability (Franko, 1971; Gomes-Casseres, 1987, 1989). Most of the empirical studies examining the effectiveness of JVs concentrate on performance in absolute terms (Chowdhury, 1992).

Objective measures embody potential limitations that are critical to the evaluation of JV performance (Geringer and Hebert, 1991). Financial measures especially fail to reflect the extent to which a JV has achieved its short- and long-term objectives (Killing, 1983). Schaan (1988) accordingly argues that JVs can be deemed successful despite poor financial performance, and vice versa. For instance, JVs formed to develop new markets are often unlikely to generate a financial profit for many years. Anderson (1990) criticised the application of profitability indicators when businesses are in risky or uncertain situations. Earlier, Cartwright and Cooper (1989), in their study of Southeast England firms, found that financially successful companies were less successful in humanistic terms.

Also, consider the case where the foreign partner learns during establishing and operating a JV in a host country: the JV itself might have been a financial disaster, whereas the parent firms could learn substantially and so save financial and managerial resources when forming another JV. Buckley et al. (1988) support this argument, suggesting that second-time investors are more successful than first-time investors. Further, the majority of the 52 US firms in Reynolds's (1984) study benefited from the experience of their Indian JVs, largely in terms of serving the Indian market itself. Further, consider cases where a JV may be concerned solely with the supply of required material or with the production of goods, possibly separately labelled, to be sold independently by both parties. In such cases, a JV does not have to be profitable in itself (Herzfeld, 1983). Equally, JV parents generate income through mechanisms other than dividends, including supply contracts, management fees, technology licensing fees, royalties and transfer pricing (Geringer and Hebert, 1991).

Stability or instability as measures of performance provide ground for criticism, too. Instability refers to major changes in ownership shares of a JV (Geringer and Hebert, 1991). These include foreign ownership crossing the 50 (downwards) and 95 per cent (upwards) lines, respectively, a partner selling out, liquidation of the JV, and major reorganisations (Franko, 1971; Killing, 1983; Gomes-Casseres, 1989). Authors, such as Gomes-Casseres (1987), Bleeke and Ernst (1991) and Reuer and Miller (1997) argue that JV termination need not reflect parent failure, though theoretical and empirical research on JVs has often characterised JV ownership structure changes as failures (Hamel, 1991). To this end, Killing (1982) discovered that the number of firms in his 19-company sample which needed the help of the local partner, decreased from 13 at the time of establishing the JV to six by the time the study was completed.



Scholars have also applied subjective JV performance measures, including the assessments of the JV and parent firms. However, as Osland and Cavusgil (1996) remark: using subjective performance measures reflects difficulties in obtaining objective evaluations, and the awareness that measures, such as profits, are not directly comparable across different industries and stages in JV life cycles. Geringer and Hebert (1991) in their study of 69 international JVs in the US and 82 in Canada, discovered positive and significant correlations between subjective and objective measures of JV performance. JV survival was the objective measure that evidenced the strongest and most significant correlations with subjective performance measures, followed by JV duration. Beamish (1988) and Geringer and Hebert (1991) discovered a significant positive correlation between the parents' and the JV general managers' assessments and between a parent's satisfaction with JV performance and perceptions by the other partner, and the JV general managers, of this parent's satisfaction. Geringer and Hebert's (1991) study was limited, however, to data on JVs that involved developed country parents. It also focused on recently formed JVs that still existed or had been terminated only recently.

### **3.3 Conclusion**

In this chapter the JV models of Killing (1983) and Harrigan (1984, 1985) have been discussed and it has been suggested that both models reflect JV reality in a developed country rather than a LDC environment. Thus, both models exhibit shortcomings for use in this thesis. Equally, Datta's (1988) JV model, though covering the international dimension, ignores essential model components such as the negotiation of JVs. The model contributes to the consequent evaluation of the appropriateness of the JV strategy as a market entry strategy for SMEs. Thus, a framework needed to be established that would allow the subsequent investigation of the JV strategy, including the JV formation and operation phases. The proposed model forms a good, general basis for the subsequent amendment with the insights from the review of the Sino-foreign JV literature in chapter six. JV dissolution aspects have not been covered in this chapter.

## Notes

<sup>1</sup> Earlier, Harrigan (1984) presented a framework for predicting how parent firms might configure JVs to achieve competitiveness. Basically, the paper presents the contents of Harrigan's (1985) later comprehensive work on JVs in domestic, mature economies.

<sup>2</sup> Beamish's doctoral thesis of 1984.

<sup>3</sup> Wells (1973) suggests that host countries may be better off if the foreign firm has all the equity. Contractor (1985) showed that putting a ceiling on the foreign equity share is the worst regulatory intervention leading to sub-optimal solutions for the companies and increasing prices for buyers of the final product, lower tax collection and increase of the venture's costs of foreign exchange. Support for that argument has been found in Afriyie's (1988) study which highlights the greater industrial impact of JVs on the host economy than that of local firms. Focusing on the relative industrial performance of JVs and local firms on their factor choice behaviour patterns, the study found that JVs produced three times more than local firms. Further, it was found that a JV has larger plant capacities than local firms. JVs also tended to employ higher capital per worker and also employ more production workers than did local firms. The study discovered that inter-industry differences appear to be smaller for local firms than for JVs.

<sup>4</sup> The local partner's main motivations are access to finance and technology that would be otherwise very difficult or time-intensive to develop or to buy. Buckley (1983) and Datta (1988) point out that the transfer of technology is likely to be the single most important reason why LDC firms seek JVs. Foreign partners in LDCs also seek access to the use of well-known brands and trademarks. Often JVs are seen as important mechanisms for achieving corporate growth and diversification objectives (Datta, 1988). In Reynolds's (1984) study of US JVs in India, the Indian firms expected equipment and foreign exchange. Raveed and Renforth (1983) also examined the host country motivations from two different perspectives - MNE executives and local elite. The authors found agreement between the attitudes of the US MNE and host country executives as to which country-oriented objectives were the most important for the host country. The two groups rated four of the same factors, namely 'to maximise the net capital flow into the country', 'to maximise the foreign exchange earnings of the country', 'to enhance the opportunity for local business interests to share in highly profitable commercial opportunities', 'to maximise the transfer of technology to the country'.

<sup>5</sup> Increasing local employment, establishing a means of import substitution, conserving foreign exchange and the technological upgrade of the economy (Datta, 1988; Albaum et al., 1992). Bieszki and Rath (1989) have challenged this, however. Studying JVs in Eastern European (former socialist) countries, they have questioned whether co-operation in the form of JVs leads to the aspired improvement in the countries' export position or whether it would result in more imports and currency outlays even. In fact, Afriyie's (1988) earlier study of foreign investment projects in Ghana found that JVs employ larger quantities of imported inputs per worker than local firms do.

<sup>6</sup> 34 of the sample firms had a US, 21 a Japanese, and 26 a Western European partner.

<sup>7</sup> Ten ventures were located in Caribbean market economies, with half of these in a single country. Beamish executed 46 interviews and received 18 questionnaires.

<sup>8</sup> Defined as either minority participations, 50-50 equity participations, licensing agreements between US and host-country firms. The investigation covered five industries, including automobiles, motor vehicle parts, food processing, pharmaceuticals and computers.

## Chapter Four

# Objectives and Methodology

### 4.1 Introduction

The previous chapter has developed the international JV framework to be used for analysis of joint venturing in China by UK and German small and medium-sized enterprises (SMEs). After setting the scene for foreign direct investment (FDI) in the Chinese market in chapter five, this framework will be amended and extended throughout chapter six based on findings from an examination of the literature on Sino-foreign joint ventures (JVs). Chapter four introduces the research objectives, the sampling process and the methodology applied in this study. It also introduces the tools for analysis and discusses the problems encountered in the sampling and data collection processes.

### 4.2 Research objectives

In chapter two it has been established that, compared with large firms, SMEs are disadvantaged when it comes to internationalisation, particularly in the form of FDI. It has been proposed in chapter two that the JV strategy is a means of overcoming traditional SME internationalisation restrictions, making foreign market entry and servicing possible for many SMEs. The overall aim of this study is to investigate whether, and to what extent, the JV supports the internationalisation efforts of SMEs. In particular, the issues addressed in this thesis include:

- the impact of resource limitations on the joint venturing in China of UK and German SMEs;
- the UK and German SMEs' entry strategy development towards the Chinese market;
- the characteristics of UK and German SME JVs in China, applying and extending the frameworks of Beamish and Wang (1989) and Beamish (1993);<sup>1</sup>
- the experiences of UK and German SMEs with their JVs in China. This proceeds along a framework based on the works of Harrigan (1984), Datta (1988) and Fan (1996). In detail, the thesis addresses both the establishment and operation phases of SME JVs in China;
- the extent to which the JV strategy relieves the resources burden that rests on SMEs in the process of internationalisation;

- the extent to which the JV has been successful as a market servicing strategy for UK and German SMEs in the Chinese market.

### 4.3 Preparatory study and piloting field work

During a first visit to the People's Republic of China in 1995,<sup>2</sup> UK and German business support organisations were contacted that could be sources for the subsequent data collection. One of the outcomes of the four-month exercise was agreement from the managing director of a Greater Shanghai-based subsidiary of a German small electronic appliances manufacturer to let the candidate investigate the company's procurement situation. It was known from various sources, including Trommsdorff et al. (1994) and Schuchardt (1994) that the sourcing of domestically-produced materials and components has been a great problem for many foreign manufacturers in China.

The subsequent research visit to this company in January 1996 had three objectives: first, to discover the problems with, and the strategies for, local sourcing in China.<sup>3</sup> Secondly, to gain experience in carrying out field research in China. Since the research with the appliance manufacturer would involve interviewing expatriate and local managers, it was considered a preparation for the subsequent execution of field research in China. Thirdly, the hope that investigation of that particular case would lead to western, possibly German, SMEs that had established JVs with local companies and were, as a result, supplying components to subsidiaries of German MNEs. Several studies have previously suggested such relationships (Schüller, 1994; Delegation of German Industry and Commerce Hong Kong, 1995). However, analysing the supply chain of the company did not detect such relationships.

However, by accident the research visit led to a German SME in East China that produces mechanical components jointly with a Chinese partner. Both its German expatriate manager and the director for international affairs at the German headquarters agreed to grant access to the company. This involved studying published company literature, executing personal interviews with the expatriate production and quality assurance manager, the assistant production and quality assurance manager and the finance and marketing managers of the JV. The director for international affairs of the company in Germany was also interviewed. This formed the pilot for the study. As Yin (1994) and Jankowicz (1994) have suggested, a pilot case assists the investigator in the development of relevant lines of questioning and also helps to clarify the research design. From the literature (Lichtenberger and Naulleau, 1993; Leung and

Yeung, 1995) it is known that pilot studies can identify sensitive questions. The piloting case research in this thesis had one major objective: that the result of the exercise should help establish a framework for the data collection that commenced in the spring of 1996.

#### **4.4 Creating a sample for research**

The identification of a population of UK and German SMEs with a JV in China was difficult. In neither case was there a readily available database that could be used to extract a sample for research. The Association of German Chambers of Industry and Commerce (DIHT), in conjunction with its representative office in Shanghai, has begun only recently to target SMEs with an existing or a planned FDI project in China and to provide SME-specific investment information (Kaiser and Grimm et al., 1997). A similar, SME-specific approach on the part of a UK institution or individual has not yet been put forward.

Data on UK and German SMEs with FDI projects in China was hoped to be available from a range of sources (UK, German, Chinese) which are detailed in Appendix III. The data from these sources is limited in its validity and usefulness for at least two reasons: first, it is not comprehensive and does not indicate the size of the companies that undertake the investment. This observation was made by Fujita (1993, 1995) in an international context. He suggests that there is no country for which consistent and systematic FDI data is available by firm size. UK companies are not required to register with the British Embassy in Beijing when setting up FDI projects in China. This suggests that official UK bodies only know fragments of the actual investment projects of UK companies. Thus, no comprehensive list exists (CBTR, August 1994, p.11).<sup>4</sup> This explains why, in mid-1994, for instance, the British Embassy in Beijing knew of the existence of only 120 or so Sino-UK JVs (CBTR, August 1994, p.11), whereas official Chinese figures at that time suggested a total of 616 UK investment projects (FT, 7.11.94, p.vi). Secondly, both the 'JV list' and the 'British Chamber of Commerce Shanghai membership list' did not indicate whether the investors were large or SMEs.

These limitations apply, principally, also to German data. Directories are not comprehensive and do not indicate the size of the investing company, although the Delegation of German Industry and Commerce Shanghai, in 1997, revealed an estimated 180 to 200 German SMEs with an FDI project in China (Grimm, 1997). On the other hand, it is equally difficult to support the argument that SME investment in China is under-represented (CHINA-INFO, No. 11, July 1995; Handelsblatt, 29.5.95,

p.14). This confirms Braun's (1982) experience when examining German SME FDI in LDCs. He complained that there is no distribution of German FDI in less developed countries (LDCs) with respect to firm size. Also Kaufmann et al. (1990), when carrying out their study of German SMEs in Europe, complained of the lack of comprehensive statistics and databases that would suggest the size of co-operating firms.

Furthermore, some of the directories provide inaccurate information. Buckley et al. (1983) had a similar experience to the above. Studying continental European SME FDI in the UK, the authors detected that 23 firms claimed not to be owned by European continental firms, although databases had suggested so. Dong et al. (1993, p.204) stressed, when investigating Overseas Chinese, Japanese, US and European investments in China, that "no two sources provided exactly the same listings and the exact size of the target population is, therefore, unknown."

Also German companies are not required to register with the German Embassy in Beijing when setting up FDI projects in China. This suggests that official German bodies only know a fraction of the actual German investment projects in China. For instance, by June 1994, the German Embassy in Beijing was aware of some 312 German representative offices, 138 Sino-German JVs and 16 German WFOEs (Grimm, 1994). However, the business press (FT, 7.11.94, p.vi) suggested 569 German investment projects established by the end of 1993, 103 more than the German Embassy proposed six months later.

Further, the database of the trade promotion department of the German Embassy had to be treated with caution. On its first page, the directory identified the company Agfa-Gaevert (HK) Ltd. Shanghai **Repr. Office** as a JV, which seems rather odd. On its page 14, the directory classified the company Homag-Anderson Machinery (Shanghai) Co Ltd. as a JV. This company is a JV, but with a Taiwanese rather than a Chinese partner. It is treated legally therefore as a wholly foreign-owned enterprise (WFOE).<sup>5</sup> Another example of inaccurate data is the directory obtained from the German Asia-Pacific Business Association. One putative Sino-German JV project whose address was found in the above directory responded that "our company is a wholly Swiss-owned enterprise, instead of a (Sino-German) JV."

As with the UK and German sources, the value of Chinese data was diminished by the fact that it fails to indicate whether the investing foreign companies are large enterprises or SMEs. During an interview with officials at the Foreign Investment Commission in Shanghai on 11. May 1995, it became evident that the Chinese authorities - although they knew the size of the foreign companies' investment projects

in China - did not know the size of the parent companies. If the foreign companies are on the 'Forbes 500' list, the officials can find out more about them, as one interviewee at the Shanghai Foreign Investment Commission indicated. However, lists such as the 'Forbes 500' only include the world's top 500 companies, not SMEs. Support for this statement was found in the China-Britain Trade Review (October 1993, p.9) where it is pointed out that local officials in Shanghai had suggested that in autumn 1993 one sixth of the world's 500 top companies had established JVs or agencies in Shanghai.

The fact that Chinese officials do not have normally available information on the investors' firm size, has been frequently ignored by researchers who,<sup>6</sup> after talking to Chinese officials, stressed: "Whereas in the past more SMEs pursued investments, it is now the large and multinational companies that tend to invest." Equally, Au and Enderwick (1994) have suggested that the average size of JVs actually decreased between 1987 and 1988 and that smaller investors in China are thus growing in importance. This argument is hampered in two ways: first, it has been shown that JV investment has not decreased, but increased (FT, 7.11.94, p.vi; Kaiser and Grimm et al., 1997; de Bruijn and Jia, 1997). Secondly, to conclude from a decreasing average investment size to SME investment is superficial since decreasing investments can also be caused by cautious investment behaviour of large MNEs.

In summary, no single directory with UK and German data on SME FDI in China could be made available from the sources outlined above. This suggested two alternative strategies. The first was to ask all UK and German companies with a JV in China which were identified in any of the available databases to participate in a survey and to use the data only from SME respondents. This would have by far exceeded the financial budget of the researcher and a low response rate would have been risked, too. The second was to create specific databases with populations of UK and German SMEs with JV projects in China. Whereas for the German SME database, the basis was largely the company directory of the Delegation of German Industry and Commerce Shanghai, the UK SME database was - due to a lack of a single, comprehensive source of company addresses - an amalgam of various elements.

#### **4.4.1 SMEs in the UK**

##### ***SMEs in Northeast England***

The database that was obtained from the Government Office for the Northeast (GONE) was used for further analysis. It was assumed that the 452 enterprise contacts on the list were involved in business within the Asia-Pacific region. However, as suggested earlier, it was not clear which countries in the Asia-Pacific region these

companies were targeting and which market servicing strategies they employed. A survey was carried out that helped to clarify this aspect and to identify companies with JVs in China (Kaiser and Kirby, 1996). After removing those companies from the list that were known not to be SMEs or known to be subsidiaries of large firms, questionnaires were sent to the owner-managers or senior management personnel of 444 companies in August 1996. The structured questionnaire covered areas such as information on the respondents' business, their internationalisation experience in general, their experience with the Asia-Pacific region, and with China in particular, and their attitudes to doing business in the Asia-Pacific region. By the end of August 1996, a total of 87 usable questionnaires were returned.

Of these, 82 Northeast England businesses were reported to be active in the Asia-Pacific region and 34 were also dealing with, or operating in, China. Seven of these indicated that they were involved in a JV in China. Question 33 of the questionnaire asked the respondents whether they were prepared to be interviewed about their JV business in China and, surprisingly, 13 respondents agreed. All 13 respondents were contacted. Brief telephone conversations revealed that not all of the companies were actually involved in a JV, but variously "were interested in establishing a JV", "wanted to establish a WFOE", "was American-owned and does not have a JV itself" or "has only a business-relationship with a Chinese agent".

Thus, the 13 Northeast SMEs originally thought to be involved in a JV in China, turned out to be six. To these, an additional Northeast England SME that operates a JV in China was added. The company that the researcher identified somewhat by chance<sup>7</sup> was not contained in the GONE company directory.

### ***SMEs in the rest of the UK***

Subsequently, qualifying SMEs were sought UK-wide. This task was expected to be more comprehensive than the one described above since the carrying out of a survey on a nationwide basis was not possible for reasons of finance and manpower restrictions. Thus, an alternative, two-step approach was undertaken: first, addresses were collected from databases with contacts of direct investors in China, as the one discussed above, and from other sources, including publications. Secondly, company directories were used in order to identify whether the China direct investors were large firms or SMEs. Although this was a time-consuming task, it was the only way of creating an SME population for the survey.

The most promising strategy to establish the UK SME database was to use the following sources of information: 'JV list' of the British Embassy in Beijing, 'British Chamber of Commerce Shanghai membership list', CBTG databases, China-Britain



Trade Review, business press, conference attendance lists, trade mission participation lists, and chambers of commerce in the UK.

The monthly periodical 'China-Britain Trade Review' (CBTR), published by the CBTG, was thought to be a further valuable source. The publication contains a two-page section listing recent contracts between Chinese and foreign companies. The data on these two pages is organised using dimensions such as 'sector', 'country', 'foreign partner', 'Chinese partner', 'agreement', 'date', and 'project'. 55 issues of the CBTR, from January 1992 to August 1996,<sup>8</sup> were analysed. Only if the country engaged in the project was the UK, **and** the project was a JV, **and** the foreign parent companies were known not to be large companies, were the firms examined further. This exercise produced a total of 216 agreements established between UK and Chinese companies. Analysing these agreements showed that 81 were JVs and 135 were other contracts.

Company news in the CBTR (Jan. 1992 to Aug. 1996), the UK business press, such as the Financial Times (Jan. 1994 to July 1996), were examined and, if the firm concerned was not known as large, it was added to the database for examination.

Conference and trade fair attendance lists seemed to be of value, too. In 1994, the researcher attended an exhibition in Harrogate in the UK. Several exhibitors were approached and asked about their China commitment. Two of the exhibiting UK firms expressed their interest in entering the Chinese market through "a JV or so". The companies were contacted in the summer of 1996 to find out if they had realised their plans. However, neither company had, at that time, established a JV, though one was involved in discussions about forming one. A list with the names of companies that participated in the 1996 UK trade mission to China was obtained at the Confederation of the British Industry (CBI) de-briefing session in London on 6. June 1996.

### ***Evaluation***

In a second step, the company entries obtained in the process described above were sifted (ie companies with more than 500 employees were removed) by applying company directory data that was available either on CD-ROM (FAME)<sup>9</sup> or on-line (DATASTREAM).<sup>10</sup> DATASTREAM was applied whenever FAME did not produce sufficient results. Evaluating the above mentioned data sources was straightforward - with one exception: the 'British Chamber of Commerce Shanghai membership list' created difficulties since the name that is contained in the list, is the name of the organisation established in the Chinese jurisdiction. Checking these names in company directories, such as FAME and DATASTREAM, did not produce results. However, usually the names of the UK companies' operations in China contain parts of the name also to be found in the parent company name. This made the identification of these firms in FAME and DATASTREAM possible. The lists also contained company

names that were not found in the directories. Although it could not be assumed that these companies were not SMEs, the enterprises were excluded from the list.

Out of the original 30 UK companies in the database, 23 qualified for the next round of the evaluation process.

### ***Additional findings***

A survey undertaken by a 1996 University of Durham MBA student examined the China business commitment of Scottish SMEs that were members of CBTG. Question ten of this student's questionnaire asked what stage the respondents' company had reached in developing the Chinese market. Three of the 23 respondents indicated that they had JVs operating in China. All three companies were added to the database for further research. The database contained the names of the companies, contact persons, addresses, telephone numbers, industry affiliation and company size information, where known.

## **4.4.2 SMEs in Germany**

### ***Database of German SMEs***

The most promising strategy to obtain addresses for the subsequent establishment of the 'German SME with a JV in China' population was to use the company directory provided by the Delegation of German Industry and Commerce Shanghai. This directory seemed to be the most comprehensive available and, thus, appropriate as the basis for further evaluation. Other sources were evaluated, including the database processed by the German Embassy in Beijing, the publications 'Ost-West Contact' and 'China aktuell', the business press, CBTR, an HWWA proposal and information from selected chambers of commerce in Germany. However, none of these other sources proved very helpful with regard to improving the comprehensive database of the Delegation of German Industry and Commerce Shanghai.

### ***Evaluation***

The process of evaluating the content of the original database was similar to the case of the UK SMEs. However, instead of FAME and DATASTREAM, the German company directory Hoppenstedt was employed.<sup>11</sup> 31 out of the original database of 38 companies thought to be German SMEs with a JV in China were eventually approached. As with the UK SME database, the German SME database contained information about the companies including names, addresses, contact persons, telephone numbers and company size information.

### ***Results of the search***

The population-creating exercises produced a total of 26 UK and 31 German SMEs with an alleged JV project in China. Employing the company directories FAME and Hoppenstedt also provided, in most cases, the addresses and telephone numbers of the companies. Where the address and/or telephone number was missing, national

enquiry services were asked for the relevant information. Consequently, in the UK the individual enterprises (excluding those that had participated in the Northeast England SME study) were phoned, and the names of the managing directors requested. Next, personal letters were sent to the managing directors or senior management personnel. The letter introduced the candidate and the research project and indicated that the candidate would telephone to find out whether the addressee was prepared to participate in a questionnaire survey.<sup>12</sup> After a fortnight of continuously contacting the companies, the researcher had spoken to all but two of the companies' representatives and asked whether they would release information about their JV in China.

This process showed that not all of the UK companies on the original list of 26 actually had a JV in China or were willing to participate in the intended study. Eventually, 14 companies agreed to participate in the research project. The remaining 12 firms did not participate as:

- "the Chinese partner insists that all technical and financial information regarding the operation of the JV would be kept confidential,"
- the contact person was never available,
- the JV was a restaurant and not part of the core business of the UK company,
- the contact person did not respond,
- the company did not operate in China,
- the managing director refused to talk to the researcher,
- the company had a WFOE and not a JV in China,
- the company had pulled out from the JV, or
- the company did not even have a representative office in China.

Additional information was obtained during the researcher's field trip to China in October and November 1996 from CBTG and the British Chamber of Commerce Shanghai. Since the names of contact persons and telephone numbers were provided by the data source, four of the above listed companies that were assumed to be JV companies were contacted from Shanghai. One JV was not approached since its UK parent had already been asked in the UK and a reply was awaited. Eventually, one contact proved useful and the company could be added to the database raising the total number of companies to 15.

The SMEs in Germany were also contacted by telephone to find out the names and positions of the persons to participate in the research. This was done in the summer of

1996. The information obtained was subsequently used to send personal letters to prospective respondents. The companies were not asked for an interview since telephoning 31 companies, perhaps as many as ten times, was simply too resource-hungry. The process of building the sample for research is presented in table 4-1.

Table 4-1: Process of building the sample for research.

Step	Search strategy	UK SMEs	Search strategy	German SMEs
1	Northeast England study (Kaiser and Kirby, 1996)	13 - 7		
$\Sigma$		6		
2	Additional entry	+ 1		
$\Sigma$		7		
3	Embassy JV list, British Chamber of Commerce membership list, CBTG databases, CBTR, press, conference attendance lists, trade mission participation lists, Chambers of Commerce in UK	+ 23	Delegation of German Industry and Commerce Shanghai database, German Embassy database, Ost-West Contact, China aktuell, business press, CBTR, HWWA proposal, Chambers of Commerce in Germany	38
$\Sigma$		30		
4	MBA survey results	+ 3		
$\Sigma$		33		
5	Firm size review	- 7		- 7
$\Sigma$		26		31
6	Approaching enterprises	- 12		
$\Sigma$		14		
7	CBTG in China	+ 1		
$\Sigma$		15		31

#### 4.5 Data collection

The tradition of research suggests basically two strategies of collecting data. One follows the positivist or quantitative<sup>13</sup> route and the other the qualitative<sup>14</sup> strand of thought. Positivist epistemology<sup>15</sup> has frequently been attacked for assuming that social sciences can be investigated in the same way as the natural sciences (Smith, 1989). This implies reducing human action to the status of automatic responses excited by external stimuli (Gill and Johnson, 1991). By limiting its conception of valid knowledge to that which is considered to be clearly observable 'sense-data', positivist epistemology has been criticised for missing out on important data when dealing with complex phenomena. Instead it establishes a causal relationship between variables that have little or no meaning to those individuals whose social worlds they are meant to represent (Hayek, 1978; Bryman, 1984; Smith, 1989; Gill and Johnson, 1991; Wright, 1996). Through an artificial distancing from the phenomenon under

investigation inherent in positivist epistemology, the researcher is not sufficiently close to the phenomenon to understand it (Smith, 1989).

The tenor of this criticism of quantitative research was the extolling of qualitative research in the psychology, economics and management branches of social sciences. Wright (1996) defines qualitative research as any research where number counting and statistical techniques are not the central issues, but where an attempt is made to get close to the collection of data in its natural setting by applying, among other things, case studies and participant observation. Qualitative research methods give the researcher more flexibility in capturing the complexities of the social sciences, which detect how factors (ie 'what') are related and what underlying psychological, economic, or social dynamics justify the selection of those factors and their relationships (Smith, 1989; Wright, 1996).

This, on the other hand, brought proponents of the positivist strand of thought into the arena. The principal criticism of qualitative research methods, such as case studies, is that they are unrepresentative and that they are suitable for exploratory studies at best, whereas quantification is necessary to establish the validity of any findings. Wright (1996) proposes to *minimise* this drawback by using more than one case, and matching cases as far as possible along some variables, including industry, similar size and entering a foreign market within the same time period. Though Wright's (1996) argument may be able to minimise the drawback of qualitative research, it is not strong enough to eliminate it. Indeed, she suggests as much with her own choice of the word "minimise", which suggests that there remains a rest which neither she nor other writers could address. Prior to Wright (1996), Gummesson (1991) attempted to justify the use of qualitative case research by challenging the importance of validity with which generalisation is closely related.

This dichotomy - which arises as a result of the acceptance one strand of research (the qualitative) and the rejection of the other (the quantitative) on the basis that one is *a priori* better than the other - loses out on a common benefit that is derived from the merits of both. The different methods have different inherent strengths and weaknesses that need to be taken into account (Gill and Johnson, 1991). Various authors have accepted such a position of triangulation, where methods are combined to strengthen both, including Smith (1989), Rohner (1977), Bennett (1983), Snow and Thomas (1994), Yin (1994), and Wright (1996). A strategy of triangulation implies combining principal research methods, such as historical research, case study, survey, and field experiment. Snow and Thomas (1994) discovered that studies that employed a triangulated methodology have an impressive record in the strategy literature.

However, Bryman (1984) criticises the combination of methods on the basis that this confuses technical and epistemological arguing: the argument for triangulated strategies is essentially a technical one (ibid). Bryman (1984) also rejects the merit of a preparatory case study since this places qualitative and quantitative methodology within the same epistemological framework.

The multi-method approach also has its limitations, however. For example, the use of more than one field method introduces analytic diversity, though such diversity is low relative to the entire range of research methods. Indeed, the use of multiple field methods may only be sufficient to create within-method triangulation (Denzin, 1978) which means that the researcher has examined a phenomenon or relationship from different angles. As a result the views share common flaws which prevent strong convergent validity from being established.

The methodology applied in this research was triangulated, extracting the merits of the methods of both strands of methodological thought. This research employed quantitative methods (survey) as well as qualitative ones (case study). The exploratory nature of case study research was exploited in the process of piloting the field work (section 4.3) in order to explore factors ('what') that are meaningful to those whose social worlds they are meant to represent. Subsequently, a causal relationship between these variables was established by asking respondents and studying certain aspects in-depth.

#### **4.5.1 Questionnaire survey**

Techniques<sup>16</sup> in survey research include the structured interview, mail questionnaire and self-administered questionnaire (Harpaz, 1996). Snow and Thomas (1994) examining the variety of field research methods used in strategic management, propose that these can realistically examine strategic processes.

The survey is particularly useful when large numbers of people have to be contacted in order to obtain data on the same issue or issues. Also, conducting a survey permits conclusions to be generalised (Jankowicz, 1994). Some authors (Jobber and Saunders, 1988) consider the use of a questionnaire survey as an inexpensive method of gathering data, making the carrying out of surveys possible. Elsewhere (Snow and Thomas, 1994) it is suggested that the questionnaire survey is an efficient, though less flexible, substitute for observation or interviewing and that it is cheaper to administer, while covering more respondents.

Questionnaire surveys also have disadvantages and there are situations where alternative means of data collection are more promising. For instance, some authors

(Gaedeke and Tootelian, 1976; Snow and Thomas, 1994) consider as a major limitation of questionnaire surveys their typically low response rates. This is especially applicable when surveys are mailed directly to respondents without prior contact or when the intended respondents are top managers (Snow and Thomas, 1994). This is problematic, as it reduces confidence about the extent to which the results generalise to the population from which the survey is drawn.

Distributed questionnaires are frequently ignored by respondents. This particularly applies to questionnaires that are too comprehensive since respondents are likely to be careless, or indeed, refuse to participate in a survey at all (Jankowicz, 1994). As a useful rule of thumb for postal questionnaires, Howard and Sharp (1983) suggest an upper limit of ten pages or 15 minutes for completion. Management personnel have only a limited amount of time and filling in lengthy questionnaires is certainly not a priority. Empirical findings confirm this: Dillman (1978) reports 52 per cent average response rates for surveys of top managers, whereas research using other managers as respondents achieved an average rate of 61 per cent.

The examination of studies on SME internationalisation (chapter two) suggests response rates between 7.5 and 92 per cent with 25 to 50 per cent as the most frequent. However, it is not known from these studies whether the authors applied sophisticated data collection methods, such as Dillman's (1978) 'total design' method. The export literature suggests response rates of approximately 30 per cent (Burton and Schlegelmilch, 1987; Cavusgil and Naor, 1987; Koh and Robicheaux, 1988; Keng and Tan, 1988; Axinn, 1988; Sharkey et al., 1989; Czinkota and Ursic, 1991; Moini, 1995), whereas the FDI literature experienced response rates of between 15 and 56 per cent (Habib, 1987; Eiteman, 1990; Lau, 1992; Gledhill, 1994; Glaister and Wang, 1993; Leung and Yeung, 1995).

Respondents are increasingly getting tired of answering questionnaires. For instance, during a session of the German *JV round table* in Shanghai, participants complained that too many researchers kept sending metre-long questionnaires through their fax machines. This was also pointed out by a researcher of the German Economics Research Institute HWWA considering this phenomenon dangerous for people with 'proper' research projects.

The identified populations of 26 UK and 31 German firms with JVs in China seemed to be too small to risk the use of a conventional data collection approach, ie initial distribution of a questionnaire and the carrying out of interviews. Considering a response rate that was experienced in an earlier study of less than 20 per cent (Kaiser and Kirby, 1996), this approach would have produced only some five or six usable

responses, respectively. Thus, a data collection mechanism had to be designed that would guarantee a maximum response rate. Dillman (1978), for instance, recommends applying the "total design method" which identifies and copes with factors that can influence the number and quality of responses. The 48 questionnaire surveys that used this method and that were investigated by Dillman (1978) produced an average response rate of 74 per cent, with none of the surveys obtaining less than 50 per cent.

The number of potential survey respondents was small enough to justify the application of Dillman's (1978) 'total design method'. More generally, high response rates are more likely to be associated with features such as: contacting respondents in advance, administering surveys on site (especially during work hours), convincing top managers to distribute surveys, contacting non-respondents and/or sending them another mailing and carrying out the survey in conjunction with interviews (Snow and Thomas, 1994).

Although, in the present study, the sample for quantitative research was not very large (26 UK and 31 German SMEs), financial constraints prevented the carrying out of structured telephone interviews with every SME. Similarly, it was not possible to carry out face-to-face interviews with each owner-manager or senior management personnel. Thus, a postal questionnaire survey was regarded as the best alternative. It was hoped to achieve a response rate of some 50 per cent as a result of using the 'total design method', as outlined above.

### ***Questionnaire design***

A questionnaire may be regarded as a written interview (Pareek and Rao, 1980; Dess and Davies, 1984). Thus, when designing the questionnaire, there has to be a flow that will keep potential respondents interested. Also the questionnaire must not be too long while the questions should be arranged in a logical order. Structured questionnaires exist in a variety of forms, including fixed alternative and open-ended forms (Jankowicz, 1994). Fixed alternative forms are multiple choice (single alternative), free choice (one or more alternatives), ranking and rating variations. The structured questionnaire employed in this thesis contains both multiple and free choice and rating elements.

Subjective rating measures may best be captured in bipolar, five-point Likert scales. Likert scales allow the application of both nominal and ordinal data measurement (Dong et al., 1993). They also permit measurement of the importance of contributions, for example, subjective success (Geringer and Hebert, 1991) and changes over time (Beamish, 1993). Five-point Likert scales have been used by authors, including Geringer and Hebert (1991) in their study of 69 and 82 international JVs in the US and Canada, Beamish (1993) and Dong et al. (1993) studying international JVs in China.



A seven-point Likert scale, as used by Stewart and Keown (1989) and Leung and Yeung (1995) in their study of the factors for successful negotiations, was not used since it was believed that more numerous response categories would exceed the respondents' ability to discriminate. The two poles of the Likert scales that were employed expressed a very high degree of agreement and a very high degree of disagreement.<sup>17</sup> The 'agreement' pole was allocated one credit and the 'disagreement' pole five credits. The three answer categories between the two poles were given credits from two to four. The structured questionnaire also included some open-ended questions, making it more flexible (Jankowicz, 1994). This addressed a concern raised by Gill and Johnson (1991) that a respondent might be constrained by the rubric of a self-completion questionnaire and have little opportunity to articulate ways in which he/she personally conceptualises and understands the matters of interest.

The questions were organised in main topics, including basic information about the participating companies, JV establishment, operation, problems, performance, financing and JV contributions to relieve the SMEs' resource commitments. A copy of the questionnaire is contained in Appendix IV.

The input for the questionnaire design was obtained from literature on internationalisation (chapter two of this thesis) and the analytical research framework on international JVs developed in chapters three and six. Additional sources included:

- owner-managers of SMEs in Northeast England that were involved in international business. These practitioners would know, from their own experience, the issues relevant to SMEs with a commitment overseas,
- academics working in the field of international business. This group of people was thought to be able, from personal experience of international companies, to direct the researcher to relevant issues of research, ie to help revise the original version of the questionnaire,
- the experience gained while carrying out a questionnaire survey in August 1996 to research the internationalisation behaviour and the attitudes of SMEs in Northeast England towards doing business in the Asia-Pacific region (Kaiser and Kirby, 1996),

### ***Questionnaire pre-testing***

Six Durham MBA students pre-tested the questionnaire and the findings were used to refine the initial concept of the questionnaire design. This included, for instance, extending the range of pre-defined answers where necessary or modifying the order of questions and pre-defined answers. MBA students as pre-testers were chosen due to reasons of convenience. Furthermore, prior to taking their MBA courses, the students were decision-makers in internationally active companies.

### ***Questionnaire distribution***

The questionnaires were distributed in September 1996<sup>18</sup> to the owner-managers or

senior management personnel of the UK and German SMEs. The owner-managers, or high-ranking management personnel, were chosen in order to ensure quality responses. Habib (1987) distributed his questionnaires to the JVs' presidents and Geringer (1991) approached respondents who had direct responsibility for the JV's operations and had been closely involved with the JV during its formation.

The respondents received either English or German versions of the questionnaire. In order to ensure precise translation of not only the wording but also the meaning, the German questionnaire was back-translated into English. Shenkar (1994) suggests that the meaning attached to a question may vary from one culture to another. Other translation techniques, as suggested by Harpaz (1996), including the bilingual method, committee procedure, and pre-testing were not applied since back-translating the questionnaire from German to English<sup>19</sup> showed a sufficiently good result.

To ensure a maximum response rate, a covering letter was produced. It was personally addressed to the respondent and signed by hand. Pre-paid, self-addressed envelopes were attached to the questionnaires and the respondents were promised an executive summary of the survey findings.

Eventually, nine UK and 12 German SMEs returned the questionnaires. This suggests a cleared response rate of 60 per cent in the case of the UK (9/15) and 39 per cent in the case of the German companies (12/31). The profiles of the participating firms are presented in table 4-2.

Table 4-2: Profile of the samples of UK and German SMEs.

Characteristics	UK SMEs	German SMEs
Ownership: limited liability company	8	9
Ownership: other (eg limited partnership)	1	3
Firm size: 1-200 employees	4	6
Firm size: 201-500 employees	4	5
Firm size: 500 plus employees	1	1
Industry: mechanical engineering	7	6
Industry: construction	1	0
Industry: electronics	1	3
Industry: services	0	2
Industry: textiles	0	1
JV establishment	1987-1996	1990-1996

#### 4.5.2 In-depth interviews

In addition to the questionnaire survey, telephone interviews were conducted with a selected number of UK SMEs to confirm responses and to explore information in greater detail. Interviews with the respondents of the SMEs that agreed to participate in the case study research are discussed under the heading 'case studies'. The

appropriateness of interviews was previously suggested by Daniels et al. (1985), Gummesson (1991), Dong et al. (1993), and Leung and Yeung (1995). Tang et al. (1992) even suggest that, in China, questionnaires should be replaced with interviews since most people in China are still unfamiliar with surveys. In-depth interviews were not carried out with German SMEs as the cost of telephoning the respondents (from the UK) or meeting them in Germany would have been too expensive.

Authors, including McGrath (1964), Bennett (1983) and Healey and Rawlinson (1994) consider interviewing as one of the main tools of the social science field investigator, gathering data through discussions with informants rather than at first hand. Interviewing involves asking questions of those who have information about a phenomenon that the researcher has not been able to observe directly. Interviews may require respondents to speak about themselves, to inform on the attitudes and actions of others, to recall events that have occurred in the past and to speculate about future situations (Cannell and Kahn, 1968). Responses are most commonly elicited from single respondents through open-ended or structured interviews (Krcmar, 1987; Snow and Thomas, 1994). Snow and Thomas note that interviewing typically involves less interaction with the situation than direct or participant observation.

Interviews, over the telephone or face-to-face, are expensive methods of collecting data compared with questionnaire surveys. In addition, interviewing a respondent always gives the opportunity to influence the respondent and so manipulate the respondent's answers. As Eisenhardt (1989) suggests, in many field studies, interview data needs to be combined with observational (and other) data to arrive at a valid characterisation of the research problem.

The interviews for this study were carried out over the telephone with those respondents who agreed to be interviewed by filling in their names on the questionnaire that was returned to the candidate. The researcher contacted the respondents to agree a date and time for the interview. The interviews lasted between 40 and 70 minutes. Three interviews were carried out in the UK. These do not include the face-to-face interviews completed for the preparation of the case studies.

#### **4.5.3 Case studies**

The purpose, strengths and weaknesses of case study research have been highlighted in the introduction to section 4.5.<sup>20</sup> Case study research deals with operational links needing to be traced over time, rather than mere frequencies or incidence (Yin, 1994). Case study research allows an investigation to retain the holistic and meaningful characteristics of real life events. The study of cases allows coverage of contextual

conditions that are believed to be highly pertinent to the phenomenon under study (ibid). If a number of variables have been identified, the importance of which to the organisations under study may be explored, it is possible to carry out a comparative case study in which the same questions are asked in several organisations (Jankowicz, 1994). According to the findings by Gummesson (1991), case study research is increasingly accepted as a scientific tool in business administration.

Case study research obtains its data largely through a review of written records and by means of interview technique (Jankowicz, 1994). Bennett (1983) suggests the following stages that need to be gone through in the process of case study research. These include the determination of the present situation, the gathering of information about background to the present situation, the gathering of more specific data to test alternative hypotheses about the important factors in the present situation, and the presentation of recommendations for action.

A wide range of information gathering can be used in case study research. (Gummesson, 1991) and explicitly Jankowicz (1994) suggest that evidence for case study research may come from six sources, including documents, archival records, interviews, direct observation, participant-observation and physical artefacts. A knowledge of the company history is also deemed to be essential since a study of significant events in company history is expected to provide insights that might act as a basis for decisions about the future (Gummesson, 1991).

From the pre-export literature (eg Caughey and Chetty, 1994) it is known that, for the aim of studying causality, the multiple case study method is the preferred approach. As the most appropriate number of cases studied, Eisenhardt (1989) suggests between four and ten. Earlier, Glaser and Strauss (1967) suggested that the actual number of cases needed in a specific study will be determined by saturation, that is, the diminishing marginal contribution of each individual case.

Case study research has been confronted with a variety of criticisms, including its lack of statistical validity, an inability to test hypotheses and of the fact that it is difficult to form general conclusions (Gummesson, 1991). Yin (1994) concedes that case studies would take too long and result in massive, unreadable documents. Furthermore - and this naturally applies more to techniques that are applied within case study research - the researcher cannot determine how much his presence is affecting the situation under study. Thus, according to Gummesson (1991), researchers in business-related subjects limit case studies to pilot studies as a basis for formulating more precise

questions or testable hypotheses.

In this thesis - to complement the findings from the questionnaire survey and the series of in-depth interviews - the cases of three Sino-UK and one Sino-German JVs in China were studied. The UK cases were selected by asking the senior management personnel at the UK SMEs for permission to investigate the JVs. Three agreed. The selection of the German SME for case study research is outlined in section 4.3 of this chapter (pilot case).

In this thesis, studying the cases of selected SMEs involved the application of a range of data collection methods, including questionnaire surveying, observation, personal interviewing, the study of company literature, organisation charts, business plans etc. For the study of the four cases of UK and German SME JVs in China, a case study pattern was designed and refined during the first interview with Case Company One. Firms were studied between three and five days. All JVs were visited in China where key informant interviews were carried out. In addition, personal interviews with the owner-managers or senior managers were conducted at the SMEs' headquarters in the UK and Germany. The individual interview sessions lasted approximately two hours each and were not taped. They were complemented by a tour through the company, office and production facilities.

The language of interviewing in China was predominantly English. Where the Chinese interviewees did not speak English sufficiently well, the interview was translated by an English-speaking employee of the company. This was the case in two companies. Using an employee had the advantage that this employee knew the company and the subject the interview partners were talking about. In one case, the Chinese general manager of the JV tried to use the services of an employee who worked for the hotel where the company had rented its office space. Although the interpreter's English was good, he did not understand what the researcher and the general manager tried to discuss. The conversation had to be postponed to the next day when the English-speaking assistant of the general manager returned from a business trip.

Table 4-3 presents the various sources that were consulted for the compilation of the case studies.

#### **4.5.4 Difficulties encountered**

##### ***Field research***

The fact that there was no readily available database from which to draw a sample, applies both to the investigation of UK and German SMEs with an FDI project in China. The sample framework had to be created first (section 4.4). Furthermore, since the objects of the research were SMEs and, within them, the respondents were the owner-

managers or senior management personnel who were busy with day-to-day duties, contacting and talking to respondents proved difficult.

Another obstacle was the fact that SMEs are usually very cautious in terms of commenting on their experiences and strategies. According to Simon (1992, 1996), this applies to SMEs in Germany where it is not the style to parade success. Simon (1992, p.116) puts forward a statement of a German 'hidden champion' that says "we are not interested in revealing our success strategies and helping those who have been inert during recent years." This totally contradicts the experiences of Killing (1983, preface) with US MNEs suggesting that "I was continually delighted and amazed at the willingness with which executives discussed both their success and their failures." However, Simon (1992, 1996) eventually convinced 39 of Germany's 'hidden champions' to participate in a study looking at their strategies and tactics.

Table 4-3: Data sources used for case study research.

Case	Questionnaire	Interviews	Printed material
GER-0-JV		<ul style="list-style-type: none"> <li>• Production &amp; quality assurance manager</li> <li>• Assistant production &amp; quality assurance manager</li> <li>• Assistant sales manager</li> <li>• Director for overseas affairs of GER-0</li> </ul>	<ul style="list-style-type: none"> <li>• Annual report</li> <li>• Product catalogue</li> <li>• Newsletter</li> </ul>
UK-3-JV	Participation in survey	<ul style="list-style-type: none"> <li>• General manager of JV in PRC</li> <li>• Managing director of UK-3</li> </ul>	<ul style="list-style-type: none"> <li>• Product catalogue</li> <li>• Business plan</li> <li>• Organisational structure</li> </ul>
UK-4-JV	Participation in survey	<ul style="list-style-type: none"> <li>• General manager of JV in PRC</li> <li>• Manager of Chinese partner</li> <li>• Managing director of UK-4</li> </ul>	<ul style="list-style-type: none"> <li>• Product leaflets of SME</li> <li>• Product leaflets of Chinese partner</li> </ul>
UK-8-JV	Participation in survey	<ul style="list-style-type: none"> <li>• General manager of JV in PRC</li> <li>• Sales manager of JV in PRC</li> <li>• Managing director of UK-8</li> <li>• Technical director of UK-8</li> </ul>	<ul style="list-style-type: none"> <li>• Product catalogue</li> </ul>

It was anticipated that carrying out field research in China would be difficult, since Fan (1996) suggests difficulties with finding 'hard' data and conducting field studies. The research sessions in China brought also a variety of difficulties and problems the candidate had to cope with. First, the organisations to be investigated had to be prepared to grant the researcher access. Gummesson (1991) considers access, the ability to get close to the object of study to find out what is happening, as the researcher's number one problem. Thereby, access manifests itself as physical, initial and continued access, and mental access, which is the understanding what is actually happening in the setting. Surprisingly, however, Gummesson (1991) suggests that physical access would not pose any problem at all.

Here, physical access was facilitated by letters of recommendation from the UK SME headquarters and parallel correspondence from the headquarters to the subsidiary in China. Mental access had to be developed throughout the interviews. Access to the German SME JV was relatively easily granted since both the production and quality assurance manager of the JV and the director for overseas affairs of the German parent company were open to the proposed undertaking. Furthermore, the researcher had a letter of recommendation from a German manager (of one of the German SME's major customers in China) to show to the aforementioned production and quality assurance manager.

Further, the prospective respondents had to have time for the interview. Usually, the general managers of the JVs were extremely busy with their day-to-day tasks. Meetings were arranged weeks in advance in order to give the respondents adequate notice. Executing a research tour that would have started in North China and continued in East and South China was not possible. Flexibility was necessary as the researcher had to visit a firm in Jiangsu Province (East China), first, then one in South China, followed by a venture in East China.

Another problem was access to, and the release of, information. Where the interview partner was a Chinese manager, the release of relevant information was not as satisfactory as had been hoped for. Duscha (1987), in his research of 22 Sino-foreign JVs, concentrated on foreign managers as interviewees since Chinese managers were regarded as being highly cautious with regard to releasing information. One reason for this is that these managers have a vested interest in creating an optimistic attitude toward economic co-operation. On the other hand, foreign managers were more open. Shenkar (1994) from his study of Chinese managers, found that the Chinese have a tendency to answer a desired rather than an actual state. This had to be taken into consideration and the answers given had to be cross-checked with the UK and German managers. Furthermore, the interviewees were sometimes very cautious in what they told the candidate. Not surprisingly, many of the questions were answered vaguely or avoided on the basis that the facts were secret. Further, although the Chinese interviewees were willing to talk to the candidate, they would not have liked the idea of the candidate 'searching' around in their company. For instance, the candidate was not granted access to the workshop of one JV in East China. One of the Chinese directors had refused that as there had been an agreement between the Chinese company and the UK SME that "nobody was allowed to enter the workshop".

Also, the answers to some questions had to be treated very cautiously and discussed

later with the UK and German managers. For instance, at the beginning of the study of one case, it was intended to tape the whole session since Jankowicz (1994) recommended the use of a tape recorder if interviews are longer than half an hour. However, this was not permitted. Krcmar's (1987) observations were similar, which might suggest that Asian interviewees are not very happy about being taped. Thus, notes were taken during all interviews in an attempt to minimise the anxiety experienced by the managers. The problem of Chinese managers' anxiety when asked about their experiences and opinions has been observed also by Wäscher and Schmitt (1994). Since the sample in these authors' research was relatively small, and the topic (foreign exchange) relatively sensitive for the Chinese authorities, the authors detected "some fear that the respondents could be identified" (p.871).

### ***Desk research***

When collecting and comparing data on FDI in China, researchers frequently encounter various difficulties. Figures provided by different sources rarely correspond. This can lead to serious difficulties if Chinese data is to be compared either with those of other countries, or over time. In order to avoid misleading conclusions, statistics on FDI in China must be treated with care, ie cross-checked with various sources, since:

- there is no strong tradition of reporting economic statistics in China (Klenner, 1986; Pomfret, 1991). For instance, at the opening of the National People's Congress (NPC) in March 1998, positive evidence of China's economic policy was presented, including a 1997 inflation rate of only 0.8 per cent. The internationally applied criterion for inflation is, however, not the retail price index, as used by the Chinese, but the consumer price index which was 2.8 per cent in China. Further, at the NPC an urban unemployment rate of only 3.1 per cent was presented - 12 million people, according to Chinese statistics. According to the same statistics, urban employment accounts for 147 million people. This would suggest an unemployment rate of 8.2 per cent, and not 3.1 per cent. However, Chinese complaints about western reporting on China have also been heard (Zhu, 1996), including Wu Yi questioning US trade figures which show a yawning gap in Beijing's favour (FT, 11.4.95, p.6);
- the data describing the pattern of FDI in China is fragmented, with the resultant data not always being consistent (Shenkar, 1990). Another barrier to providing a comprehensive list of FDI figures in China becomes manifest in the fact that even recent contributions in business journals are not providing updated figures. Woodward and Liu (1993), for instance, refer to figures as current as 1988 which lead them to the erroneous conclusion that WFOEs were "to date" (= 1993) not significantly preferred. In contrast, different studies have shown that, after the law governing WFOEs was effected in 1986, the number of WFOEs increased, from 18 in 1986 to 2,795 in 1991 (Tsang, 1994);



- it has not yet been clarified how much of the invested money is 'round-trip' investment (Pomfret, 1991; Kelly, 1994). This is money which has been invested in foreign enterprises by Chinese companies and is being re-imported to China by the foreign company (ie an Overseas Chinese investor from Hong Kong or Taiwan) in order to make use of the preferential treatment of FDI. De Bruijn and Jia (1997) suggest that in 1992 and 1993, one third of all JVs could be counted as fake, while in 1994 and 1995 less than 10 per cent had to be considered a fake construction. This is because many of the formerly granted preferences are no longer granted (partly in response to complaints from Chinese companies);
- a natural time lag exists between the signing of a contract and the actual operation of the business, resulting in a more or less large gap between the volume of pledged and utilised investment. A possible reason for this delay as suggested by Beamish and Wang (1989) and Woodward and Liu (1993) might be the complex bureaucratic procedures which have to be followed when investments are set in motion. Other factors have a bearing too, including inflexibility, short-term orientation, management and foreign exchange problems. In a considerable number of cases, foreign-funded enterprises received the contracted investment after being in operation for two years or more;
- also, western sources do not always report data on FDI in China consistently. For instance, the *Financial Times* of 31. August 1994 (p.4) discussed the sources of FDI into China. It ranked the US (with pledged investment worth some US\$78.5bn (£50.3bn) number two among the ten largest investor countries by the end of 1993, after Hong Kong (US\$150.9bn; £96.7bn), but ahead of Taiwan (US\$18.4bn; £11.8bn) and Japan (US\$8.9bn; 5.7bn). France was considered the fifth largest investor (US\$6.8bn; £4.4bn)! In its issue of 7. November 1994, the same source considered the US (now with investments of US\$14.6bn; £9.4bn) as having been overtaken by Taiwan (by this time having invested some US\$18.5bn; £11.8bn). France was not even on the top ten investors list. Further, as opposed to the figure of US\$5.8bn (£3.7bn) of contractual UK investment by the end of 1994, a British Embassy paper<sup>21</sup> suggested some US\$8.1bn (£5.2bn) of contracted investment. Compared with 1993 figures of US\$3bn (£1.9bn) of cumulative contractual investment, as provided by MOFTEC, these figures do not add up. Has MOFTEC changed its methods of accounting investment by country and now, for the first time, ascribed to Britain money invested by overseas subsidiaries of British companies? This question remains open.

## 4.6 Analysis

Analysis is an activity to familiarise oneself with the recorded data until emerging patterns are revealed - either those that were in mind, or fresh patterns - and to

tabulate the data in such a way that these insights or perceptions are informative, obvious rather than hidden (Jankowicz, 1994). The statistical analyses that were applied to the quantitative research data in this thesis were frequency analysis of the questionnaires' content and content analysis of the interviews to review the rich, but disorganised data/material. Since contingency analysis and rank correlation analysis (Spearman) was also to be applied, the quantitative survey material was processed with the social sciences analysis package SPSS.

This contradicts the recommendations of, for instance, Jankowicz (1994) who suggests that with a sample of less than 100 people and a questionnaire of 15 items or so, the job can be finished faster by hand than by using a computer. However, Jankowicz (1994) when making this statement, was referring to the application of frequency analysis solely, not to more complex forms of analysis as applied in this study.

These types of analysis enabled the candidate not only to show how important individual factors were for the two groups of SMEs, but also whether significant differences were apparent between each of the two groups of SMEs when the discriminating criteria of nationality and firm size were applied. It was necessary to detect differences between UK and German SMEs and also between small SMEs (1-200 employees) and larger SMEs (201-500 employees). The Spearman rank correlation coefficient helped to highlight differences of the perceived importance of factors between the two groups.

Content analysis of the case studies was applied according to the research framework that was introduced in chapter three and subsequently followed throughout this research. Information on each JV case was gathered with regard to the individual section of the framework and subsequently cross-analysed. This enabled the researcher to identify similarities or differences in the approaches towards joint venturing of the four SMEs investigated. Occasionally, the informants did not provide equal amounts of information on the individual sections. Thus, the depth of insight into the cases with regard to the individual sections of the framework varies.

Serious problems with the analysis of the data – quantitative and qualitative – did not appear, the reason being that the tools of analysis were rather straightforward and the findings easy to interpret.

## **4.7 Conclusion**

This chapter has introduced the objectives of the study and the methodological approach developed to achieve them. It has been suggested that the sampling procedure was a comprehensive task, but had to be carried out since no readily

available data on UK and German SME investment in China existed. This relates to the shortcoming of this methodological approach. There is no known figure to define the actual size of the population of UK and German SME JVs in China. An estimation of the number of German SMEs in China exists. However, this estimation has been criticised. It gives no indication whatsoever of its reliability. The UK and German SME JVs in this study are spread over China: no pattern could be determined, nor established. Nor does there exist an industry pattern. Earlier, Dong et al. (1993) suggested that, due to the geographical dispersion of JVs in China, it is very difficult, if not impossible, to select a sample that covers all major sectors and locations. In other words, the sample in this study is a convenience sample. Consequently, there is no way to estimate how big it is relative to the entire population of UK and German SME JVs in China. Simon (1996, p.5) had a similar problem. He noted that "since there are no statistics for a 'hidden champion' category, my collection is not comprehensive".

Some of the lessons learned from this study for conducting research in China include:

- be patient,
- do not allow your time and financial budgets to be too tight,
- do not place yourself under pressure,
- do not forget that the Chinese want to get to know you before they tell you about their business.



## Notes

<sup>1</sup> Beamish and Wang's (1989) nine dimensions were: region of investment, source of investment, industry division, total investment, foreign partner equity contribution, foreign equity percentage, most frequently observed foreign equity percentage, foreign equity percentage by country, pre-determined duration of JVs.

<sup>2</sup> Working and research placement with the Delegation of German Industry and Commerce Shanghai (a representative office of the Association of German Chambers of Industry and Commerce - DIHT) from May to August.

<sup>3</sup> For details see Kaiser (1997).

<sup>4</sup> During a visit on 17. August 1995 to the Consulate General in Shanghai, the British Consul Commercial, Steve Smith, told the researcher that, at a recent diplomatic event in Shanghai, the Japanese Consul had revealed to him how many British companies were present in China. The Japanese Consul received this information from a Chinese official.

<sup>5</sup> This was discovered during a personal visit to the company in the summer of 1995.

<sup>6</sup> Internal report by one of the candidate's former colleagues.

<sup>7</sup> The managing director of this company phoned the candidate in order to talk about his JV in China. On 15. July 1996 this managing director was visited for an initial interview.

<sup>8</sup> December 1993 and January 1994 are covered in one issue.

<sup>9</sup> FAME is a financial database of major public and private UK companies. The database provides detailed data on 100,000 and outline data on another 60,000 UK companies. Since 160,000 companies covered by the CD-ROM, is small, relative to the total number of companies in the UK of more than 2m, it is unlikely that the database contains data on the smallest of the companies in the UK. However, 160,000 is big enough to contain medium-sized UK companies with up to 500 employees.

<sup>10</sup> The on-line database DATASTREAM provides share price and accounts information for major British and international companies.

<sup>11</sup> The Hoppenstedt SME directory lists more than 50,000 enterprises of the German 'Mittelstand' and provides details on address, telephone data, legal status, names of the management, industry, subsidiaries, import and export data, etc.

<sup>12</sup> The subsequent contacting of the addressees was rather difficult and time-consuming. Some companies had to be telephoned up to ten times since the potential addressee of the questionnaire was "just talking on the phone with somebody else", was "in a meeting", or "on a business trip abroad", "in the workshop", or "had just left the company five minutes ago." In another case, the managing director had left the company and his successor was not aware of the researcher's enquiry.

<sup>13</sup> Or empiricist.

<sup>14</sup> Or naturalistic, ethnographic, interpretivist, constructivist.

<sup>15</sup> Epistemology is a branch of philosophy concerned with the theory/ies of knowledge. It is the study of nature and grounds of knowledge about phenomena (how a person comes to know what he or she knows).

<sup>16</sup> Harpaz (1996), for instance, uses the term methods, instead of techniques. This is considered inaccurate. Equally, Harpaz's distinction between structured interview and telephone interview is unsound: also a telephone interview can be structured.

<sup>17</sup> Expressed as degrees of importance, satisfaction, etc.

<sup>18</sup> An English version questionnaire was distributed in November 1996.

<sup>19</sup> This was accomplished by a German friend of the candidate.

<sup>20</sup> For a review of case study research see Yin (1993, 1994).

<sup>21</sup> Fax of 6.6.95 from the British Embassy to the British Consulate General in Shanghai.

## Chapter Five

# FDI Environment in China

### 5.1 Introduction

Chapter four has discussed the objectives of this thesis and the methodological approach taken. This chapter introduces the Chinese environment of foreign direct investment (FDI) projects. It is divided into two main themes. The first introduces the investment environment foreign firms encounter when establishing a production facility in China. China's opening up to the outside world and, in particular, the economic reforms are discussed, as are the country's impressive growth record and the need for joint ventures (JVs). The contents of the first theme are the legislative framework that has been evolving over the past years to enable and attract FDI to the country, as well as cultural aspects and the country's infrastructure. Chinese national and international politics are not discussed separately but are addressed in cases where they affect foreign investors.<sup>1</sup> The political future of FDI in China is contemplated in chapter ten.

The second theme of chapter five reviews the characteristics of foreign and, in particular, UK and German direct investment in the country. For this task, a framework is applied that was proposed earlier by Kaiser, Kirby and Fan (1996) for an examination of FDI in China. This framework investigated FDI dimensions, including the development of FDI in China, its importance to the Chinese economy, sources, regional distribution, and its distribution by industry.

### 5.2 An economy opens up<sup>2</sup>

*"Let China sleep, for when it awakes, it will shake the world"*  
(Napoleon Bonaparte, 1816)

Since 1974, the Chinese Communist Party leaders have been directing the country towards its long-term national goal, the modernisation - to world class standards - of agriculture, industry, science and national defence by the year 2000. In 1975, and later under premier Zhou Enlai's leadership, the ambition of the 'Four Modernisations' first emerged.<sup>3</sup> During the Fourth National Party Congress in 1975, Zhou initiated reforms "so that our national economy will be advancing in the front ranks of the world" (Chen, 1978, p.176). At the 'Third Plenary Session of the Eleventh Central Committee of the Communist Party' in December 1978, the new leadership, headed by Deng Xiaoping, restated that China's primary objective was to achieve the 'Four Modernisations'.

This was the starting signal for reforming the Chinese economy and re-opening its doors to the outside world.<sup>4</sup> After a period of political and economic isolation under

Mao Zedong,<sup>5</sup> the country's industrial structure was to be shaken up, its participation in international trade to be increased and FDI into the country permitted. In fact, trade was the first area of economic activity exhibiting an 'open door' (Brown, 1985).<sup>6</sup> China's economic development may be attributed partly to the reforms that unleashed a repressed rural economy.<sup>7</sup> In 1992, Deng, the most outspoken advocate of the new trade liberalisation policy, announced the 'socialist market economy'.<sup>8</sup> Though some of China's biggest remaining challenges are the modernisation of its state-owned enterprises (SOEs)<sup>9</sup> and an end to growing disparities, particularly between urban and rural areas, where average incomes in the former exceed those in the latter by four to one. In fact, at the 15th Communist Party Congress in 1997 Zhu Rongji<sup>10</sup> identified the reforming of the state-owned sector as a priority and set a target of three years to revive most loss-making SOEs (FT, 23.9.97, p.1). However, the government's fear of rising unemployment<sup>11</sup> has discouraged it from pursuing these much needed reforms.<sup>12</sup>

In 1975, the Chinese authorities recognised that the only way to pursue the ambitious goal of the 'Four Modernisations' was to attract FDI which would provide the capital, the technology and the management skills that were lacking (Tai, 1988; Grub and Lin, 1991). Authors, including Duscha (1987) and Woodward and Liu (1993), estimated the technological gap between China and the developed countries at between ten and 40 years. To access western technologies, the Chinese government, in 1978, accepted compensation trade arrangements<sup>13</sup> and, in 1979, the establishment of JVs. In the 1980s China was one of the largest importers of technology in the world (Tsang, 1994), though its ability to assimilate and make effective use of technological knowledge has been poor, even amongst less developed countries (LDCs) (Roessner et al., 1992; de Bruijn and Jia, 1993b).

Chinese officials believed that partnerships with foreign companies could facilitate access to international markets which would absorb the country's exports and generate the foreign exchange needed to finance its imports (Child, 1994). China has viewed foreign investment as a means of conserving funds for building and accelerating the pace of construction, learning about management and using foreign capital markets (Grub and Lin, 1991). Child (1994) points out that the new policy was both an immediate reaction to the shortcomings of the cultural revolution and a desire to exceed the limitations of the Soviet-style, centralised system developed in the first half of the 1950s.<sup>14</sup>

Indeed, China's awakening has been shaking the world. The country's impressive economic growth, potential capital gains and vast opportunities are universally

recognised (Fortune, 1994; Owen, 1995). According to an IMF report (New York Times, 20.5.93, p.1), China, with a per capita income of US\$1,600 and a total economy of US\$1,700bn, was, in 1993, the third biggest economy in the world. Only the USA and Japan, says Spar (1996), loomed larger in the international economic arena.<sup>15</sup> China is set to overtake these economies - Japan by 2000 and the USA by 2030 - provided the economy continues to grow at an average of 6 per cent per annum (Kelly, 1994). According to Thiess (1994) this may happen earlier, in about 2015, if the growth experienced between 1989 and 1995 continues and Gledhill (1994) suggests the year 2005 as the date when China might be the world's largest economy.

However, apart from these optimistic projections, the speed at which China has been catching up with other economies, such as the US and Japan, has been questioned. The World Bank (1997) recently argued that "continued success is possible, but uncertain," though China has been doubling its income per head every ten years. Although the World Bank (1997) believes that China's economy can grow at an average rate of 7.6 per cent until the year 2000, it questions whether China can continue its rapid growth until 2020. Also Lardy (1994) argues that China's output would not exceed that of the US<sup>16</sup> until the year 2040 (Economist, 30.4.94, p.97). In justifying this estimate, he assumes a per capita income in 1990 of only US\$1,000 and a rate of growth of about 5 per cent after the year 2000.

Even Lardy's modified figures represent China's per capita GDP at purchasing power parity (PPP), whereas the equivalent figures at market prices are still very modest since GDP at market prices does not consider the consequent revaluation of China's low-quality, non-tradable services. For instance, the World Bank estimated China's per capita income at US\$370 in 1990 and at US\$470 in 1992 (ibid). It is kept to this low level to ensure China's eligibility for concessional lending. This conforms to Chinese interests that repeatedly demonstrated the country's LDC status which would entitle China to enter WTO on special terms. These include a five year extension - as opposed to one year for most countries - after WTO entry to bring patent and copyright laws into line with rules agreed in the Uruguay round. China would also have five years, instead of two, to remove some controls on FDI (Economist, 6.8.94, p.65).<sup>17</sup>

The fact is, however, that, for the past 18 years, the economy of the world's most populous<sup>18</sup> and third largest country has maintained a high rate of growth. Apart from small, diamond-rich Botswana (FT, 28.6.96, p.4), China has been the fastest-growing economy in the world since 1978. The World Bank (1997) in its recent study entitled 'China 2020' praises China's GDP growth, both compared with other economies and

over time. Between 1978 and 1997, China's GDP averaged 9 per cent a year.<sup>19</sup> This was the longest period of high and relatively stable expansion since 1949. The original target, to double the 1980 GDP by the year 2000, was reached five years early (Liu, 1997).<sup>20</sup> The peak of China's economic growth was reached in 1992, with a rate of 14.2 per cent. Since then, there has been a steady decline<sup>21</sup> to 8.8 per cent in 1997 (FAZ, 6.3.98, p.8).<sup>22</sup> Later in 1997, Zhu forecast growth of 8 per cent per year until 2000 and 7 per cent for the following decade (FT, 23.9.97, p.1). This corresponds with projections by the Economist Intelligence Unit, proposing 7 to 8 per cent until the year 2000 (Wilde, 1996).<sup>23</sup>

China's decline in GDP growth has not been unintentional. The Chinese government recognised that the only way of reducing the high inflation which plagued the country in 1988 (18.5%), 1989 (17.8%) and again in 1993 (13.2%) - and then peaked at 21.7 per cent in 1994,<sup>24</sup> - was to cool down the overheated economy. The strategy has worked: the rate of price increases has been controlled with the introduction of macro-economic policies (Liu, 1997). By 1995, inflation was reduced to 14.8 per cent and in 1996, the consumer price index showed an increase of 6.1 per cent. In 1997, inflation was only 0.8 per cent, according to Chinese statistics (FAZ, 5.3.98, p.18).

### **5.3 Investment environments**

This section discusses the legislative and cultural environments which foreign companies face when establishing FDI projects in China. Also, the different forms of FDI open to foreign companies are reviewed.

#### **5.3.1 Legislative framework**

With the establishment of an institutional and legislative framework, investment conditions were improved and became more attractive for FDI. According to Yamada (1979), China was only the second Asian socialist country to introduce a foreign capital investment law, following the Vietnamese law announced in April 1977. Fan (1996, p.78) notes that the "legal and policy environment for international JVs has been much improved throughout the past 15 years with the continuing addition of new regulations, the cutting off of red tape and easing of infrastructure problems." According to Brown (1993), since 1979 more than 300 laws dealing with economic matters, have been promulgated. In addition, the State Council has issued in excess of 400 regulations. Table 5-1 documents the development of the Chinese legislation structure for FDI.<sup>25</sup>

In October 1986, the State Council issued, for the first time, 22 'Regulations Concerning Encouragement of Foreign Investment'.<sup>26</sup> The regulations were designed



in order to provide additional investment incentives to foreign investors, including further reductions in the income tax rate, easier access to financial resources, better access to the domestic labour market, more autonomy in hiring and firing, as well as other related decisions. Further, management was granted more autonomy in seeking raw materials from the domestic market and in making production, financing, and marketing decisions. Also, controls over the remittance of profits in foreign currencies abroad were reduced (Grub and Lin, 1991).

Table 5-1: Development of the Chinese legislation structure for FDI.

Date	Law or regulation
1. July 1979	Law of the People's Republic of China on JVs Using Chinese and Foreign Investment (Equity JV Law) <sup>27</sup>
20. September 1983	Regulations for the Implementation of the Law of the People's Republic of China on JV Using Chinese and Foreign Investment (Implementation Regulations)
15. January 1986	Amendment of the Implementation Regulations
12. April 1986	Law of the People's Republic of China on Enterprises Operated Exclusively with Foreign Capital
13. April 1988	Law of the People's Republic of China on Sino-Foreign Contractual Cooperative Enterprises
4. April 1990	Revision of the Equity JV Law
12. December 1990	Detailed Rules for Implementing Law of the People's Republic of China on Enterprises Operated Exclusively with Foreign Capital
29. December 1993	First general company law of the People's Republic of China <sup>28</sup>

Projects include those earning foreign exchange through exports and projects producing import substitutes. Priority would also be given to energy resources, transportation, the raw materials industry, the renovation of out-of-date enterprises and education (Tai, 1988). Preferential treatment to these industries was promised by the then premier Zhao (ibid) and restated by Wu Yi, the then Chinese Minister of Foreign Trade and Economic Cooperation, during her visit to Germany in 1993 (OAV, 1994). During her more recent visit to the UK in February 1996, Ms. Wu encouraged investments in the following priority sectors: power generation, telecommunications, transport, environmental protection, agriculture and electronics (CBTR, March 1996, p.3). It was reported that the Chinese government wished to divert FDI away from the labour-intensive and small-scale projects that dominated the early years of the country's economic reforms to bottlenecks and high-tech areas (FT, 27.6.96, p.4). In 1996 the then prime minister, Li Peng, confirmed: "We want more investment in infrastructure ]...[ and welcome co-operation in the technical transformation of SMEs in light industries ]...[ and are ready to co-operate in services" (FT, 27.9.96, p.3).

Chinese laws and regulations make clear the industries in which foreign companies

can establish JVs and wholly foreign-owned enterprises (WFOEs) (and those where they cannot). For instance, the establishment of WFOEs is not possible in industries, such as the press, publishing, broadcasting, TV, film, wholesale and retail, foreign trade, insurance, tourism, post and telecommunications, as well as industries which are embargoed by the Chinese government. They include, in the manufacturing sector, for instance, the automobile and engine building industries, selected petrochemical industries as well as important raw material extraction and production industries. Included also are public utilities, traffic and transportation; there, the respective ministries give approval on an individual basis (Kaiser and Grimm et al., 1997). In some industries, the establishment of a JV is still required, with the local partner holding a majority stake. In other industries, such as defence and telecommunications, FDI is prohibited.

This contradicts earlier findings by Grub and Lin (1991, p.38) who insist that "in contrast to FDI in some LDCs, the claim that unilateral FDI is discouraged and that some sort of local participation in investments is mandated does not hold true for China." However, China watchers suggest that the government in Beijing - provided neither the national security nor the political and social stability of the country are endangered - will gradually permit projects in industries that are yet not open to FDI. This would be down to a lack of know-how and financial resources for a successful development in those sectors (Kaiser and Grimm et al., 1997).

The Chinese central government has been aware that the provision of an adequate infrastructure would be essential for attracting foreign businesses. Thus, Beijing created various administrative entities able to provide advanced infrastructures and a more liberal set of investment incentives. The first that were established, and probably the most publicised of all, were the special economic zones (SEZs). Apart from the short-term objective of establishing the SEZs to promote inflows of FDI, technology and management know-how, the long-term goal was more ambitious, namely to act as laboratories for China's economic reforms. It was hoped that the more market-oriented approach to business operations would be tried in these zones first, with successful experiences later being passed on to the rest of the country (Grub and Lin, 1991). The first four of the five SEZs, Shenzhen, Zhuhai and Shantou in Guangdong Province and Xiamen in Fujian Province, were established along China's Southeast coast by the central government in early 1979. Encouraged by the rapid development in these SEZs, Beijing declared, in 1983, the entire island of Hainan as a 'special area open to foreign investment'. In 1988, Hainan was declared a 'Super SEZ' and was given

provincial status with greater authority to attract FDI (Glaister and Wang, 1993).

In the SEZs, foreign investors could expect: preferential treatment in respect of tax incentives, flexible arrangements for land use (with reductions in charges), reduced welfare contributions, flexible employment arrangements, preferential prices for raw materials and equipment (Child, 1994), foreign exchange provisions, much reduced regulation (Spar, 1996), a faster progression through set-up formalities and exemptions from a range of duties. The SEZs are further characterised by an above-average infrastructure (Ruggles, 1983) (eg container terminals, road networks, national and international airports, supply of energy, water, telecommunications and services) and above-average skilled labour.<sup>29</sup> However, the SEZs' unique role of attracting FDI has declined over the years (Glaister and Wang, 1993) with the establishment of other special investment zones.<sup>30</sup>

China's 14 bonded zones<sup>31</sup> were introduced with the aim of promoting foreign trade, the finishing and storing of goods and the establishment of financial services. Since 1. April 1996, new regulations which set out the administrative procedures for importing, exporting and tax policy, offer ventures in the bonded zones further opportunities to extend their scope of activities. The distinctive advantage of bonded zones is that ventures can import duty-free construction material, production plants, fuels and office fittings. Also, export licenses are not necessary for manufactured goods and they are exempt from value added tax. Finally, ventures can enjoy preferential tax treatment after moving into profit and are allowed to cash up in foreign exchange.

In the spring of 1984, the central government selected 14 major cities<sup>32</sup> along China's East and Southeast coasts and granted them many of the privileges it had previously reserved for SEZs. All of them were former treaty ports. Brown (1985) argues that this is a superficial parallel to the 19th century opening up of the Chinese coast to foreign penetration. These cities were given greater autonomy in economic policy making and allowed to offer special incentives (tax and customs when upgrading existing factories: Brown, 1985). The open cities were further authorised to set up special districts, so-called 'economic and technological development zones' (ETDZs), in which they created a particularly favourable economic environment for foreign investors (Grub and Lin, 1991). These are similar to the SEZs in that they offer sites for Sino-foreign JVs and WFOEs and are able to offer their own tax incentive packages. These reportedly include a uniform tax rate of 15 per cent for all projects and waiver of the usual 10 per cent profit-remittance tax. The zones are similar to the bonded zones. Phillips (1985) suggests that the 'open cities' offer better opportunities than the SEZs since, in most cases, the existing infrastructure, industrial bases, managerial and technical personnel

and skilled worker availability are superior.

During the second half of the 1980s, Beijing created a range of 'open economic zones', including the Yangtze and Pearl river deltas, Southern Fujian, and the peninsulas of Shandong and Liaodong. These were allowed to offer a variety of privileges and special treatment for foreign investors - similar to those of the 'open cities' (Child, 1994). In 1990, the Pudong district of Shanghai was granted similar rights as the SEZs. The development of Pudong was aimed at establishing foreign trade and high-tech ventures as well as financial and insurance institutions. Pudong's administration particularly emphasises the development of 'new industries', including electronics, information technology, telecommunications, medicine technology and chemical industries. To date, Shanghai, with Pudong, is the country's most important and modern economic centre and, early in the next century, will be its most important financial centre.

The remaining regions of China have long been lacking in the infrastructure necessary for economic development. Thus, China experts warn not to be too optimistic about the short-term traffic connections of certain locations, for instance. They also recommend settlement in already-developed industrial locations (Schwantes, 1991).

Infrastructure bottlenecks in the power, telecommunications, water and transport sectors are considered a threat to future growth in China (Economist, 12.11.94, p.3; FT, 6.12.94, p.6). For instance, according to a World Bank report (1994), the lack of an adequate transport infrastructure has cost the Chinese economy about 1 per cent of its GNP annually in recent years.

Increasingly thus, the Chinese government directs its efforts to upgrading the infrastructure outside the SEZs.<sup>33</sup> The World Bank calculates an infrastructure demand, over the next five years, worth approximately US\$280bn (£179.5bn). It also estimates a further US\$400bn (£256.4bn) will be spent to meet the surging demand for electrical power,<sup>34</sup> gas, telecommunications,<sup>35</sup> highways, railroads, harbours and airports. The World Bank forecasts further that infrastructure demand over the coming decade will represent 7.4 per cent of China's annual GDP (FT, 23.9.97, p.6).<sup>36</sup>

Apart from the hard, physical, infrastructure, China has also experienced an immense improvement in its soft infrastructure: the provision of services and labour force. In most of the major cities, legal and corporate consultancies, as well as financial service providers, have set up in business. Although, as the Economist (13.9.97, p.23) remarks, quality still varies, encouraging foreign investors to continue making use of the services of providers with international reputations.

### 5.3.2 Cultural environment

According to Hofstede (1980, p.43) culture is "the collective programming of the people

in an environment which serves to distinguish people in one environment from those in another". Each culture provides the grounds for a different socialisation of its members via the socio-educational process, causing 'value-sets' or 'mental programmes' which are culture-specific (Hofstede, 1985).<sup>37</sup>

China is a high context culture within which people may communicate indirectly and the expressive manner is important. The context is high because it includes a lot of additional information, such as the sender's values, position, background and associations in the society. As such, the message cannot be understood without its context (Osland, 1990). Traditional Chinese social behaviour is based on Confucian philosophy (Cheng, 1986; Shenkar and Ronen, 1993). According to Child and Markoczy (1993) the characteristics of Confucian philosophy are respect of hierarchy, group orientation, preservation of face and the importance of relationships.

A closer look at the implications of Confucian philosophy to Chinese behaviour from the Chinese perspective is imperative. In fact, the theses of Chinese scholars, such as Cheng (1986) and Gao (1995) carry the student of Chinese culture far beyond conventional western wisdom - or simplification. For instance, from the Confucian philosophy characteristics of 'respect of hierarchy' and 'group orientation', Child and Markoczy (1993) derive a Chinese lack of individual responsibility. For the western researcher, such thinking is rather typical and logical and only few take the effort to look behind the curtain.

Gao (1995), in his study provides an insight into Chinese ethics of 'the self' and its implication for democracy. The Chinese ethical maxim that "every individual should subject the self to servicing the grand purpose of maintaining a harmonious cosmos" has penetrated the Chinese culture so deeply that individualism as a neutral term cannot even be appropriately translated into the Chinese language. In contemporary China this aspect of Chinese ethics is the device most frequently employed by the authorities to oppress diverse opinions: for the sake of stability and order, individualism should be relinquished (ibid). Gao (1995) refuses to "take it for granted that the hostility to individualism is a mode of consciousness peculiar to the Chinese tradition which is able to resist change" (p.302). Instead, the ideology of individualism has to be instilled into the Chinese consciousness from the West (ibid).

Pye's (1982) contribution on the concept of *face* limits itself to statements, that include: "to a Chinese manager, losing face is more important than to a western manager" and "to a foreign businessman, much can be gained by helping the Chinese gain face, and much can be lost by any affront or slight, even if unintended." Going far beyond that, Cheng (1986) discusses the inner duality of *mien-tzu* and *lien*. A person's *mien-tzu* is a

function of specific relationships between its 'owner' and its recogniser. It is attached to a person because of what he or she has achieved, or to the office or station that a person officially occupies or is in charge of (*ibid*). *Mien-tzu* plays a role in preserving, promoting, or degrading social relationship and mutual respectability.

The positive value of gaining *mien-tzu* is honour, the negative value of breaking it is disgrace due to depreciation or withdrawal of one's social status and prestige. However, to lose *mien-tzu* need not be regarded as a personal affront, it is to lose something extending from one's basic dignity and sense of shame. Therefore, in proportion and in comparison, it does not need to be taken as seriously as breaking one's face in the sense of *lien*. This is below one's dignity, because one will then be unable to face society and other people. Cheng (1986, p.335) argues that "in ordinary circumstances a person can afford to lose *mien-tzu* but cannot lose *lien*." In other words, to lose *lien* means dishonour and disgrace, while to lose *mien-tzu* means merely that one's honour is not honoured or not recognised (Cheng, 1986). While in the case of *lien* the individual "should always blame himself," (p.335) since it implies a certain fault on the part of the person who loses *lien*, in the case of *mien-tzu* "the blame for losing face may be due to others, but not oneself, because it may be due to the insensibility of persons other than oneself who loses *mien-tzu*" (p.335).

Chinese cultural values are largely formed and created from interpersonal relationships that take on importance in China in ways that are often not observed in northern European cultures. Business is transacted in the context of relationships. Therefore, a key to doing business in China is *guanxi*, the personal connection. Brown (1993) stresses the importance of having the support of governmental departments and particularly officials in a position to help remove obstacles to a project. Most *guanxi* ties stem from shared relationships. This is because in their high-context culture, the Chinese are often more concerned about the trustworthiness of foreign business people than about legal contracts.

### 5.3.3 Forms of investment

Exporting, licensing and FDI are the three archetypal methods of servicing foreign markets (Kaiser et al., 1996).<sup>38</sup> Specifically, Ding (1993) discovered four distinctive types of FDI in China: the equity JV, contractual JV, co-operative development and the WFOE. Authors, including Kueh (1992) and Wei (1993) also regard compensation trade<sup>39</sup> as a form of FDI, although, according to Kueh (1992), the importance of this method has waned over time. Its share in FDI declined from about 20 per cent in the early 1980s to less than 5 per cent in 1990. Duscha (1987) considers compensation trade agreements as predecessors of equity JVs.

The literature suggests further disagreement. Under the term FDI, Grub and Lin (1991), the Hong Kong Shanghai Banking Corporation (February 1993) and Plasschaert (1993) incorporate also processing and assembly agreements [and international leasing: Grub and Lin (1991)], as well as compensation trade, JVs, joint development and WFOEs. Nyaw's (1993) four FDI strategies are different again. He includes compensation trade, equity and contractual JVs, and WFOE. On the other hand, Seo (1993) only considers equity JVs, contractual JVs and WFOEs as forms of FDI in China. Also of interest is the classification by Lee and Lo (1993, p.209). These authors consider processing trade, compensation trade, contractual JVs, equity JVs, and WFOEs as "new forms of trade".

Also divergent, when compared to the standard JV classification (as accepted in this thesis: equity and contractual JV), are Wäscher's (1992) and Braun's (1996) positions. The former regards joint development as a form of JV and the latter incorporates under JV, direct investments, co-production, counter trade, and various forms of loan and aid arrangements. The existence of different understandings of sometimes one and the same concept creates substantial discrepancies when comparing statistics.

The JV is the most common form of FDI in China (Woodward and Liu, 1993). It has been particularly favoured by foreign investors due to its ability to attract assistance from the Chinese authorities. It is also the most preferred form by the Chinese partner (Ding, 1993). The Chinese have high expectations in the establishment of JVs since they are regarded as crucial instruments in bringing in the technological, product and management know-how that is essential for the country's economic and technical development (Dutta and Merva, 1990; Wäscher, 1992; Brown, 1993). Loong (1982) points out that the closeness of the JV relationship makes it preferable to direct borrowing for the raising of capital because of the indirect injection of foreign expertise in areas such as quality, control, and management. JVs are further regarded as tools for boosting exports and substituting imports and, thus, creating and saving funds necessary for the importation of high-tech goods.

By the end of 1996, 79.8 per cent of the total of 215,995 international JVs in China were established as equity JVs (Kaiser and Grimm et al., 1997). Compared with the 1979 to 1994 figures (Kaiser et al., 1996) this suggests a 1.4 per cent decrease in the occurrence of these type of JV. Appendix VI presents the detailed features of the two forms of JVs, equity and contractual JVs.

The co-operative development [joint development: Wäscher (1992)], is a specific form of co-operation to exploit natural resources. It is mainly employed in the exploration and development of offshore oil resources and takes only a small share of all FDI in China (Kaiser et al., 1996). It is not discussed further in this study, nor is the WFOE.

## **5.4 Direct investment in China**

For the examination of existing FDI in China, the Kaiser, Kirby and Fan (1996)

framework is applied. This was established in correspondence with Beamish and Wang's (1989) investigation of 840 Sino-foreign JVs.<sup>40</sup>

#### 5.4.1 Development of FDI in China

Having experienced investment activities of foreign companies before the Chinese Communist Party came to power in 1949, China ended FDI in the early 1950s.<sup>41</sup> State-owned joint companies with the Soviet Union were the only form of FDI that remained. However, these were also terminated in the late fifties and turned over to the Chinese (Wu, 1982).<sup>42</sup> For a long period - Wäscher (1992) suggests 30 years<sup>43</sup> of economic isolation and self-reliance - FDI was prohibited for historical, ideological and practical reasons (Ding, 1993). Nevertheless, it is suggested (Brown, 1985) that, prior to July 1979, individual JVs existed. These were between Overseas Chinese and mainland Chinese companies (private involvements in SOEs via investment corporations, so-called *Overseas Chinese Investment Corporations*; this investment system was terminated in January 1967 during the Cultural Revolution). Although the pace of investment activity was slow initially, by the end of 1996 the country's governments had approved a total of 283,793 foreign-funded ventures with a contractual investment of some US\$469.3bn (£300.8bn) and US\$177.2bn (£113.6bn) of utilised funds that were contributed to approximately 140,000 ventures.

FDI in China has passed through a number of distinct phases. The literature does not agree upon a certain pattern, but proposes three (Wäscher, 1992) and four (Fan, 1996) different phases from 1979 to approximately 1990. Both strands agree to a starting period from 1979 to around 1982 or 1984, although this is the extent of their agreement. Wäscher (1992) proposes a boom period (1983 to 1985) which underwent the refining of the legal investment framework, including the establishment of SEZs and open coastal cities,<sup>44</sup> and a stagnation period (1986 to 1988). The latter was characterised by economic distortions (inflation, lack of foreign exchange), student unrest<sup>45</sup> and reports of problems with foreign investors in China (ie infrastructure, bureaucracy). Fan (1996) extends the legislation period up to early 1989. He ignores the temporary setback of new project approvals in 1985 and considers only a period of temporary setback, commencing in June 1989 with the tragedy at Beijing's Tiananmen square. (This is universally considered to be the point at which reforms went into reverse and disillusionment with the Chinese regime experienced by many foreign investors peaked.) Wäscher (1992), on the other hand, completely overlooks the June 1989 incident and the effects of the retrenchment programme to combat inflation in 1989 and 1990 by reducing investment and money supply, and selectively controlling credit. Seo (1993) argues that the sudden switch to a tight money policy, the reduction of credit, the increasing interest rates, and the reduction of loan guarantees, threw the economy into chaos. Fan's (1996) new surge period commences in about 1991 with



the recovery from the Tiananmen incident and Deng Xiaoping's re-statement of economic reforms.

The past two years (1996, 1997) have seen a slowdown in new project approvals, initiated certainly by the withdrawal in 1996 of preferential tax and duties on imports of capital equipment. Manufacturing companies have since faced duties of up to 40 per cent. In 1997, China announced that, due to an improved fiscal position, it would re-introduce these preferential treatments. However, the revised rules are likely to offer tax exemptions on a narrower range of machinery than before, giving special treatment to equipment that will serve high-technology industries - projects that conform to China's economic strategy (FT, 23.9.97, p.1). On the other hand, it is also reported that China aims to remove all preferential tax rates granted to foreign businesses by the year 2000 which will more than double the tax burden on foreign enterprises. Only recently, Premier Zhu announced the reform of the tax system which was last overhauled in 1994, as one of the government's key tasks (FT, 16.4.98, p.4).

There has been a steady development of FDI in China from 1980 when the first Sino-foreign JV, Beijing Air Catering, was established (Shenkar, 1990). Investment figures up to the end of 1985 represent solely the number of, and capital committed through, equity JVs. Up to that date, the equity JV was virtually the only vehicle for FDI. Only from April 1986 and April 1988 were the establishment of WFOEs and contractual JVs possible.<sup>46</sup> After two years of the new policy permitting foreign investment, China had received US\$1.7bn (£641m), including both JVs and co-operative production projects (Brown, 1985). 1982 witnessed a slump in FDI, although in 1983 the investment pace quickened considerably and in 1984 accelerated dramatically.

Progress in the formation of JVs in the first few years between 1979 and 1982 was slow for two reasons: first, the Chinese were tardy in granting approvals and seemed to need to gain a broad base of experience before moving ahead rapidly (*ibid*). Secondly, since the JV law is both brief and ambiguous on many key points, foreign attitudes were somewhat sceptical. Therefore it was only after some of the required additional regulations (eg tax laws) had been promulgated (promoted), that real progress was possible. Brown (1985) considers this as one of the reasons for the early relative success of the Overseas Chinese and prevalence of the co-operative production agreement.

The first eleven years from 1979 to 1989 experienced two major setbacks in the development of investment projects. The first slowdown in new projects and pledged investment was caused by austerity measures introduced by the Chinese government

in 1985 to cool down the overheated economy (Pomfret, 1989).<sup>47</sup> This corresponds with findings by Glaister and Wang (1993), whereas others (eg Chua and Kin-Man, 1993) regard JV management problems as being responsible for the decline. The second slowdown, in 1989, when the number of projects was smaller than the year before, was caused by the Tiananmen incident of 4. June 1989. With this event, China briefly retreated into a period of isolation when reforms stalled, foreigners departed, and economic production returned to its earlier levels (Spar, 1996). Winckler (1991) points out that the political instabilities since Tiananmen created a general negative influence which pervaded the investment climate. However, others, including Thoburn et al. (1990) and Kelly (1994) consider credit restrictions to be the cause. Introduced in autumn 1988, they left prospective Chinese JV partners very short of funds. Eventually, to overcome this difficulty, the government tried to encourage WFOEs (Thoburn et al., 1990, p.16).

From then until 1993, the number of approved projects, as well as contracted and utilised investment, experienced a steep rise. A first big jump in FDI activities in China was observed in 1992, when foreign companies established more projects (116%), worth more of pledged investment (111%) than in the complete period 1979 to 1991. In 1993, the country experienced an even steeper rise in FDI. 83,000 new projects were approved, 70 per cent more than the year before. This new influx of foreign funds equalled (91.4%) the total number of projects approved in the previous 14 years. The projects approved in 1993 accounted for some US\$111bn (£71.2bn) worth of contractual and US\$21.3bn (£13.7bn)<sup>48</sup> of utilised investment which is an increase over the previous year of 91 and 94 per cent, respectively. Between 1978 and 1993, investment grew, according to Chinese statistics, by 360 per cent in real terms, equalling a compound growth rate of 11 per cent per year (FT, 7.11.94, p.iv). The massive inflow of foreign funds into the country made China the most important recipient of FDI in the developing world (Economist, 30.4.94, p.97)<sup>49</sup> and the second most important worldwide after the USA (China aktuell, August 1994, p.788).

In 1994, the direct investment activities of foreign enterprises slowed down significantly - at least with respect to the number of projects and the value of contractual investment. In that year, Chinese authorities approved only 46,209 new projects, worth some US\$8.5bn (£5.4bn) of contractual investment and accounting for 71 per cent of the contracted investment of 1993. In terms of utilised investment, however, 1994 experienced a steep increase with US\$39.5bn (£25.3bn), or 85 per cent more than in 1993. As reasons for the slow down China aktuell (June 1994, p.572), the monthly periodical published by the German Asia-Pacific Business Association (OAV),

suggests enforced government control of investment activity,<sup>50</sup> the introduction of new taxation practice (foreign enterprises treated like national ones), improved investment incentives in neighbouring Asian countries, a sharp rise in the costs of labour and land lease and, as pointed out elsewhere (Far Eastern Economic Review, 1.6.95, p.46), inflation and overheating. According to Fan (1996, p.79), another contribution to this slowdown was the establishment of trade unions in Sino-foreign JVs by the end of 1994 to "protect the rights of eight million Chinese from unscrupulous or negligent foreign employers." Despite its slowdown, the FDI inflow to China in 1994 accounted for roughly half the total for all LDCs (Economist, 18.3.95, p.18).

In 1995, China, with US\$38bn (£24.4bn) of utilised investment, received more FDI than any country except the US (Economist, 1.3.97, p.30). In 1996, it secured 24,529 foreign investment projects, down by 33.7 per cent in comparison with 1995. The total contractual value of these projects amounted to US\$73.2bn (£46.9bn), down 19.8% on that of the preceding year. However, actual investment climbed to US\$42.3bn (£27.1bn), up 12.9 per cent cumulating in US\$177.2bn (£113.6bn) by the end of 1996. Beijing's announcement to phase out tax exemptions for capital goods imports from 1. April 1996 has certainly resulted in a rush by foreign investors to secure approval for project proposals by the end of the year. In 1997, utilised investment rose to US\$45.2bn (£28.9bn), up 8.5 per cent over 1996. Contracted investment, however, fell by 29.3 per cent to US\$51.8bn (£33.2bn) (FT, 16.2.98, p.2).

For 1998, the Delegation of German Industry and Commerce Shanghai (1997) expects a significant decrease in FDI following China's gradual withdrawal of preferential measures for foreign investors. Also, the recent devaluations by export-oriented economies in Asia, and the unravelling of the financial systems in Japan and Korea, two of China's most important inward investors, have raised concerns about a decline in FDI in 1998.

#### **5.4.2 Importance of FDI for the Chinese economy**

The Chinese government has regarded FDI as a way of upgrading its economy and boosting exports. Indeed, FDI is of considerable importance to China's economy, including: (a) its contribution to industrial output, (b) the generation of foreign exchange, (c) the injection of technology and know-how to develop the economy and (d) the absorption of surplus labour from the declining state sector.<sup>51</sup> In fact, during a symposium on the relationship between foreign investment and the national economy held in Beijing on 16. October 1996, experts said that FDI will go on playing an important role in the development of the economy (China Daily, 17.10.96, p.5).

Foreign-funded production of technical and consumer goods, as well as the provision of services, has reinforced the output power of the Chinese economy. Even prior to 1990, foreign-funded enterprises accounted for more than 8 per cent of the industrial output and fixed asset investment (Thoburn et al., 1990). They have become increasingly important to the Chinese economy also with regard to the ever loss-making and declining importance of the state sector. For instance, between 1978 and 1992 the share of the industrial output contributed by SOEs dropped from 80 per cent to 48 per cent (Child, 1994).

Foreign-funded enterprises contribute considerably also to China's trade, boosting its total volume from US\$20.6bn (£13.2bn) to US\$325bn (£208.3bn) in 1997.<sup>52</sup> Exports in 1997 accounted for US\$182.7bn (£117.1bn), up 20.9 per cent over the previous year (FAZ, 5.3.98, p.18). This steady increase in China's export volume raised the country from a ranking of 32 in 1978 to ten in 1997. In 1991, the export contribution of foreign-funded ventures increased to 16.7 per cent, compared with more than 12.6 per cent in 1990 or an estimated US\$12bn (£7.7bn), up from US\$10bn (£6.4bn) in 1990. At 54.2 per cent, the growth rate of exports generated by foreign-funded ventures was considerably higher than the growth rate for exports as a whole which stood at about 15.8 per cent (China aktuell, February 1992). In 1993, foreign-funded firms accounted for 27.5 per cent of China's exports (34.3%: China aktuell, January 1995) and for all of the growth in its exports over 1992 (Economist, 18.3.95, p.18). Figures presented by the Economist (30.4.94, p.97) estimated the contribution to exports by foreign-funded ventures during 1992 and 1993 at about two-thirds.

Throughout 1994, foreign-funded ventures realised an export volume of US\$87.7bn (£56.2bn) or 37 per cent of the economy's total exports (China aktuell, January 1995, p.14). This represented an increase of more than 30 per cent over 1993. In 1995, one-third of China's exports and half of its imports involved Sino-foreign JVs (World Bank, 1997). Exports by foreign-funded enterprises totalled US\$36.6bn (£23.5bn) in the first nine months of 1995 which was an increase of 45 per cent, while imports climbed 23 per cent to US\$49bn (£31.4bn) (FT, 27.6.96, p.2).

In 1996 foreign-funded ventures generated exports worth US\$61.5bn (£39.4bn) or 40.7 per cent of China's total (South China Morning Post, 11.2.97, p.19). The Delegation of German Industry and Commerce Shanghai suggests that, in 1996, foreign-funded ventures contributed 47 per cent of the Chinese foreign trade volume (41% of exports and 55% of imports), compared with 39 per cent in 1995 (32% of exports, 48% of imports) (FAZ, 15.1.98, p.18). In summary, the contribution to exports by foreign-

funded ventures is increasing, whereas their contribution to import volumes is declining. In other words, foreign-funded ventures increasingly substitute imports with their own production and boost exports simultaneously. However, according to the *Economist* (22.11.97, p.93), after double-digit export growth for many years, single-digit growth is likely for 1998 since foreign firms playing a big role in the export sector are taking a more balanced view about their prospects in China.

Exports of foreign-funded ventures are primarily in the areas of textiles, chemicals and electronics (China aktuell, November 1993), with textiles contributing about one-third to total exports that, in 1997, totalled US\$46bn (£29.5bn) (FAZ, 16.2.98, p.18). Glaister and Wang (1993) discovered that, whereas most of the large and mid-sized JVs are aimed at the domestic market, the smaller manufacturing JVs are export-oriented. Simultaneously Wei (1993) argues that the above-average growth rates of the coastal areas can be explained entirely by their effective use of exports and FDI.

In addition to the direct effects of FDI on the Chinese economy, such as the infusion of capital, FDI also makes a contribution in the form of technological or managerial know-how. This is through those firms that interact with foreign invested/managed firms via various channels, as well as through those that receive foreign investment direct or under foreign management (Wei, 1993). Foreign-funded ventures also contribute considerably to China's labour employment, stabilising and absorbing surplus labour from the declining state sector. At the end of 1994 about 12 million Chinese were employed in Sino-foreign JVs or WFOEs (China aktuell, January 1995).

### 5.4.3 Sources of FDI into China

Since the early days of China's 'open-door' policy, the flow of investment capital into the country has been dominated by ethnic Chinese investors from Hong Kong and Taiwan (Daniels et al., 1985; Seo, 1993; Tsang, 1994). The former British colony has been the major investor both in terms of the number of projects and capital invested which, at the end of 1992, accounted for some 60 per cent of all FDI in China (Fan, 1996). Until 1984, more than three-quarters of the 840 Sino-foreign JVs in Beamish and Wang's (1989) study were established with partners from Hong Kong<sup>53</sup> and the shares of the USA, Japan and Europe were 7.0, 6.6 and 3.7 per cent, respectively. Between 1984 and 1990, Hong Kong's share of FDI exceeded 50 per cent for every single year except 1985, when it was 48.9 per cent (Wei, 1993).

The latest figures on the ten largest direct investing countries in China, in the period 1979 to 1996, are presented in table 5-2. Compared with the 1994 ranking by Kaiser et al. (1996), Hong Kong still leads the list of the ten biggest investors, with US\$261.8bn

(£167.8bn) of pledged investment, following US\$200.4bn (£128.5bn) at the end of 1994. The USA now ranks second with US\$35.2bn (£22.5bn), replacing Taiwan which was second in 1994 and now ranks third with US\$34.6bn (£22.2bn) of contracted investment. Japan, with US\$26.4bn (£16.9bn) has kept its position as have Singapore (US\$23.6bn; £15.1bn), the UK (US\$11.9bn; £7.6bn) and South Korea (US\$11bn; £7.1bn). Thailand which ranked eighth at the end of 1994, was replaced by Germany with US\$5.4bn (£3.5bn) of pledged funds, followed by Canada (US\$4.5bn; £2.9bn).

Table 5-2: The top ten direct investors in China (1979 to 1996).

Rank	Country	Investment					
		Projects			Volume (pledged)		
		No.			US\$,bn		
		-1994	-1996	%	-1994	-1996	%
1	Hong Kong	139,959	162,712	20.3	200.39	261.79	34.7
2	USA	16,257	22,248	36.9	20.73	35.17	69.7
3	Taiwan	27,002	35,033	29.7	23.61	34.60	46.5
4	Japan	10,322	15,002	45.3	14.23	26.39	85.5
5	Singapore	4,567	6,697	46.6	8.63	23.62	173.7
6	UK	1,017	1,800	77.0	5.80	11.93	105.7
7	South Korea	4,247	8,117	91.1	3.78	11.01	191.3
8	Macao	-	5,634			8.22	
9	Germany	892	1,503	68.5	2.72	5.41	98.9
10	Canada	2,178	3,169	45.5	2.70	4.51	67.0

Source: Kaiser, Kirby and Fan (1996), Kaiser and Grimm et al. (1997). Note: For calculation, Macao's 1996 value has been added to the Hong Kong share.

The positions of the UK and Germany as direct investors in China were sixth and ninth, respectively, at the end of 1996. Within Europe, the UK and Germany are the two biggest direct investors in China. However, compared on a worldwide scale with other direct investor nations, the shares of both the UK and Germany are remarkably small, accounting for 1.3 per cent and 1.1 per cent of projects or 2.5 per cent and 1.2 per cent of pledged volumes, respectively. In terms of utilised investments, the shares of the UK and Germany account for only 2 per cent and 1 per cent, respectively, suggesting a below-average rate of contributing pledged funds.<sup>54</sup>

Analysing new project approvals and contracted investment, ie comparing the accumulated 1979 to 1994 figures and the accumulated 1979 to 1996 figures reveals that South Korea's and Singapore's FDI contributions have shown the most impressive growth.<sup>55</sup> Remarkable also are the FDI growth rates of both the UK and Germany. They are amongst four of the ten most important FDI providers whose contributions have experienced the most impressive growth. On the other hand, contributions from Hong Kong/Macao and Taiwan have experienced the most moderate growth rates amongst the ten most important FDI contributors to China, according to this analysis.

The declining growth of Hong Kong/Macao and Taiwan FDI to China was also suggested by China aktuell (June 1994, January 1995). Recently, however, it has been suggested (FT, 30.10.97, p.5) that Taiwanese investment in China rose strongly in the first nine months of 1997 (up 14%), despite Taipei's go-slow investment policy towards China. Table 5-3 summarises the findings of the growth analysis.

Table 5-3: Growth analysis 1994 – 1996 stocks.

Rank	Project		Investment (pledged)	
	Country	Growth (%)	Country	Growth (%)
1	South Korea	91.1	South Korea	191.3
2	UK	77.0	Singapore	173.7
3	Germany	68.5	UK	105.7
4	Singapore	46.6	Germany	98.9
5	Canada	45.5	Japan	85.5
6	Japan	45.3	USA	69.7
7	USA	36.9	Canada	67.0
8	Taiwan	29.7	Taiwan	46.5
9	HK/Macao	20.3	HK/Macao	34.7

Source: Own analysis.

Further analysis should reveal whether, and to what extent, the impressive growth of direct investments from the UK (projects: 77%, pledged investment: 105.7%) and Germany (projects: 68.5%, pledged investment: 98.9%) is reflected in the outward statistics of these countries. Comparison of the outward investment figures of both countries for the years 1994 and 1996 would be helpful. However, although the Office for National Statistics (1995)<sup>56</sup> observed a major increase in UK direct investment in the rest of the world in 1994 of 88 per cent (to £4.3bn),<sup>57</sup> this was largely due to an increase of £1.2bn in investments in Caribbean, Central and Southern American countries. Neither China, nor the entire Asia-Pacific region were explicitly mentioned and highlighted for their increase in importance as a direction of UK FDI. Other destinations of UK direct investment in 1994 (total £18m, plus 10% to 1993) were European Union countries (£5.4bn), North America (£5.1bn), other developed countries (£2.4bn) and other Western European countries (£1.3bn).

Table 5-4: German outward investment in the period 1991 to 1995.

Year	Direct investment							
	Abroad		DCs		LDCs		China	
	DM,m	Growth	DM,m	Growth	DM,m	Growth	DM,m	Growth
1991	253,453		228,567		22,827		339	
1992	275,780	8.8	246,314	7.8	25,774	12.9	529	56.0
1993	308,399	11.8	272,437	10.6	29,701	15.2	734	38.8
1994	329,757	6.9	287,274	5.5	33,576	13.0	867	18.1
1995	361,687	9.7	313,799	9.2	35,385	5.4	1,526	76.0
91 – 95		42.7		37.3		55.0		350.0

Source: Deutsche Bundesbank, 'Kapitalverflechtung mit dem Ausland', May 1994, May 1996, May 1997. Note: DCs = developed countries, LDCs = less developed countries.

The examination of German outward investment statistics reveals different results. For

instance, primary data from the German Federal Bank (Deutsche Bundesbank, 1996) shows that between 1991 and 1995, accumulated German outward direct investment increased by 42.7 per cent, with an increase of 37.3 per cent of accumulated flows to developed countries and an increase of 55 per cent of accumulated flows to LDCs. German direct investment to China grew by 350 per cent between 1991 and 1995. This trend was also documented by the Delegation of German Industry and Commerce Hong Kong (1995). It suggested that, whereas in 1992 2.7 per cent of all German FDI was directed towards Asia, the respective 1994 figure was 8.1 per cent and that Asia, China and Hong Kong are the most important destinations for German FDI (table 5-4).

#### **5.4.4 Regional distribution of FDI in China**

The most preferred locations for FDI in China are the SEZs, major municipalities such as Beijing, Shanghai, Guangzhou or Tianjin and the 14 coastal areas (Duscha, 1987; Campbell, 1989; Beamish and Wang, 1989; Grub and Lin, 1991; Tsang, 1994). Nearly 40 per cent of the 840 Sino-foreign JVs in Beamish and Wang's (1989) study were located in SEZs, 27 per cent in the coastal cities and 5 per cent in Beijing. Up to 1992, China's Eastern coastal areas absorbed more than 80 per cent of the total capital (China Industrial Economics Research, 1993) and a recent World Bank (1997) report refers to 85 per cent of all FDI being located in China's nine coastal areas and municipalities.<sup>58</sup> This is confirmed by findings of Glaister and Wang (1993) who suggest that 16 of the 21 Sino-UK JVs in their study were located in the coastal areas and five in China's hinterland.

By the mid 1990s, only about 9.5 per cent of all approved FDI projects and roughly 7.5 per cent of all utilised funds were located inland. However, as the coastal areas are gradually becoming too expensive for many investors, FDI will eventually spread to the vast inland provinces that are backward both in terms of their economy and their infrastructure. In fact, changes in the directions of FDI have been evident since the mid 1990s when FDI growth in hinterland provinces showed a bigger percentage jump (FT, 7.11.94, p.vi) and surpassed FDI growth in the coastal provinces (China aktuell, September 1993). According to Fan (1996), FDI in areas such as Guangdong, Hainan and Beijing declined dramatically in 1992, whereas the proportion of investment to China's hinterland increased by 60.9 per cent. Elsewhere (China aktuell, January 1995) it is suggested that the share of investment to inland provinces had increased to 20 per cent. However, since many overseas investors prefer the coastal areas, it would be unrealistic to expect overseas investments to pour into the region in large amounts (China Daily, 2.11.96, p.4).



In general, foreign investors target the South and Southeast coastal provinces of Guangdong, Jiangsu, Fujian, Shandong and Shanghai (Schüller, 1994). Due to their proximity, Guangdong and Fujian are the most favoured investment locations for investors from Hong Kong and Taiwan (FT, 30.10.97, p.5), respectively, whereas China's Northeast was primarily targeted by Japanese and Korean investors (Campbell, 1989; Dong et al., 1993; Seo, 1993). Dong et al.'s (1993) findings support the theory that companies with a high propensity to export tend to locate near the coast and particularly in SEZs where fiscal incentives for off-shore production are strong: Overseas Chinese JVs export more than those with western parents.

Whereas there is no reliable, large-scale data on the favourite destinations of UK investment in China, various authors have elaborated on the locations of German direct investment. Most of German companies have approached the urban centres, such as Beijing and Shanghai (Schüller, 1994). The examination of the 1994 edition of the investment guide of the German Asia-Pacific-Business Association (OAV, 1994) supports the above observation: up to January 1994, 25 per cent of all Sino-German JVs and German-funded representative offices in China were located in Shanghai, and more than 46 per cent in Beijing. The remaining 29 per cent of German investment projects were located in the Chinese coastal and inland provinces (Kaiser, 1995).<sup>59</sup>

The Northeast, East and Southeast coastal areas were also identified as predominant locations for German investment by Grimm (1994) who points out that German investment is highly concentrated in areas of advanced development, dominated by manufacturing industries as opposed to raw material and power industries with relatively high growth rates. Grimm (1994) discovered that 56 per cent of the 140 German JVs<sup>60</sup> were located in Shanghai, Beijing and Guangdong and about 80 per cent were concentrated in six locations, including, in addition to the above, Tianjin, Jiangsu and Fujian. The high concentration of German FDI projects in Shanghai, Beijing and Guangdong was further confirmed by the Delegation of German Industry and Commerce Hong Kong (1995). Also, interrogation of a database that logged German direct investments showed that 37.8 per cent, 35.8 per cent and 9.9 per cent of all German investment projects in China were located in Shanghai, Beijing and Guangdong, respectively (China-Info No.11, 1995). According to information by MOFTEC (August 1995), German direct investment projects are concentrated in Beijing, Tianjin, Shanghai, Shenzhen, Nanjing, Kanton, Dalian and Wuhan.

#### **5.4.5 Distribution of FDI by industry**

Since the beginning of the 1980s, Hong Kong and Japanese firms have invested in the textile, medicine, food, motorcycle, and electronics industries. In addition, enterprises from the US and Europe have contributed capital to the automotive, chemical,

machinery and coal industries (de Bruijn and Jia, 1993). However, it is suggested (Grub and Lin, 1991) that investors were initially reluctant to engage in manufacturing projects since manufacturing projects were perceived as taking longer to pay dividends. As a result, FDI in the manufacturing sector had originally concentrated on export processing and assembling operations. Only after 1987 did the flow of inward investment gradually shift towards the manufacturing sector, including electrical equipment, electronics, precision machinery and transportation equipment (ibid) – as a reaction to the promulgation of the '22 articles' (Brown, 1993). This coincides with findings by Schwantes (1991) that most of the early JVs were operating in services, in particular the hotel sector.

Campbell's (1989) examination of 496 equity JVs suggests that in the late 1980s, 71 per cent of the investment was accounted for by six sectors, including real estate (25.1%), transportation (14.1%), manufacturing of building materials (10.2%), food (8%), consumer goods (7.8%), and electricals (6.1%). By the end of 1991, the bulk of investment capital (90%) was poured into productive projects (China aktuell, March 1992). However, in 1992, the proportion of manufacturing dropped slightly, whereas real estate and services increased by 40 per cent. Woodward and Liu (1993) argue that most of the JVs established in China are engaged in the exploitation of natural fuels, labour-intensive manufacturing or tourism and infrastructure-projects, such as highways, railways and port development. MOFTEC figures (August 1995) reveal that 74.1 per cent of the total foreign capital by the end of 1994 was invested in the manufacturing sector, 14.3 per cent in the real estate and services sector, 2.5 per cent in agriculture and less than 10 per cent in infrastructure projects. This coincides with Fan's (1996) argument that manufacturing, as well as real estate and services, are the industries which have received the most foreign investment.

Since the Chinese government places considerable emphasis on the development of the country's infrastructure, publishing new investment guidelines for FDI in high-tech and infrastructure projects, the proportion of telecommunications and power generating industries in China is set to increase in the 1990s. In fact, de Bruijn and Jia (1997) report that, recently, just these sectors have attracted investment.

Data on the industrial distribution of UK FDI in China does not exist in comparable quality as it does in Germany. It is known, for instance, that the German direct investment structure, in general, roughly corresponds with the economy's exporting structure. The majority of German investors represent industries such as mechanical engineering (27%), textiles (23%), electrics and electronics (9%) and chemicals and

pharmaceuticals (9%) - industries which face a structural and cost crisis in Germany (Schüller, 1994). Three years earlier, Winckler (1991) suggested that two-thirds of the existing industrial co-operations were concentrated in mechanical engineering. The Delegation of German Industry and Commerce Hong Kong (1995) points out that most German investors are in trading (61% of 120 firms), services (30%) and retail (23%).

## **5.5 Conclusion**

This chapter has introduced the FDI environment in China. The legislative framework for FDI, including the various locations for investment, has been reviewed, the cultural environment has been discussed and the different forms of investment presented and analysed. To date, the equity JV has been the most frequently used form of FDI in China, although its occurrence is decreasing relative to other forms of FDI such as contractual JV and WFOE.

The chapter has also documented the impressive inflow of foreign funds to the country since the opening up of the Chinese economy in 1978, the origin of these funds, their regional, as well as industrial distribution, and their economic importance to the Chinese economy. Analysing stocks of foreign investment in the country over a period of time has revealed that the UK and Germany have not been major players as foreign direct investors in China, though they are growing in importance. Both the UK and Germany are the most important investors in China within the European Union.

The recent, ongoing downturn in privileged treatment could slow the growth of FDI because it could also discourage round-trip investment. However, this is unlikely to deter genuine FDI because the overwhelming worldwide evidence is that tax and other incentives have only marginal effects on the location decisions of firms (World Bank, 1997). A more serious threat to FDI flow is the current financial crisis in Asia which causes western investors to be cautious and rethink their China investment strategies.

## Notes

<sup>1</sup> For a review of the political environment of business agreements in China see Chew (1996), Dumbaugh and Sullivan (1996), Morrison (1996), Orentlicher and Gelatt (1996).

<sup>2</sup> For detailed reflections on China's 'open door' policy see Hayter and Han (1998).

<sup>3</sup> Chen (1978) stresses that Zhou had tentatively put forward this concept as early as 1964.

<sup>4</sup> Authors (Grub and Lin, 1991; Chua and Kin-Man, 1993; Spar, 1996) insist on 1979 as the year when China announced its 'open door' policy. This is wrong. Although it came into effect in early 1979 [not late 1979 as Tang et al. (1992) argue], it was announced in late 1978.

<sup>5</sup> Mao Zedong, in 1949, formed the Chinese Communist Party. He acted as its Chairman, State President, Head of the Central Military Committee and Chairman of the Political Consultative Conference of the Chinese People. He died on 9.9.1976. Since the late 1950s, China pursued an economic policy that would develop the country without reliance on the outside world. Foreign trade contacts and thus, access to the international technical progress were kept on a very low level (Klenner, 1986).

<sup>6</sup> The stagnation of China's foreign trade up to 1970 is demonstrated in Brown (1985). For a comprehensive overview of China's historical economic relations with the West see Brown (1985). His work covers, amongst others, the late Qing dynasty (1842-1911), Republican China (1912-1949) and Communist China (1949-1976).

<sup>7</sup> Phillips (1985) offers a good investigation of China's rural and urban reforms. Details on China's internal reforms are also in Bloodworth, D. (1995) (ed.) 'The profile of an opportunity'.

<sup>8</sup> Economic systems are classified on the basis of who owns the means of production (capitalism - socialism) and of a country's method of resource allocation and control (market economies - command economies). Thus, the 'socialist market economy' is a hybrid.

<sup>9</sup> Reforms of China's SOEs, including the shedding of millions of surplus workers, would cost the country some RMB500bn (£39bn) during the next five years (FT, 11.3.96, p.4). By some estimates, as many as 30 to 40% of the SOEs' workforce might lose their jobs if they were forced to operate on strictly commercial lines (Economist, 10.6.95, p.26). By the end of 1996, about 43.7% of the country's 400,000 (305,000 as suggested by the World Bank, 1997 and the Economist, 13.9.97, p.23; 370,000 in FT, 20.2.98, p.8) or so SOEs were in the red, up 5% over the same period of last year (Delegation of Germany Industry and Commerce Shanghai, 1997). Elsewhere (FT, 10.9.97, p.31), it is suggested that approx. 70% of SOEs lost money in 1996 with a worsening position in the early part of 1997. The World Bank (1997) argues that about half of all industrial SOEs made a loss in 1996. Most recent news indicated that losses of Chinese enterprises, in the first two months of 1998, were up 21.7% compared with 1997 (FAZ, 25.4.98, p.9). SOEs produce less than 40% of industrial output, and that share is falling (Economist, 13.9.97, p.24). Repeatedly, the World Bank demanded more concerted efforts to reform China's SOEs, bolster public finance and drive forward market reforms if China is to maintain present levels of economic growth. Chinese authorities have given permission to foreign investors to buy the assets of some small SOEs in Southern Guangdong province (FT, 1.2.96, p.29). Further, president Jiang announced in September 1997 that China would speed the sale of state assets and increase public ownership (FT, 10.10.97, p.4).

<sup>10</sup> At the National People's Congress in March 1998, Zhu Rongji was elected Prime Minister.

<sup>11</sup> China's official urban unemployment rate (in September 1997) was nearly 4%, compared with 2.9% in September 1996. This vastly understates the problem especially in the Northeast industrial heartland where joblessness may be as high as 20%. During the 9th five year plan (1996 - 2000) China needs to find jobs for up to 180m workers (FT, 31.7.97, p.6).

<sup>12</sup> China's gap between rich and poor is widening and government policies are heightening inequalities risking social upheaval. China achieved spectacular results in poverty alleviation early in its reforms, but the momentum slowed in the 1980s before picking up again in 1992. In 1995 less than 6% of the population had incomes below the absolute poverty line, or about 70m people, compared with more than 200m people in 1981.

<sup>13</sup> Grub and Lin (1991) argue that counter-trade was used only for some large equipment transfers from Eastern European countries.

<sup>14</sup> On 27.3.1950 the agreement of Sino-Soviet JVs was signed (Kraus, 1989).

<sup>15</sup> The PPP equation, in 1990, lifted China's per capita income figure from estimated US\$370 (£237.2) to US\$2,000 (£1,282), making the economy about as big as the Japanese (Economist, 30.4.94, p.97).

<sup>16</sup> The assumed growth rate is 2.5% per year.

<sup>17</sup> The US and EU are pressing Beijing to cut tariffs on many industrial products to no more than 5% by early next century and to phase out tariff-quotas on imports by fixed dates (FT, 1.12.97, p.7).

<sup>18</sup> In 1995, 1,224m people lived in China (Statistical Yearbook of China 1996).

<sup>19</sup> Others (eg Morgan-Harris and Longshaw, 1996), for the period 1980 to 1992, suggest an average GDP increase of 9.1% and the SSB proposes that, between 1978 and 1993, the Chinese economy expanded at a compound rate of 9% for an overall increase of 260%.

<sup>20</sup> Wu Yi was optimistic suggesting that "at this speed we'll reach our year 2000-target already in the next five years, which is a quadrupling of the GDP of 1980" (OAV, 1994, p.12).

<sup>21</sup> 13.5% in 1993, 12.7% in 1994, 10.5% in 1995, 9.7% in 1996.

<sup>22</sup> Originally, for 1997 the Chinese government predicted a GDP growth of modest 8%. For 1994 and 1995, Chinese rulers expected the economy to grow at 9% (Economist, 30.4.94, p.97; FT, 11.1.95, p.3). The real growth rate in 1994 was 12.7% and 10.5% in 1995, though.

<sup>23</sup> Also the OECD (in FAZ, 14.4.98, p.17) suggests growth rates in 1998 and 1999 of 7.2 and 7.5%, respectively.

<sup>24</sup> This is more than double the official target of 10%.

<sup>25</sup> For a discussion of China's corporate tax system see Schröder (1990). He found that, in order to implement a sound system of corporate taxation, the Chinese still have a long way to go and further development of the institutional framework is necessary. China has entered a variety of investment protection agreements with 51 states and has agreements to avoid double taxing with approximately 30 countries (OAV, 1994, p.15). See also Brink and Li (1996), Weiguo (1996) and Potter (1996) for a discussion of Chinese investment laws.

<sup>26</sup> According to Grub and Lin (1991), the 22 Regulations were issued because of a sharp decline of FDI in China in 1986 due to foreign investors' dissatisfaction with currency non-convertibility, employment restrictions, and difficulty in dealing with local bureaucracies.

<sup>27</sup> For an examination of the Equity JV Law see Nehemkis and Nehemkis (1980).

<sup>28</sup> It applies subsidiarily to the above laws.

<sup>29</sup> National and international airports have been, in the meantime, established in all of the SEZs and the major cities of the country. In 1995 and 1996, 17 new airports have started operation and 41 other airport projects are planned by the year 2000.

<sup>30</sup> In the SEZs above-average skills and availability of trained labour had to be well paid for. For an analysis of the investment climate, ie costs and quality of labour etc. in different cities in China see Delegation of German Industry and Commerce Hong Kong (1995).

<sup>31</sup> Dalian, Tianjin, Qingdao, Waigaoqiao, Zhangjiagang, Ningbo, Fuzhou, Xiangyu, Shantou, Guangzhou, Shatoujiao, Futian, Haikou, Zhuhai.

<sup>32</sup> Beihai, Dalian, Fuzhou, Guangzhou, Lianyungang, Nantong, Ningbo, Qingdao, Qinhuangdao, Shanghai, Tianjin, Yantai, Wenzhou, Zhanjiang.

<sup>33</sup> One of the main issues of increased infrastructure spending is to overcome striking regional disparities (FT, 27.6.96, p.1).

<sup>34</sup> By the year 2000, China's capacity for energy generation is to be increased to about 280m kilowatt. This requires investments of some US\$70bn (£44.9bn) which China cannot raise on its own. Thus, the Chinese government encourages foreign investors to engage in so-called

BOT (build-operate-transfer) projects.

<sup>35</sup> At the end of 1996, the Chinese telephone network accounted for some 100m lines, lifting the telephone penetration rate to 6.2%. By the year 2000, so suggests the Ministry of Post and Telecommunications, the whole of China should be covered by a net of glass fibre wires.

<sup>36</sup> Infrastructure spending in the five year plan period 1996-2000 is estimated at US\$295bn (£189.1bn) to US\$370bn (£237.2bn), including US\$60bn (£38.5bn) to US\$100bn (£64.1bn) for power, US\$60bn (£38.5bn) for telecommunications, US\$40bn (£25.6bn) to US\$45bn (£28.8bn) for railways, US\$35bn (£22.4bn) to US\$45bn (£28.8bn) for oil/gas development, US\$35bn (£22.4bn) to US\$40bn (£25.6bn) for refineries, US\$30bn (£19.2bn) to US\$40bn (£25.6bn) for roads, US\$20bn (£12.8bn) to US\$25bn (£16.0bn) for coal, US\$10bn (£6.4bn) for ports, US\$5bn (£3.2bn) for airports (FT, 19.3.96, p.7).

<sup>37</sup> Hofstede's value dimensions are power distance, uncertainty avoidance, individualism, and masculinity.

<sup>38</sup> Campbell (1989) refines this. His enumeration suggests export entry (direct imports, indirect exports via agent, indirect exports via distributor), contractual entry (licensing, processing and assembly contracts, CJV, counter trade, barter), investment entry (EJV, WFOE).

<sup>39</sup> Foreign firms provide machines or product designs to Chinese enterprises and obtain, as payment, a part of the output.

<sup>40</sup> Beamish and Wang (1989) applied nine dimensions, including region of investment, source of investment, industry division, total investment, foreign partner equity contribution, foreign equity percentage, most frequently observed foreign equity percentage, foreign equity percentage by country, pre-determined duration of JVs.

<sup>41</sup> Daniels et al.'s (1985) thesis is that rather than simply banning FDI, the Chinese government set regulations on labour, taxes, and profits which made it impossible for foreign firms to operate profitably. Firms had to apply for permission to terminate their operations. Thus, the Chinese Communist Party created a situation where firms left on their own accord rather than being officially expropriated.

<sup>42</sup> Apart from China's economic co-operation in the 1950s with the former Soviet Union, authors suggest also ties with Eastern European countries and there was also the import of industrial equipment and technology from Western European countries and Japan in the early 1960s and 1970s (Ho and Huenemann, 1984). There is inconsistency revolving around the termination of the Sino-Soviet ties. Whereas Wu (1982) suggests that the split was in 1955, Plasschaert (1993) and Child (1994) propose the year 1960 and Campbell (1989) and Grub and Lin (1991) refer to the [early] 1960s.

<sup>43</sup> Stewart and Keown (1989) suggest 12 years.

<sup>44</sup> Kelly (1994) suggests the occurrence of two distinct 'investment waves' since 1979 (with the first being the heavy investments by Overseas Chinese in export oriented industries along the East coast and the second being investments in infrastructure).

<sup>45</sup> On the occasion of the death of Hu Yaohang.

<sup>46</sup> Apart from few joint development and compensation trade projects and WFOEs in the SEZs and Shanghai. 3M set up the first WFOE outside of a SEZ in 1985 (Davidson, 1987).

<sup>47</sup> For details on the foreign exchange difficulties of several large domestically-oriented JVs see Pomfret (1989).

<sup>48</sup> As 1993 figure, Far Eastern Economic Review (1.6.95, p.46) suggests US\$40bn (£25.6bn).

<sup>49</sup> Earlier, the Financial Times (7.11.94, p.vi) presents exact 50% and in its issue of 5.12.94 (p.4) the publication suggests 33% as the share of FDI to LDCs. In 1995, FDI in LDCs rose to a record US\$90bn (£57.7bn) (FT, 13.3.96, p.4).

<sup>50</sup> Recently, China started checking how much money investors are bringing into the country.

<sup>51</sup> Duscha (1987) stresses that the creation of jobs is not a declared objective of JV policy. Accordingly, China seems to ignore the JVs' ability to increase employment.

<sup>52</sup> In 1977, China was the 30<sup>th</sup> largest exporting country in the world.

<sup>53</sup> A proportion of the Hong Kong investment is Taiwanese capital that is disguised for political reasons. However, the bulk of the Hong Kong investment is genuine Hong Kong capital, says Kueh (1992).

<sup>54</sup> The investment ratios were established as follows: projects UK 1,800/140,000; Germany 1,503/140,000; pledged investment UK 11.9bn/469.3bn; Germany 5.4bn/469.3bn; utilised investment UK 3.5bn/177.2bn; Germany 1.7bn/177.2bn.

<sup>55</sup> In 1992, South Korea was due to establish diplomatic relations with China.

<sup>56</sup> Companies were asked to supply separate information for each country with which they had direct investment transactions. Where outward investment to a country was channelled through a holding company which was itself an overseas subsidiary of the UK company, the whole investment was allocated to the country of the intervening subsidiary. Subsidiaries are companies in which the parent company holds more than half of the equity share capital.

<sup>57</sup> This suggests a different order from the findings in the Far Eastern Economic Review (1.6.95, p.46) where it is suggested that the US remain the top destination of UK investment (41% of UK FDI), followed by Commonwealth countries (23%) Europe and Asia (each 18%).

<sup>58</sup> Already in 1997, Beijing had declared Chongqing the fourth municipality. The World Bank report ignores this.

<sup>59</sup> Note: representative offices are not regarded as FDI projects.

<sup>60</sup> Based on an evaluation of June 1994 statistics by the German Embassy in Beijing.

## Chapter Six

# Sino-Foreign Joint Ventures

### 6.1 Introduction

Chapter five has introduced the foreign direct investment (FDI) environment in China: the legal, socio-cultural and physical infrastructures faced by the China investor when establishing a joint venture (JV). This was necessary to develop further the analytical framework established in chapter three with the findings from a review of the literature on Sino-foreign JVs. The insight derived from this chapter will be used for the subsequent analysis and discussion of the empirical findings throughout chapters seven, eight and nine.

### 6.2 The model framework

In his analysis of Sino-foreign JVs, Beamish (1993) examined JV characteristics, including JV design, operation and performance. This corresponds with the framework proposed in this thesis. Extensions and modifications to the model framework are expected, according to evidence from the literature. Beamish and Wang (1989) and Beamish (1993) emphasise that the JV process in China is different from that in developed countries and less developed countries (LDCs) with market economies. Based on eleven studies carried out prior to 1989, and his own investigation of 22 JVs in China, Beamish (1993) compared 12 characteristics of international equity JVs in China with JVs in LDCs with market economies.<sup>1</sup> He found five characteristics unique to China, ie 'frequency of association with government partners', 'origin of the JV investment' (from ethnically related countries), 'ratio of enacted to announced ventures' (less than 50%), 'use of JVs with a pre-determined duration', and 'JV stability'.

In chapter three of this thesis it has been established that the international JV is formed between at least two partners. It has been established also that there is a relationship between the partners (ie the formation phase of the model) and between the JV and its parents (ie operation phase of the model). The constellation of these relationships depends on the relative bargaining power of the partners that can change over time, thus making the model dynamic. In this aspect, the thesis model corresponds with that of Harrigan (1985). In chapter three it has been further established that, as opposed to Killing (1983) and Harrigan (1985), only Datta (1988) has taken into account the international aspect of the JV. However, the question that needs to be addressed is to what extent Datta's (1988) model is able to capture the internal and external relationships of a Sino-western JV. The thesis model has to



explain the formation and operation of an enterprise that has at least two parents, one from China and one from a western country.

Fan (1996) rejected the models of Harrigan (1985) and Datta (1988) to analyse Sino-western JVs. Instead, he emphasises cross-cultural communication and understanding as the key aspects of international JVs. He stresses that the existence of cultural barriers makes the creation and operation of an international JV more complex and difficult than a domestic one. Gaps between the perceptions, expectations and objectives of the partners are often conflicting. Also the cultural differences in the organisation structure and management style complicate managing a JV and can even threaten its survival. Fan (1996) argues that to break down these cultural barriers the investor must be committed to JV success, be able to adapt, learn and co-operate, willing to build up communication channels and to enhance mutual understanding.

Fan's (1996) model discusses three relationships: between the foreign firm and the Chinese firm (motivation for investment, objectives in the JV, need for partner's resources, bargaining power) and between the foreign and Chinese firms and the JV (ownership and control, objectives, changes in management system, strategies and performance). Fan (1996) has introduced two cultural barriers in his model: one between the foreign firm and both the Chinese firm and the JV. These are located at levels, such as: (1) East-West, (2) national origin, (3) business systems, (4) organisational and (5) individual variables. The second barrier divides the Chinese firm and the JV, located on cultural levels (ie organisational and individual variables) only.

As Harrigan's (1985) model corresponds with the elements developed in chapter three of this thesis, so does Fan's (1996): the foreign firms' attributes, motivations and objectives are captured by JV motivations in the thesis model. The need for the partner's resources is equivalent to the JV partner contribution of the model in this thesis and Fan's (1996) 'bargaining power' attribute is incorporated in the negotiation element of the thesis model. The additional sub-element 'JV partner selection' of the thesis model complements the relationship between the foreign and the Chinese partners. Neither Fan (1996), Datta (1988) or Harrigan (1985) examined explicitly this element of the JV formation process, despite its importance for JV success (Berg et al., 1982; Killing, 1983; Gomes-Casseres, 1989; Geringer, 1991; Schuler et al., 1992; Hamill and Hunt, 1993). Fan's (1996) JV 'child' attributes (ownership and control, changes in management system, strategies and performance) are also captured in the thesis model. However, the objectives of the JV are discussed in this model as the objectives of the parents.

Fan's (1996) JV model resembles much of the work of Harrigan (1985) and Datta (1988). Basically, he introduced the existence of cultural barriers and created an international JV model applicable to the analysis of Sino-western JVs. However, Fan (1996) did not provide further explanation of his model as he expects the reader to be familiar with the work of Harrigan and Datta. Many questions remain open: to what extent do cultural components, such as food and dress influence JV formation and operation? Further, although incorporated as model attributes, Fan (1996) does not establish a link between cultural components and JV strategies and performance.

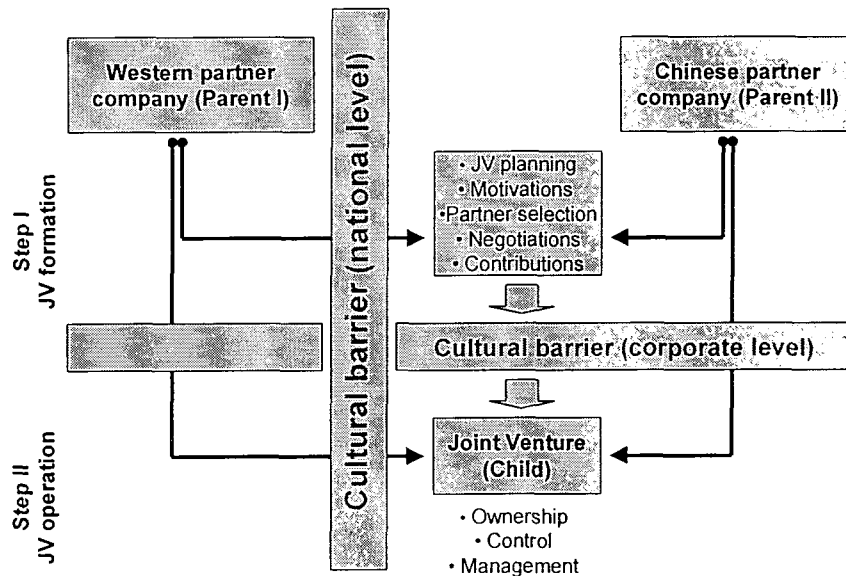
On a parallel track to Fan, Kim (1996) proposed a conceptual framework for comprehension and analysis of international JVs in China. Kim's (1996) typology includes dimensions such as the partner status (size, experience, investment, nature of the equity) and JV content (chief executive officer/organisational structure, accounting/finance, marketing/sales, production/operation, research and development and product design, motivations for JV formation, and implementation of technology transfer). Kim's (1996) approach contains elements from the models of Harrigan (1985) and Datta (1988), although its applicability to, or usefulness for, improvement of the existing thesis model is doubly flawed: first, Kim (1996) mixes up elements of the formation and operation phases and does not provide the reasoning for his use of four different line functions as elements of the model. For instance, why are, JV formation motivations and accounting/finance control at the same hierarchical level? Secondly, Kim (1996) eventually produces a typology of four different JVs ('companion JV', 'mentorial JV', 'colonial JV' and 'degenerate JV'), suggesting a variety of evolutions for each type and the conditions that would have brought them about.<sup>2</sup> This, however, is not essential to the model of this thesis.

Based on the framework that has been developed in chapter three, and using the inputs from Fan's (1996) 'culture JV model', the design of an analytical Sino-foreign JV model needed in this study is possible (figure 6-1).

In an examination of the literature on Sino-foreign JVs carried out at an early stage of this PhD research (Kaiser, Kirby and Fan, 1996),<sup>3</sup> a four-dimensional evaluation grid was applied, including 'level of study', 'stage in the JV life cycle', 'perspective of the foreign JV partner', and 'size of the foreign JV partner'. The research found that the majority of the studies examined (68.75%) were carried out on the micro level. They occupied an insider's point of view, drew conclusions from case studies or surveys and tried to explain certain behavioural aspects, based on political, economic or socio-cultural variables. Few studies (18.75%) were carried out on the macro-level, ie

examined, first, the political, economic or socio-cultural environment before attempting to arrive at suggestions for individual cases. Even fewer studies (12.5%) adopted a micro/macro level approach.

Figure 6-1: The Sino-foreign JV model used in this thesis.



Source: Adapted from Fan (1996.)

Kaiser, Kirby and Fan's (1996) work further revealed that the majority of studies examined had undertaken investigations of the preparation and creation of JVs as the first phase in the JV life cycle. The study found that the motivations for entering into a JV and the negotiating of a JV had attracted a major share of the writers' attention. The examination also discovered that in approximately half of the cases, investors from the US were subjected to investigation. Surprisingly, however, more papers than expected, researched European investment in China.

The examination by Kaiser et al. (1996) finally revealed that most studies investigated the China investment undertaken by large MNEs, whereas only few studied the JVs by SMEs (eg Au and Enderwick, 1994; Leung and Yeung, 1995). However, authors, such as Wu (1993), who examined the China market entry of European enterprises, draw attention to the fact that less experienced firms are more likely to enter China through JVs. A subsequent extension of this early examination of the literature on Sino-foreign

JVs provides support for the finding that studies on the joint venturing in China of SMEs are rather limited, albeit there is substantial literature on large MNE JVs.

Danenburg and Tan (1989) and Anyansi-Archibong (1989) discuss the increasing importance of SMEs to the Chinese economy's development as a result of their flexibility and ability to turn out new products in shorter periods of time than other Chinese enterprises, create employment and provide much-needed modern technologies. Danenburg and Tan (1989) and Anyansi-Archibong's (1989) contributions are based on the 1984 Chinese launch of an economic initiative programme featuring SMEs. This established the so-called 'Coordinating Center for Business Cooperation', responsible for advising and co-ordinating the activities of SMEs involving foreign investors. However, this is as far as these studies touch on the issue of FDI: they concentrate on Chinese SMEs, rather than foreign ones.

Au and Enderwick (1994) examined the JVs of New Zealand SMEs, looking, in particular, at the motivations and factors for success and failure as perceived by the firms. Later, Leung and Yeung (1995), in a cross-industry survey of 168 SMEs from Hong Kong, Asia, North America and Europe, investigated the negotiation strategies of these firms with their counterparts in China. More recently, Kaiser (1997c), on behalf of the Delegation of German Industry and Commerce Shanghai, documented the JV experiences of 25 German SMEs in China.<sup>4</sup> Subsequently, selected findings of this study have been incorporated into Kaiser and Grimm et al.'s (1997) direct investment handbook for German SMEs with an interest in China<sup>5</sup>. Various other contributions used the findings of this study as the basis for their conclusions, including Grimm (1997, 1997b) and Hermany and Mischke (1997). New insight, however, was not provided by these works.

### **6.2.1 Joint venture<sup>6</sup> formation**

Foreign investors have to pay great attention to the formation stages of JVs in China. The length of time and difficulty associated with establishing a JV was top of the list in Davidson's (1987) study. Au and Enderwick (1994) suggest investors must realise JV negotiations, planning and preparations will proceed according to the Chinese agenda.

In a recent contribution, Pan (1997) showed that the equity JV formation strategies adopted by companies from different nations differ. Examining six variables of JV formation (selection of the Chinese and foreign partners, foreign equity ownership, foreign capital contribution, JV business scope and JV location), the author revealed that US, Japanese and Hong Kong firm JV formation strategies differ significantly in their characteristics and also over time. The details of Pan's (1997) study are

discussed in subsequent sections of this chapter. A similar study comparing, for instance, UK and German JV formation strategies has not yet been compiled.

### ***Sino-foreign joint venture planning***

JV strategies need to be developed early on in the process of establishing such a business, in fact as integral part of the company's overall international strategy (Stofan and Stultz, 1991). Newman's (1992) model of establishing a Sino-foreign JV proposes three stages including devising a win-win basis for co-operation, preparing scientific plans for joint activities and converting plans into performance. The quality of the conclusion at each stage in Newman's (1992) model either supports or constrains the potential effectiveness of the work at the following stage. Later, Brown (1993) stresses the importance of planning stages, including market research, an investigation of overseas production capabilities, industry patterns, standards and potential partners. These, adds Brown, should be combined with on-site visits and evaluations to ascertain whether the project is politically, economically and legally acceptable to China, as well as profitable and financable. Subsequently, a Commerzbank (1995) study, researching 45 German companies with a JV in China, suggested the need to clarify the medium- and long-term goals of an investment in China and analyse the market volume, the competitive situation, and the development of the market.

Frequently, however, especially in the early days of China's open-door policy, foreign investors entered the Chinese market as a consequence of the so-called 'two-billion-sock' syndrome. That is, they attempted to sell into the Chinese market whatever could be sold, regardless of whether there was a market for it (Pye, 1986; Frankenstein, 1986; Beamish and Wang, 1989). This approach would not work. Instead, de Bruijn and Jia (1993b) advocate the necessity of a product selection process. Frequently executed in two phases, the process includes the identification of possibilities and final selection by the addition of operational criteria. De Bruijn and Jia suggest that the product selection strategy should depend upon market demand, local supply, the goals of the owners and the partners' ability, and the key operational criteria.

SMEs have been criticised frequently for not carrying out sufficient preparation for their investments abroad. For SMEs, the accurate planning of a JV is fraught with difficulties due to the lack of readily available and reliable information (Stofan and Stultz, 1991).

### ***Motivations for Sino-foreign joint venture formation***

The body of literature on Sino-foreign JVs contains substantial information regarding the forces that drive businesses to collaborate in a JV project (Daniels et al., 1985; Tai, 1988; Beamish, 1987, 1988; Shenkar, 1990; Grub and Lin, 1991; Aiello, 1991; Newman, 1992; Glaister and Wang, 1993; Gledhill, 1994).

In line with the findings in chapter three, there appears to be confusion surrounding the motivations for entering the Chinese market and a JV. Various authors propose as motivations for JV activity general motivations for FDI activity (Daniels et al., 1985; Shenkar, 1990; Glaister and Wang, 1993). For instance, Shenkar (1990), discussing entry into a JV, suggests the desire for profits and the utilisation of outdated technology as motivations for the western partner and the accumulation of technology and foreign exchange as motivations of the Chinese partner. For the western company, the vast market potential is, indeed, a pervasive motivation for doing business with China. It is not, however, a sufficient motivation for establishing a JV, as profits can also be made by exporting or setting up a wholly foreign-owned enterprise (WFOE). It is a reason for setting up a JV if the foreign company has no access to alternative modes of FDI, exporting or licensing, due to, for example, government regulations, tariff and non-tariff barriers. Equally, one way of utilising outdated technology is through transferring it into a JV. This was the strategy used by Volkswagen of Germany when setting up in 1984 the Shanghai Volkswagen Automotive Company Ltd - its JV with the Shanghai Automotive Industry Corporation. It came about after VW spent substantial funds on the development of the 'Santana', a model that did not sell well in Europe. As a consequence, VW decided to utilise it to develop the Chinese market instead. However, the utilisation of outdated technology and the gain of technology (for the Chinese) could, generally, also have been achieved through licensing agreements. Also, foreign exchange could have been earned through exporting.

It has also been established that partner motivations are often not symmetric (Ruggles, 1983; Shenkar, 1990; Fan, 1996), causing conflicts and problems in various areas of JV activity (Shaw and Meier, 1993; Kim, 1996; Weir, 1997). A variety of authors point out that the main concern of western businesses in China has been to make profits from the world's largest (potential) market. However, the Chinese partners were more interested in the servicing of export markets (Ruggles, 1983; Davidson, 1987; Tai, 1988; Beamish and Wang, 1989; Shenkar, 1990). Davidson (1987) discovered from his study of 47 US firms operating JVs in China that the Chinese partner wanted to flood foreign markets with low-priced products whereas the US partners had the opposite tendency. Davidson suggests further that as soon as the JV is formed, the Chinese want to earn as much hard currency as possible as quickly as possible. In addition they seek a faster pace of technology transfer than the western (US) managers. In accordance with the above, Weir (1997) argues that multinational enterprises (MNEs) are looking at long-term investment, establishing a market

presence and developing dominant national brands, whereas Chinese state-owned enterprises (SOEs) want technology, funding and ways to keep staff employed.

Foreign firms form JVs with Chinese local firms for a variety of reasons, eg as a means of developing the Chinese market, establishing a production base with cheap land and labour, and gaining a partner who possesses local knowledge and talent (Kim, 1996). In fact, the market motivation has been dominating the joint venturing of UK firms (Gledhill, 1994), German investors (Köhler, 1987; Stofan and Stultz, 1991; Trommsdorff et al., 1994; Commerzbank, 1995; Kaiser, 1997c), US firms (Daniels et al., 1985; Davidson, 1987; Punnett and Yu, 1990), New Zealand enterprises (Au and Enderwick, 1994) and Canadian investors (Punnett and Yu, 1990). Various firms have realised the necessity of servicing the Chinese market through FDI, rather than exports, in order to sustain their share in the market. For instance, the eleven US manufacturers and service firms in Daniels et al.'s (1985) study suggested this argument as their motivation for JV activity. However, a local market presence could have also been achieved through a WFOE. Daniels et al. (1985) do not provide meaningful reasoning why the firms in their sample eventually chose a JV. Also, from the work of Daniels et al. (1985) it is not clear which of the motivations were most important to the US investors.

Important motivations for JV activity were also to conform to host government policy, spread risk, exchange resources, gain local knowledge and access to favourable cost production (Glaister and Wang, 1993; Commerzbank, 1995). Some authors consider the influence of government mandate on the formation of JVs as very strong (Köhler, 1987; Teagarden, 1990; Punnett and Yu, 1990; Glaister and Wang, 1993; Beamish, 1993). For instance, establishing a JV was the only way for the US car manufacturer, Chrysler, to access the Chinese market (Aiello, 1991).

The literature also suggests differences in motivations between investors of various national origins. Punnett and Yu (1990) and Dong et al. (1993) found evidence of this in their empirical studies. Punnett and Yu (1990), in their examination of the attitudes of US and Canadian executives toward opportunities in China, found that - whereas the companies were in accord with regard to the high importance of the market motivation and cultural differences - government mandate as a reason for JV activity was rated as more important by US firms than by their Canadian counterparts. Also, whereas US respondents were more concerned about restrictions, Canadian enterprises were more interested in home government incentives.

Also Dong et al. (1993), in their study of 114 North American, European, Japanese and Overseas Chinese JVs in China, discovered that - while local market entry and profit generation were the first and second most important JV motives, respectively, for western investors - local market entry was the fourth most important only for the Overseas Chinese investors. On the other hand, the provision of incentives was most important for the Overseas Chinese investors, whereas it ranked sixth only within the group of western firms. The authors further distinguished between the JV formation motivations of North American, European and Japanese investors and revealed that European investors were more interested in access to raw materials, low transportation and labour costs than were US and Japanese investors. On the other hand, local market entry and profits were more important to US companies than to their European or Japanese counterparts. Profits were even more important to Japanese than to European investors. The reason for this could be that the Chinese market, or business environment in general, is not as familiar to Europeans. As a consequence they do not aim high in respect of profit in the short term. Strangely, however, Dong et al. (1993) refer to investors from Japan as western direct investors.

The utilisation of cheap labour costs is often proposed as the motivation for entering a JV (Tai, 1988; Tang et al., 1992; Newman, 1992; Dong et al., 1993; Glaister and Wang, 1993). This needs consideration, however. The seemingly low labour costs in China are inflated by an extensive number of add-ons, including housing, insurance, pensions and training. Explicitly, it was suggested (China aktuell, January 1995, p.14) that China had lost its comparative labour cost advantage. As early as 1988, Hiemenz and Li had pointed out that, in comparison with ASEAN countries, labour costs had made China relatively unattractive. Subsequently, Kraus (1989) noted, that labour costs in China had reached a level close to that of western industrialised countries. In addition, the level of productivity of Chinese workers is considerably lower than in western economies (Tai, 1988; Shenkar, 1990; Ding, 1993; Woodward and Liu, 1993).

These statements by Hiemenz and Li (1988) and Kraus (1989), however, seem inaccurate and all too general. According to the Far Eastern Economic Review (1.6.95, p.46), in the mid-1990s the hourly manufacturing costs in Europe amounted to approximately US\$21, whereas they stood at about US\$2 in the economies of Southeast Asia. Again, this is too all-embracing. Nevertheless, whereas the above statements by Hiemenz and Li (1988) and Kraus (1989) might reflect the situation in China's coastal area, they are not a true reflection of the cost situation in China's vast hinterland, where production is considerably cheaper than along the East coast. Apart from Köhler's (1987) findings in the mid-1980s of 17 German enterprises which



expected lower factor costs from their JV commitment, there is also more recent evidence available: Daewoo, the South Korean car manufacturer, estimated production costs in China to be about 15 per cent of those in South Korea. This was born out by British Polythene Industries. It closed one of its UK plants in May 1995 to shift the manufacture of plastic carrier bags to China. It was estimated the move would enable it to produce at one-tenth of the UK labour cost (FT, 7.2.95, p.21).

### ***Partner selection***

#### Partner requirements

Selecting the right partner has been considered important in the Sino-foreign JV context (Campbell, 1989; Stofan and Stultz, 1991; Schwantes, 1991; Glaister and Wang, 1993; Shaw and Meier, 1993; Gledhill, 1994; Thiess, 1994). The local partner has been required to be resourceful (Economist, 6.8.94, p.65) and well connected (Shenkar, 1990; Kim, 1996). In developed countries, a successful JV requires partners to have compatible and comparable capabilities and experiences, ie the partners should complement one another. It is difficult, if not impossible, however, in East Asian countries to find a local firm that has comparable management capacity and experience (Kim, 1996).

Lists of Chinese partner requirements can be found in various studies, including those by Tai (1988), Casson and Zhang (1992), Shaw and Meier (1993), Glaister and Wang (1993), Woodward and Liu (1993), Delegation of German Industry and Commerce Hong Kong (1995), Commerzbank (1995) and Kaiser (1997c). According to these sources, foreign investors aim to find a partner that can add value to their JVs in the form of securing plant space, personnel, sources of raw materials, access to technology and ready-made sales and/or distribution channels, access to the market, flexible rulings on the use of foreign exchange or state funds, fiscal concessions, etc. Foreign investors also seek *guanxi*. Tai (1988), Shaw and Meier (1993) and Woodward and Liu (1993) highlight the importance of developing *guanxi*, the art of cultivating a personal relationship with those in power. Another important partner requirement is a previous favourable association with a local company. This could be in the form of, for example, a principal-agent relationship (Casson and Zhang, 1992; Commerzbank, 1995). This argument, however, appears relatively late in Glaister and Wang's (1993) list of partner requirements. The risk of choosing the wrong partner is reduced if the Chinese company is previously known to the foreign firm (Campbell, 1989).

The primary problem with most of the studies commenting on the partner requirements for JVs is that they do not provide a clear ranking that would indicate the relative

importance of individual criteria (Casson and Zhang, 1992; Delegation of German Industry and Commerce Hong Kong, 1995).

Partner requirements vary between companies from different nations, as Dong et al.'s (1993) study has shown. Investigating the partner requirements of North American, European, Japanese and Overseas Chinese investors when forming a China-based JV, the authors found the provision of a local image and environment relations were regarded as most important within the western group of investors. However, the most important selection criterion for the Overseas Chinese investors was government relations. In general, the local partner's sources were more important to western firms than to Overseas Chinese. This suggests that western investors in China first and foremost aim at acquiring the Chinese element that they lack. This explains Schwantes' (1991) earlier argument that unlike the Chinese, a foreigner never has equal access to Chinese authorities. The provision of government relations ranks only seventh in the western group of Dong et al.'s (1993) investors, however. Apparently, Overseas Chinese investors are more aware of the crucial role of government and bureaucracy involved at different levels of business. The provision of government relations was also rated highly by Japanese investors. This indicates that the Japanese are closer to Chinese investors in understanding the Chinese culture and political environment than their American and European counterparts. Dong et al. (1993), however, found no significant difference between ventures with North American and European firms when making partner selection decisions.

Often, JVs with local Chinese partners are established on the site of the Chinese parent company, as opposed to a green-field venture. While the first strategy has the advantage of being able to build a production-appropriate plant, the second strategy allows production to commence immediately and is often cheaper also.<sup>7</sup>

In cases where the Chinese partner is sought for its provision of a production site, the location of the foreign partner becomes far more important. Various authors have reported on the factors for investors' choices of locations, such as Thoburn et al. (1990), Glaister and Wang (1993), Delegation of German Industry and Commerce Hong Kong (1995) and Kaiser (1997c). These most important factors include the location of the partner, proximity to target markets, attitudes of government officials and infrastructure. Kaiser (1997c) further proposes the availability of tax concessions. However, tax concessions are not a discriminatory factor when selecting a location for FDI since they are granted to foreign investors in a variety of investment zones such as the special economic zones and economic and technological development zones.

#### Selection process

There are a number of ways a foreign investor can use to get in touch with potential partners. Thiess (1994) presented ways, such as existing contacts (customer, licensee), recommendations by Chinese officials, contacts established at trade fairs

and exhibitions or through banks, accountants, solicitors and management consultants, as well as own research and company database searches. Elsewhere (Delegation of German Industry and Commerce Hong Kong, 1995), it is suggested that information on potential local partners can also be sought, apart from chambers of commerce, from broker agencies, solicitors and the CCPIT (China Council for the Promotion of International Trade). Using databases in China, however, has not been a matter of course in the past. For instance, the South China Morning Post in July 1985 (in Beamish and Wang, 1989, p.59) pointed out that it is not easy for a western investor to find a suitable partner in China. The reason it cites is because China has nothing like the system of the Hong Kong Trade Development Council's trade enquiry databank, which contains information on more than 18,000 manufacturers, exporters and importers and a file on more than 80,000 overseas importers. De Bruijn and Jia (1993) support this observation, suggesting that, whereas Chinese firms can acquire information about possibilities and alternatives at international exhibitions from foreign information centres or by sending delegations, the foreign partner initially has to go to Chinese government organisations.

Increasingly, however, foreign investors in China can seek information about potential local partners from institutions, including chambers of commerce, that work with electronic databases, such as China-on-disc™. The British Consulate General in Shanghai, for instance, offers its visitors the opportunity to carry out their own China-on-disc™ search – free of charge (Paul Davies interview, 11.11.96). The foreign investors in Campbell's (1989) study found their partners predominantly through previous business contacts and through the use of middlemen.

#### The local partner

Basically, foreign investors can choose as their partners SOEs, town and village enterprises or private Chinese firms. None of the 22 JVs in Beamish's (1993) study were with Chinese private sector firms. The frequency of choosing a government partner depends on the national origin of the foreign investors. This becomes evident in the works of Glaister and Wang (1993), Osland and Cavusgil (1996) and Kaiser (1997c). Further, from his study of Hong Kong-based, American and Japanese investment in China, Pan (1997) discovered that Japanese firms were more likely to choose a local Chinese partner owned by the central or provincial governments, compared with US firms. Both Japanese and US investors were more likely than Hong Kong firms to select a local partner owned by the central or provincial government. However, the Japanese firms were more likely to do so than the US firms. The majority of Japanese partners chose another Japanese firm, and only a small portion of them

selected a Hong Kong firm. In contrast, more than half of the US firms chose a Hong Kong firm as the second foreign partner (Pan, 1997).

However, as has been shown in chapter three, JVs with local private firms are more desirable than those with SOEs (Thoburn et al., 1990). Although large SOEs have good connections to local governments, they are rather inflexible, whereas a rural enterprise is dynamic and suffers less bureaucratic interference (Tsang, 1994).

### ***Sino-foreign joint venture negotiation process***

Negotiating is an art and this is particularly true in China (Campbell, 1989). According to authors, such as Frankenstein (1986), Tai (1988) and Eiteman (1990), negotiating with the Chinese is difficult for western managers, with negotiations taking longer than elsewhere (Daniels et al., 1985; von Glinow and Teagarden, 1988). Negotiation periods vary considerably, between seven months and more than four years (Daniels et al., 1985; Davidson, 1987; Campbell, 1989; Au and Enderwick, 1994; Kaiser, 1997c). Harwit (1992) noted that more than four years of negotiations preceded the 1983 establishment of the Beijing Jeep Corporation. However, statements on the duration of negotiations in various studies are difficult to compare since there is no clearly defined period of negotiation: do initial talks count as negotiations? When do negotiations end? These and other similar questions have to be answered first, before any meaningful comparison between investors of different nations, or of different company sizes, can be undertaken.

Tai (1988) believes that the amount of time it takes to come to an agreement in Sino-foreign negotiations is likely to be the greatest frustration for foreigners doing business in China. The reasons Davidson (1987) suggests for the long duration of negotiations are the administrative structure of the Chinese government, the absence of decision-making authority on the Chinese side, and two variables that basically influence the time involved in establishing a JV (whether or not the Chinese partner is on the growing list of industries that have been organised into national corporations and the planned location or being one of few investors in a location). For instance, nearly half of the 1,676 respondents in Wei's (1993) study of Sino-foreign JVs reported that the Chinese team lengthened negotiations to get concessions and that the more important the deal, the more the Chinese were inclined to discuss it from every possible angle.

The Chinese are thorough and methodical negotiators. During the 1996 Heseltine China trade mission de-briefing in London, one of the participants remarked: "We are dealing with the world's toughest negotiators." The personal qualities of Chinese negotiators were, for instance, highly regarded by the US executives in the

Frankenstein (1986) study where more than two-thirds of the managers asked, felt that Chinese negotiators tended to be co-operative. Chinese negotiators believe that patience – which also includes an extended get-acquainted period – is of particular value in negotiations. The Chinese consider social formalities as part of the substance of business. Lee and Lo (1993) in their study of American business people's perceptions of negotiating in the PRC, point out that in the course of China trade, much time and expense will be invested in the non-task 'sounding out' which is necessary to establish and deepen relationships.<sup>8</sup>

However, it has been suggested that negotiation practices are becoming less time-consuming (Stewart and Keown, 1989; Worm, 1997) and more western-style in content (Brown, 1993). A change in Chinese negotiating behaviour was observed by Frankenstein (1986) in his study of 26 managers from US manufacturing, trading and service firms in China. The managers had been quizzed on their perception of Chinese business behaviour, the operational climate and Chinese negotiation tactics. However, Frankenstein (1986) also noted that while closer contact with more technically competent end users might result in relatively direct negotiations, the Chinese side still functioned in a bureaucratic mode. The penalty for being seen to have given away too much to 'foreigners' is likely to remain severe. This makes Chinese negotiators very cautious. Frankenstein (1986) identified four different phases in Sino-foreign negotiations: the opening moves, where the two sides reach general agreement on intent, mutual goals and start building a relationship, the assessment phase, that involves the bulk of negotiations, the end-game, where the Chinese focus on hard items such as price and delivery schedules, and the implementation phase - a continuing process of adjustment and discussion.

Frankenstein's (1986) findings have to be treated with caution. He does not indicate within which industries the 26 firms were operating (different statements might emanate from different industries) nor does he distinguish between, or give a reason for, his selection. Furthermore, he did not indicate his use of a questionnaire survey until the very end. Up to that point, the methodology used was subject to speculation.

In his subsequent research of the case of a US MNE JV in China, Newman (1992) found that the character of negotiating changed between the first and second stage of the process. Whereas during the deal-making stage the main task was to find a way of servicing the separate wants of each partner, during the concept, elaboration and planning stage, a mutual interest assumed dominance. This was to design a viable, effective structure. Campbell (1989), in his study of 21 Sino-foreign equity JVs emphasised the need for foreign firms to develop an understanding of the Chinese

negotiators' position. While they may not get any thanks for a job well done, they will most certainly be censured if the contract does not adequately protect China's interest.

As difficult negotiating issues, the 26 managers in Frankenstein's (1986) study detected price and technology issues, with price being the single most difficult to resolve. Stewart and Keown (1989) came up with similar findings. However, they noted that in addition to financial matters, such as price for assets, technology and training, technical matters were also important in the negotiating process, indicating technical and budgetary issues were uppermost in the minds of the Chinese. Stewart and Keown (1989) studied the factors critical to negotiation success or failure as perceived by 50 Hong Kong-based China traders from North America, Europe and Australia. The results of their study suggest that factors for successful negotiations with China have tended to become more product and finance-related and less personal and culture-related. Stewart and Keown (1989) recommend that China traders should expect to spend large amounts of time explaining technical features and negotiating the price.

Encouraged by inconsistency in the literature between Stewart and Keown (1989) and Tung (1982), as well as Leung and Wong (1993), regarding the importance of personal and non-personal factors affecting negotiation success or failure, Leung and Yeung (1995) investigated, in a cross-industry study, the negotiation strategies of 168 Hong Kong, Asian, North American and European SME executives together with those of their counterparts in China. Contents of the negotiations were the selling price, non-pertinent small talk, as well as financial and credit arrangements. Leung and Yeung's (1995) findings support the earlier observations by Leung and Wong (1993) and Tung (1982) and thus contradict those of Stewart and Keown (1989). However, Stewart and Keown's (1989) findings are confirmed by the results of a recent study of 25 German SME JVs. As factors influencing JV negotiations, technology transfer and investment volume were ahead in importance of, for instance, *guanxi* (Kaiser, 1997c). This also coincides with an Arthur Andersen study (in People's Daily, 24.11.95, p.2), where the concept of quality was more important in negotiations than *guanxi*, for instance.

Eiteman (1990) investigated the perception of the bargaining experiences of 25 executives from American manufacturing firms during the 1980s, including the perceived strengths and weaknesses of both the Chinese and US negotiation approach. As the most important perceived American strengths, Eiteman (1990) discovered the possession of unique technology, patience, and understanding of each other's objectives and desires. Highlighted as the bargaining weakness of the US side was a lack of patience. Another obstacle for JV negotiation with China is the absence of decision-making authority amongst the Chinese negotiators. Stewart and Keown (1989) noted that, while decisions of the western partner's delegation were made by

the management, no one seemed to have any authority in the Chinese teams. This was also found by Frankenstein (1986). More than half of the 26 US managers in his study thought the Chinese they had dealt with had no final decision-making authority.

This is confirmed again in later research work by de Bruijn and Jia (1993) and Tse et al. (1994). They note that while Chinese front-line negotiators may be decision-makers on special technical aspects, they do not concern themselves with overall issues and, as a result, have to consult their superiors more frequently than western negotiators. Tse et al. (1994) studied the reactions of 101 executives from Canada and China to conflicts in JVs, differences in intra- and inter-cultural negotiations, and how person-related and task-related conflicts generate different resolutions by executives of collective and individualistic cultures. They found that Chinese executives prefer to consult their superiors more often than western executives.

Tse et al.'s (1994) study found that home culture affects the executives' responses to conflicts. It uncovered the fact that difficulties with negotiations can be caused by the absence of certain areas of expertise from the Chinese negotiators' skills portfolios. Ten out of 12 respondents in Tse et al.'s (1994) sample assessed the (legal) business knowledge possessed by the Chinese as poor or very poor while six assessed their technical knowledge as good or very good which only four rated as poor or very poor. Negotiation tactics revealed in the Tse et al. (1994) study included attempts by the Chinese to elicit unnatural pledges, delay negotiations and rake over old ground.

The American executives perceived the Chinese strengths to be their perpetual bargaining, ability to prolong discussions and their process of bureaucratic review. Eiteman (1990) observed the Chinese seemed to have no time restrictions. Most US managers in Frankenstein's (1986) study and the foreign managers in Campbell's (1989) study would agree that somehow clocks run slower in China. The Chinese team's attempt to re-negotiate business agreements was also found by Aiello (1991) in his study of the Chrysler Jeep JV in Beijing. The latter complains a deliberate lack of clarification is part of the preferred Chinese negotiating strategy that leaves contracts open to continual negotiation and re-negotiation. As a consequence, in the Chrysler case, the company was forced to adopt the strategy of annual negotiations with the appropriate planning authorities to determine the number of completely-knocked-down kit import licenses that would be issued for the forthcoming year (Aiello, 1991). Harwit (1992, p.135) points out that "...[once the Germans had agreed to a price for the engines sold to them from Shanghai Volkswagen, they believed it was a solid commitment]...[the Chinese on the other hand insisted that the selling price was too low, and apparently wanted to ignore the contract stipulations.]" Eiteman's (1990)

approach might be criticised in that it relied on the opinion of Chinese students in the US, instead of Chinese business people, reducing the validity of his research.

For Sino-foreign JVs the contracting language is Chinese (Köhler and Wäscher, 1989). Thus, Frankenstein (1986) and Eiteman (1990) recommend that foreign investors have at least one Mandarin speaker in the negotiation team. Nearly two-thirds of the 26 US companies in Frankenstein's (1986) research had a person speaking Chinese at the working level or better. Almost all managers felt that the Chinese language capability was at least helpful, while nearly two-thirds considered it essential. In the Stewart and Keown (1989) study, more than half of the firms had a person who spoke Chinese. In cases where interpreters are to be used, more than half of Frankenstein's (1986) respondents stressed the necessity for companies to employ independent interpreters of their own, rather than relying on those provided by the Chinese side. This was later supported by Campbell's (1989) research. Contrary to this recommendation, the majority of the German SMEs in the Kaiser (1997c) study relied on the Chinese side to provide the interpreter. Even more surprisingly, only seven out of 50 western negotiation teams in Stewart and Keown's (1989) study used any interpreter.

In conclusion, authors (Davidson, 1987; Beamish and Wang, 1989; Campbell, 1989; Eiteman, 1990; Aiello, 1991; Newman, 1992; Woodward and Liu, 1993; Shenkar and Ronen, 1993) propose negotiating guidelines. However, no single negotiation method can apply to the whole of China. Instead, negotiating needs to be adjusted to the individual negotiation environment (Stewart and Keown, 1989). Guidelines include: the use of a translator, the preparation and announcement of clear alternatives, the drawing up of an initial written agreement, the team to stay together, the presence of at least one Mandarin speaker in the team, and the need to be patient coupled with the ability to exert pressure to finalise agreements. Negotiators are also advised to clarify the target market (export or domestic), clarify foreign exchange requirements, be flexible, draft carefully a JV contract, avoid black holes (such as "we will decide this later") (see Stofan and Stultz, 1991), negotiate with experienced managers only, use boundary-spanners who understand the viewpoint of both partners (interpreters familiar with both cultures may fill a new role by translating not only verbal statements, but also non-verbal responses - Shenkar and Ronen, 1993), maintain a written record of all discussions and decisions, and to know precisely who the negotiators and the authorities are. Shenkar and Ronen (1993) argue that effective negotiation depends also on an understanding of the other side's negotiation practices and the avoidance of an overly aggressive behaviour.<sup>9</sup>

Eiteman (1990) further proposes that negotiations are carried out in the home country since this would save foreign investors' time and accustom the Chinese to the foreign partner's business environment. Interestingly, two-thirds of the US managers in Frankenstein's (1986) earlier research agreed that the Chinese side manipulates or otherwise uses the home court advantage. However, this strategy is not



recommended: the Chinese negotiation team differs from the people later working in the JV. Therefore, this may not be a sensible strategy. Accordingly, most of the German SMEs in Kaiser (1997c) negotiated their JVs exclusively in China.

### ***Partners' contributions***

When establishing a JV, each firm contributes assets and attributes to it. Mutual advantages are combined. As a result, the most successful JVs are those where both parties contribute human, commercial and financial resources (Gledhill, 1994). Various studies have provided insight into the contributions of both foreign and Chinese partners (Aiello, 1991; Woodward and Liu, 1993; Gledhill, 1994; Commerzbank, 1995; de Bruijn and Jia, 1997). According to these authors, the foreign partner in a Sino-foreign JV contributes primarily capital, technology, marketing and management know-how and access to international markets. On the other hand, the Chinese side supplies land, the plant, access to personnel, infrastructure, some machinery and materials.

As has been established in chapter three, the valuation of both partners' assets and attributes frequently causes conflict between the partners.

## **6.2.2 Sino-foreign joint venture operation**

The strict distinction between formation and operation phases needs to be re-thought in the Sino-foreign JV context. Various authors (Frankenstein, 1986; Aiello, 1991; Newman, 1992; Tse et al., 1994) have suggested that the Chinese perceive the actual JV operation as a continuation of negotiations. Bearing this in mind, the following sections of the chapter discuss the ownership structure, control and management of Sino-foreign JVs.

### ***Ownership***

In China, foreign companies are permitted to hold shares of between 25 per cent and 99 per cent of the JV's total equity - although in some industries the upper limit is (much) lower (see chapter five of this thesis and Kaiser and Grimm et al., 1997, chapter six). The equity ownership structure is determined by the contributions of the individual JV partners. This is difficult, however, especially when the contribution cannot easily be expressed in monetary terms. For instance, what is the value of the foreign firm's management know-how and how much is its facilitation of access to world markets worth? Equally, how can the good relationship of a Chinese partner with government officials be valued?

Measurement problems are many, but are basically of two types: first, many foreign investors do not understand how important a relationship with a government official is or could be. Dong et al. (1993) have shown this. Secondly, even if the foreign firm can appreciate the importance and essence of the relationship with, for instance, a senior

municipal government official, how can this be measured? What was the cost of developing the *guanxi* that the Chinese partner can now bring to the JV? To date, no study has mastered or attempted, even, to answer these important questions that could help academic researchers and practitioners alike. Ultimately, the value of both partners' contributions, assets and attributes, has to be negotiated. However, this frequently creates conflict between the partners.

As has been established in chapter three, JV partners can hold majority, equal or minority equity shares. However, it has been outlined in chapter three that equal equity splits can easily lead to a deadlock in decision-making. Thus, many investors opt against equal shares in a Sino-foreign JV. For instance, a manager of one of Siemens' numerous JVs in China has reportedly suggested that "from my interviews with many JVs, I can only recommend to pursue the majority stake when negotiating a joint business. In any case, a 50-50 equity distribution should be avoided" (Delegation of German Industry and Commerce Hong Kong, 1995, p.29). This manager considers even a minority equity position a better solution than an equal distribution between a foreign and a Chinese partner, though his first priority is a majority JV stake.

Whereas more than two-thirds of the US companies in Davidson's (1987) study shared the equity ownership of their JVs, the foreign (German) investors in both the studies of the Delegation of German Industry and Commerce Hong Kong (1995) and Commerzbank (1995) had the distinct majority in more than two-thirds and 50 per cent of the respondents, respectively. The relative avoidance of equal equity JVs in China was found earlier by Beamish and Wang (1989) who discovered that the foreign firms in their study of 805<sup>10</sup> Sino-foreign equity JVs, had an equal equity split in 31 per cent of all cases, whereas they had a minority equity position in 60 per cent of the cases. In only 9 per cent had the foreign party a majority equity holding. The predominant foreign minority position was later confirmed by Beamish (1993).

Beamish and Wang's (1989) study was carried out some ten years ago. In the meantime, however, the Chinese FDI approval practice has experienced a considerable relaxation. This suggests that Beamish and Wang's (1989) findings are no longer comparable in terms of their equity distribution between the partners. Later findings by Pan (1997) from a study of 373 Sino-Japanese and 653 Sino-US JVs confirm this assertion. Over time, the Japanese and US investors have shifted gradually from a 50:50 to a majority equity position. This happened especially during the period 1991 to 1993, following on from the 1988 to 1990 period when US contributions of noticeably less than 50 per cent equity were the norm.

Authors have also investigated the equity preferences of investors from different foreign countries. Beamish and Wang (1989) revealed that investors from Hong Kong seem much more willing to take a minority position than investors from Europe, the US or Japan. Whereas a minority share of less than 40 per cent has experienced the highest frequency within the group of Hong Kong investors (36.2%), within the groups of US, Japanese and European investors the highest frequency was observed with equal equity distribution (US: 33.9%, Japan: 46.3%, Europe: 46.7%). The Japanese investors in Pan's (1997) study were more likely to own a 50 per cent or higher equity share in the JV than US firms (55.2% to 44.4%).

### ***Joint venture control***

The share of ownership of the JV is perceived as a mechanism of control (Osland and Cavusgil, 1996). However, in chapter three it has been shown that ownership and control do not necessarily correlate (Killing, 1983; Schaan, 1988). Beamish (1993) suggests that in LDCs (such as China), foreign firms are typically able to exercise greater control than their equity levels would suggest. However, it is unclear whether this is due to the nature of their contribution, or to a more sophisticated knowledge of the control mechanisms available. Some 17 out of 22 JVs in Beamish's (1993) study indicated that split control is most common in China.

Shenkar (1990), Teagarden (1990) and Beamish (1993) consider it effective to divide up control along functional lines. To have one partner making nearly all decisions increases the probability of poor JV activity performance in China. The local economy, politics and culture in China are so far removed from the experience of most western firms and managers, as to make dominant foreign control extremely risky. Similarly, the Chinese lack of technology and managerial skills makes their dominant control equally risky. Teagarden and von Glinow (1990) observed Sino-foreign JVs that split the control of management functions became profitable faster than passive alliance forms. However, Ding's (1993) later examination of the linkage between control strategy and performance in Sino-US JVs, revealed that effective managerial control exercised by the US partner over the JV operation is positively related with the JVs' performance. He could not find any significant performance difference between US-dominant and shared management JVs.

As a measure of control, Osland and Cavusgil (1996) proposed determination of who makes the final decision on prices of the JV's output. In none of the ventures in Osland and Cavusgil's (1996) sample of eight Sino-US JVs and a total of 18 organisations in the US, China and Hong Kong, was this a Chinese manager. The authors argue that the structural variable 'JV size' affects the extent of control desired. In two of the JVs,

control is shared, in three the US has dominant control and in three other JVs it is split as each side manages the functions that it considers as most important.

The literature shows that marketing is controlled by the foreign side (Dong et al., 1993; Commerzbank, 1995; Osland and Cavusgil, 1996) as controlling marketing and sales secures long-term control over the JV. The foreign partner also controlled pricing (Osland and Cavusgil, 1996), and production (Commerzbank, 1995; Kim, 1996), whereas the human resources issue was considered best taken care of by the Chinese (Ireland, 1991; Woodward and Liu, 1993; Dong et al., 1993; Osland and Cavusgil, 1996; Kim, 1996). Conversely, however, scholars such as Hendryx (1986) and Tai (1988) regard retaining control of personnel management as imperative for the success of a business in China.

Kim (1996) argues that the external variables seem to be more important than the internal ones in controlling JVs. The partner who controls the external variables appears to have more influence on the direction of JV development. It is especially noteworthy that the variables close to the market (external-front end) are more important than external back-end variables (Kim, 1996). In three cases of Hong Kong firms, Kim (1996) revealed that the internal variables are mostly controlled by the Chinese, with the exception of production and operation functions. In contrast, in all three cases (Kim, 1996), foreign firms had majority control over the external variables. However, the findings relate to Hong Kong-based enterprises and the extent to which they can be transferred into the context of western firms has to be questioned. Studies have shown that Hong Kong FDI is different from that of, for instance, US firms which have more in common with the UK and Germany than Hong Kong (Dong et al., 1993).

Most dissatisfaction with JV performance occurred in the shared-control ventures in Osland and Cavusgil's (1996) sample where Chinese governmental bodies controlled production and pricing issues. Accordingly, Osland and Cavusgil (1996) insist that the sample JVs managed entirely by the US sides ranked as some of the best JVs in China, with sales growing strongly, seemingly solid long-term profitability, hard and soft technologies being transferred, a harmonious relationship between the partners being enjoyed, and stakeholders being very satisfied with the ventures.

The points of view of different nationalities' with regard to control over decision areas were investigated by Dong et al. (1993). The study made the distinction between western and Overseas Chinese investors. Its authors found that in both groups, foreign partners had much more control over such areas as product planning and quality control, and a little more over marketing. On the other side, local partners had more

control over production planning, wages and labour policy, and management recruitment. Dong et al. (1993) also found that on dividend policy, organisation, purchasing, budgeting, accounting as well as export and import, control was roughly shared between the partners. Compared with western companies, Overseas Chinese were found to have relatively more control over pricing policy, quality control, and export and import and to leave more control in the hands of their local partners on matters such as wage and labour policy and organisation. They also found that both partners co-operated with each other over the decisions on capital expenditure, organisation, product planning, budgeting, and loan funds, whereas disagreement arose more often in areas of dividend policy and quality control. However, disagreement often exists in the decision over pricing policy, accounting, management recruitment and marketing.

### ***Sino-foreign joint venture management***

Managing a JV in China differs from that in developed countries (Zamet and Bovarnick, 1986) and in other LDCs (Fan, 1996). Hofstede (1991) has argued that contrasting cultural characteristics of nations give rise to distinctive patterns of managerial behaviour. The hazards of JV management are particularly intense in Sino-foreign JVs due to extreme differences in managerial systems and philosophies (Davidson, 1987). It is "indeed frustrating and challenging" as one manager in Davidson's (1987, p.93) study of Sino-US JVs stated. An effective management style varies according to different cultures and the recognition and understanding of the cultural differences of groups helps to solve some of the problems in conducting international business (Chow et al., 1987; Campbell, 1989). The key to a JV's success is to be able to find the right management approach based on good communication and mutual understanding - a right balance between prescribed western management techniques and sensitivity to the Chinese culture (Ireland, 1991; Chua and Kin-Man, 1993; Fan, 1996).

Culture has a profound impact on JV management. In their comparative study of the attitudes of Chinese and American managers to JV success, Baird et al. (1990) found numerous significant attitudinal differences between 67 American and Chinese managers with regard to their management philosophies and their leadership behaviour. Differences between American and Chinese management thinking were discovered earlier by Nehemkis and Nehemkis (1980) from two cases of Sino-US JVs. Baird et al. (1990) further found that Chinese managers regard power relationships in their managerial philosophies as important, whereas US managers' management philosophies are much more personal, group- and delegation-oriented. Further, Chinese managers were less tolerant of ambiguity than their American colleagues.

Baird et al. (1990) discovered Chinese managers exercise an impersonal approach based on competition, collectivism and an emphasis on authority, whereas the Americans regard the involvement of equal-work groups as ideal. A problem affecting western managers highlighted by Baird et al. (1990) was vertical communication - the system of 'who-reports-to-whom' in the Chinese business. Hendryx (1986) found vertical lines of communication being initially stronger than any horizontal patterns instituted by a JV management. Von Glinow and Teagarden (1988) found that extreme departmentalism inhibits co-operation between individuals and between units.

From his early study of the Sino-US Tianjin-Otis JV, Hendryx (1986) discovered that autonomy among departments produces irrelevant activities and that strong vertical lines of communication produce a high degree of regional and inter-bureau rivalry. As strategies to combat vertical communication, Hendryx proposes articulation of company goals to all departments in the JV in an attempt to get them talking and co-operating and, in so doing, to integrate their activities to achieve common goals. The conflict of loyalty between the venture and the parent companies was also detected by Shenkar (1990) as a major JV management problem. As a solution, the Delegation of German Industry and Commerce Hong Kong (1995) recommends the operative management of the JV be left with the Chinese. Conversely, Stofan and Stultz (1991) insist that the general manager of the JV should be from the foreign party.

Hendryx (1986) also identified slow decision-making as a problem of JV management. He suggests many decision-making difficulties stem from the way the JV's board of directors is structured: although the board is the highest authority within the JV, the JV is subject to Chinese laws which are administered by bureaucrats. For this reason some successful JVs attempt from the very start to strengthen the power of their boards and the foreign general manager through negotiation and lobbying.

Subsequently, Ireland (1991) studied 30 US, European, Hong Kong-based and Japanese China investors. The study revealed US and European companies consider their management approaches fail to cope with a system where developing and using *guanxi* - facilitated by frequent interactions in both work and social contexts (Chua and Kin-Man, 1993) - is necessary to progress. Ireland (1991) discovered that all of the companies executed management changes in their JVs with foreign and Chinese elements. Many of the companies employed Chinese general managers to fuse foreign and domestic management goals. To this end, Davidson (1987) has pointed out that in an effort to develop a corps of effective Chinese managers, most JVs have been pairing up US and Chinese managers at the same levels. Ireland (1991) detected the extent to which Sino-foreign JVs have adopted formalised business procedures, such as a structured process for decision-making, varies greatly with the nationality of the

foreign partner. Among Hong Kong and European companies, about 50 per cent had made serious efforts to install formalised procedures, whereas the US expatriates had been frustrated over the slow absorption rate of these practices (Ireland, 1991).

Child and Markoczy (1993) investigated the behaviour of host country managers in 30 Sino-foreign JVs with European (11), US (7), Japanese (7) and Hong Kong-based (5) partners. The authors revealed that two-thirds of local managers were reluctant to make decisions and accept responsibility for their actions, were unwilling to share information or provide inadequate information. Also, communication between departments was considered very poor. Child and Markoczy also discovered that 29 foreign partner managers had observed great differences between their home country personnel practices and those they were obliged to follow in China. Eleven of the 30 JVs were able to recruit at their discretion on the open labour market. Others still experienced restrictions, especially pressures from local labour bureaux to take on people indiscriminately without regard to competence or required numbers. Only three of the JVs said that it was straightforward to lay off poor-performing workers. After some resistance, two-thirds of the JVs were operating incentive bonus schemes, while 40 per cent of them had a differential salary system aimed at reflecting responsibility.

Child and Markoczy (1993) propose Chinese JV managers, who were particularly reluctant to change existing practices and control in human resource management, were, conversely, willing to permit the importation of new commercial, financial and technical practices and even to accept foreign leadership in those areas.

Various authors have attempted to profile the Chinese manager (Davidson, 1987; Teagarden, 1988; Shenkar, 1990; Ireland, 1991; Woodward and Liu, 1993). China has experienced a lack of managers resulting from the Cultural Revolution in the sixties and seventies (Hendryx, 1986; von Glinow and Teagarden, 1988; Tsang, 1994). Davidson (1987) points out that the Chinese manager does not concern himself with the relationship between costs and revenues, that he is very cautious, lacks inter-departmental communication and has a poor relationship with workers. The author refers to the Chinese manager as somebody who implements other people's plans and who has an aversion to individual decision-making. This is confirmed in the studies of Shenkar (1990), Ireland (1991), and Woodward and Liu (1993). Accordingly, von Glinow and Teagarden (1988) found that the Chinese were not responsible for financial planning. Whereas Chinese managers are inexperienced in issues such as profit, planning, pricing, hiring and firing, cost control and marketing, the younger Chinese managers, aged between 30 and 40, were not as burdened by these traits (Woodward and Liu, 1993).

Worm (1997) from his study of Scandinavian businesses in China confirms this, suggesting that it is far from true that decision-making processes are always long and drawn-out in Chinese firms, many of which are small and patriarchal ]...[ these types of firms, often run by Overseas Chinese, or to an increasing extent by private Chinese entrepreneurs, are known to be very flexible, indicating rapid decision-making. Also Pearson (1997) in her recent contribution, 'China's new business elite' sheds light on a rather different species of Chinese managers, also in its historical context.<sup>11</sup>

Frequently, foreign investors expatriate managerial personnel to their JVs in China who manage and monitor the local venture. Wu (1993) argues that any firm that does not have such resources should avoid using high resources commitment modes to enter China. However, expatriate foreign management personnel in JVs in China frequently experience problems (Tung, 1982; Campbell, 1989). Tung (1982) suggests an expatriate failure in US MNEs of 30 to 40 per cent. Studying US corporate executives and their families in China, Tung (1986) discovered they experience problems both working and living in the different Chinese cultural environment. Root causes were the different Chinese lifestyle, customs and behaviours, inadequate facilities, the Chinese attitude toward life and foreigners, food and language difficulties.

The value of the above studies regarding the expatriation of personnel has been depreciating over time. Since the 1980s, when they were conducted and composed, the working environment in China has changed drastically and much of what was said more than ten years ago, is no longer valid. The situation for expatriates has improved remarkably, at least in the major cities along China's East coast.

One strategy for reducing high expatriate failure is sound preparation of staff due to be sent to China, for instance. Not only is it important to familiarise expatriate managers with the Chinese language but also with the socio-cultural differences between the home country and China (Commerzbank, 1995). Training expatriates for an appointment in China needs a special approach far removed from that which is applicable to other foreign locations. Earlier, Zamet and Bovarnick (1986) pointed out that, since China presents an alien environment, western standard practices need to be re-interpreted in order to prove effective. They discovered several characteristics that tend to separate foreign company expatriates in China from foreign company expatriates elsewhere, including the level of management that is more senior in China.

Worm (1997) in his study of 19 JVs and two WFOEs with Scandinavian parents provides an insight into multiple cultural differences between Chinese staff and Scandinavian expatriates. In a total of 44 interviews with managers of both cultural traits he establishes a relationship between cultural values (= independent variable)



and phenomena affected by cultural values and practices (= dependent variable). However, since Worm (1997) limits the applicability of his study to Scandinavians, as opposed to Europeans (such as UK and German), its value is not clear.

### 6.2.3 Joint venture performance

#### *Measurements of performance*

The performance of Sino-foreign JVs has been measured in various ways (Beamish, 1993; Dong et al., 1993; Glaister and Wang, 1993). Additionally, Osland and Cavusgil (1996) propose and discuss technology transfer and the export contribution of JVs, ie a JV performs if it transfers technology or if it contributes to exporting, although these measures seem to be measures applied by the Chinese side, rather than by the foreign investors. As in the general international JV context, Tang et al. (1992) have criticised the inappropriate application of performance measurement methods in the Sino-foreign JV context as well. This is based on validity and reliability problems.

Interestingly, when assessing the performance of JVs, foreign and Chinese partners do not apply the same standards. Tang et al. (1992) noted Chinese partner satisfaction ratings were much higher (mean = 7.5) than those of the foreign partners (mean = 3.5). Osland (1993), who studied the performance of Sino-US equity JVs from the perspectives of both US and Chinese managers, came to a similar conclusion. This coincides with parallel findings by Dong et al. (1993), who investigated performance assessment by both local and foreign partners in Sino-foreign JVs, based on profitability, growth, competitor comparison and overall satisfaction. In accordance, Osland and Cavusgil (1996), detected that US managers expressed more dissatisfaction with their JVs and their partners than did their Chinese counterparts.

Table 6-1: Findings on JV performance.

Study	Performance result
Davidson (1987)	More than two-thirds of 47 US enterprises achieved/exceeded performance expectations
Campbell (1989)	10 out of 13 Sino-foreign JVs claimed to have good or very good profitability
Eiteman (1990) <sup>12</sup>	10 out of 17 Sino-US JVs were an economic success
Pearson (1991)	Most of the interviewed managers were positive about the JVs' performance
Stelzer et al. (1992)	Nearly two-thirds of the Sino-US JVs met/exceeded performance expectations
Dong et al. (1993)	Foreign partner was satisfied with JV performance
Ding (1993)	53 per cent of the Sino-US JVs expressed a high level of satisfaction with financial performance
Commerzbank (1995)	47 per cent of the 45 German companies expressed satisfaction with the JVs' economic development
Osland and Cavusgil (1996)	43 managers and government officials were satisfied with the performance of eight Sino-US JVs. Each JV in the sample was profitable and in seven of the eight cases, profit levels exceeded both partners' expectations

Zhao and Culpepper (1997) in a study of 82 US and 107 Chinese managers aimed at ascertaining whether or not US and Chinese managers rate criteria within performance dimension groupings similarly. They found support for a greater similarity in performance assessment orientations among the two groups of parent managers than expected. Manager groups generally show a high level of agreement about which performance criteria are most crucial in JV performance assessment. In three of the five dimensions tested, ie the financial, marketing and relational dimensions, there was a remarkable correspondence in ratings of importance of criteria within dimensions suggesting the Chinese are further along the learning curve than previously thought.

### ***Expression of performance***

Opinion on the actual performance of Sino-foreign JVs is divided. Whereas some authors (Davidson, 1987; Kraus, 1989; Campbell, 1989; Eiteman, 1990; Pearson, 1991; Stelzer et al., 1992; Ding, 1993; Dong et al., 1993; Osland and Cavusgil, 1996) report strong performance of JVs, others have not found any evidence of positive JV performance. Table 6-1 summarises these findings.

All the above measures of performance are subjective and individual comparison between studies is difficult since good or very good profitability in one study might be considered only satisfactory in another. For instance, whereas Stelzer et al.'s (1992) foreign investors considered a return on investment (ROI) of 11.6 per cent as satisfactory, Cable & Wireless were disappointed by 15.2 per cent (Woodward and Liu, 1993). Can these JV performance satisfaction measures thus be expressed in quantitative terms? Various authors quantified the performance of Sino-foreign JVs. And here again, the opinion of the literature is divided. Whereas some sources report Sino-foreign JVs are profitable (Brown, 1985; Eiteman, 1990; Stelzer et al., 1992; Harwit, 1992; Shaw and Meier, 1993; Ding, 1993; Duffy, 1995; Commerzbank, 1995; FT, 25.6.96, p.6; China Daily, 2.11.96, p.3; Asien-Pazifik, 20.1.97, p.8), others point out that foreign investors find it difficult to make money with JVs in China (Tai, 1988; Shenkar, 1990; Baird et al., 1990; Newman, 1992; Beamish, 1993). Table 6-2 summarises quantitative findings on JV performance.

Negative voices about the performance of Sino-foreign JVs include that of Tai (1988, p.9). He points out that "whatever money is made by foreign-financed enterprises, it is not made in anywhere near the quantity or with anywhere near the ease expected." According to Shenkar (1990), many JVs in China seem to have run into major difficulties. Table 6-3 summarises the findings of dissatisfactory JV performance.

Sino-foreign JV performance was also expressed in stability terms. 16 out of Beamish's (1993) 22 JVs were relatively stable, though the author does not specify

how stable 'relatively stable' ventures are. Conversely, Osland and Cavusgil (1996) discovered instability in their sample of Sino-US JVs.

Table 6-2: Quantitative findings on JV performance.

Study	Performance result
Stelzer et al. (1992)	60 per cent of the US parents reported a five-year-average RoI of 10 per cent or higher. The overall average was 11.6 per cent
Shaw and Meier (1993)	More than half of the foreign investors made a return on sales of 10 per cent and another third achieved between 6 and 10 per cent
Commerzbank (1995)	Nearly half of the 45 Sino-German JVs that were older than two years achieved an average profit of 8.5 per cent of turnover after tax
Duffy (1995)	80 per cent of the approximately 6,000 Sino-foreign JVs in Shanghai made money, though the average profits were modest at about US\$150,000
FT (25.6.96, p.6)	Hong Kong investors made return of approximately 25 per cent
China Daily (2.11.96, p.3); Asien-Pazifik (20.1.97, p.8)	The majority of the 500 or so biggest Sino-foreign ventures were profitable in 1995 (concentrated in electronics, machinery, food processing, textiles, garments, automobiles)

### **Reasons for success and failure**

From his study of 47 US firms with JVs in China, Davidson (1987) suggests that JV performance depends largely upon qualitative variables such as individual personalities, organisational cultures, administration styles and management philosophies. This finds confirmation in the work of Tai (1988) who also considers cultural variables as important factors for the success or failure of Sino-foreign JVs. Subsequently also Beamish and Wang (1989) consider personal attributes as important for JV success in China. In detail, a long-term flexible attitude to overcome foreign exchange difficulties, to offer China what it needs, to show patience and willingness to reconsider some of the traditional methods Chinese have used for the execution of business, are considered as success factors for JV activity.

Table 6-3: Findings on dissatisfactory JV performance.

Study	Performance result
Beamish (1993)	14 of 22 MNEs assessed the JV performance as unsatisfactory
FT (16.2.98, p.2)	FIDUCIA (China-based management consultancy) finds that 54 per cent of 96 managers of Sino-European investments in China indicated that JVs had performed worse than planned

Later, Wilpert and Scharpf (1990) researched the factors for success and failure in Sino-German JVs and examined the impact of socio-cultural values on the behaviour of interacting managerial systems and managers from two different cultures. The authors discovered significant differences in the concepts of time, quality, space and privacy. While for German managers time was a limited good, it was not for the

Chinese. Tolerance in terms of quality was wider in the Chinese than in the German concept and finally, German managers needed more space and privacy than did the Chinese managers. For foreign firms to be successful in the Chinese environment, acknowledgement of the different cultural setting is of considerable importance.

Personal qualities, such as sincerity, good faith, honesty and patience were also found by Au and Enderwick (1994) from their study of 13 New Zealand SMEs with JVs in China as the most important factors for success. In Au and Enderwick's study, personal factors were considered even more important than knowledge of the target country, familiarity with the Chinese business practices, good business connections, and relationships with Chinese officials.

On the other hand, there are a variety of factors that constitute problems for foreign investors and, in cases, eventually cause JV dissatisfaction, even failure. Economic and management problems, including an over-estimation of the Chinese market, low labour productivity, unavailability of raw materials, and slow bureaucratic decision-making were considered to be the most significant difficulties for JV activity in China. This by the four UK companies in Woodward and Liu's (1993)<sup>13</sup> and the 13 New Zealand investors in Au and Enderwick's (1994) study, as well as the 96 managers of Sino-European investment projects in the FIDUCIA study (FT, 16.2.98, p.2). However, problems for foreign JV entrepreneurs were also caused by the country's inadequate infrastructure. This was repeatedly suggested by authors, including Tai (1988), Dutta and Merva (1990), Woodward and Liu (1993) and Gledhill (1994).

Hu and Chen (1997) from their research of 2,576 Sino-foreign JVs found that performance of such ventures is more dependent upon partner-related factors, such as partner commitment, and number of partners than JV- or environment-related factors, such as product/industry characteristics and location. In detail, the authors detected a positive correlation between the number of partners and performance. The same applies to JV duration and total JV investment. However, the authors found the effect of control on performance to be insignificant.

The results of the Au and Enderwick (1994) study have to be treated with caution. Out of an initial sample of 13 China investors, only two SMEs 'survived' the JV process and reliable insights are thus based on only two respondents. Equally, although the findings of the FIDUCIA study are the most recent available, the study only presents frequencies of pre-determined answers. New insights into the problems of JVs in China of foreign (here European) companies could not be captured by the FIDUCIA study. A more qualitative approach could have met this methodological shortcoming.

According to Davidson's (1987) and Köhler and Wäscher's (1989) early investigations of the difficulties of joint venturing in China, problems were more technical in nature. These included staffing, operational procedures, transfer pricing, sourcing, technology selection, dividend policy, product line, pricing, cost/investment allocation, market priorities and management control. Köhler and Wäscher (1989) investigated the problems of 14 German enterprises during the formation of their JVs in China. The authors split the JV development process into five phases: initiation, negotiation, waiting, implementation and operation. Found to cause difficulties for German investors in China were the long duration and cost of negotiations, unclear instances, and the limited competencies and responsibilities exercised by the Chinese institutions and bureaucracy. The authors found relatively few problems in the implementation phase, though they were more severe. They included language and translation problems. Köhler and Wäscher (1989) also discovered numerous problems with input factors for production in China, with Chinese managers and pioneering personnel being the most frequently stated.

Later, Shenkar (1990), studying the cases of three Sino-foreign JVs,<sup>14</sup> found that many of the problems experienced by the JVs were a product of their structural complexity rather than the cultural and political differences between the foreign and the Chinese parent environments. Shenkar's (1990) cultural impact-neglecting statement was rather new in the international JV literature. However, the author's simplistic framework fails to assess the differential weight of cultural, economic, political and legal factors. Furthermore it lacks differentiation between different types of JVs, eg different ownership constellations. In accord with Shenkar (1990), Bennet and Zhao's (1995) UK companies reported cultural and management difficulties to be less of an issue in the transfer of technology to China than negotiations, habit and bureaucracy.

Conversely, from a survey of 121 of the 250 largest listed companies in the UK with direct investments in China,<sup>15</sup> Gledhill (1994) proposes cultural issues, legal and regulatory aspects as the major difficulties for foreign (UK) companies when investing in China. This is supported by findings in the study of the Delegation of German Industry and Commerce Hong Kong (1995). However, there is no ranking provided. As a result, it can only be assumed that the order of presentation corresponds with the order of importance. Operational issues that were all too important in Shenkar's (1990) research were less weighty than in that of Gledhill (1994) and the Delegation of German Industry and Commerce Hong Kong (1995).

Interestingly, language difficulties were a problem for only a few of the respondents in Gledhill's (1994) study. However, he fails to provide details for this: Did the companies consider the language barrier as not too important? Did their partners in the Chinese

companies all speak English? Or had their own staff a good command of the Chinese language? No answers are given to these questions, indicating, again, the dominant positivist approach of studies, such as those of Gledhill (1994) and of the Delegation of German Industry and Commerce Hong Kong (1995). Conversely, Frankenstein (1986), Eiteman (1990) and Ireland (1991) categorised the lack of language skills as a major obstacle to the smooth operation of Sino-foreign JVs.

### **6.3 Conclusion**

Chapter six has developed further the JV model framework that has been designed in chapter three of this thesis. Fan's (1996) JV research framework comes closest, meeting the requirements of an analytical JV model being used in this thesis to evaluate the appropriateness of the entry strategy for UK and German SMEs into the Chinese market. Various authors have written on issues in the joint venturing of foreign investors in China. However, only few have carried out research into the joint venturing in China of SMEs – an unsurprising result, bearing in mind the literature on SME internationalisation (chapter two) and international JVs (chapter three).

The greatest difference between the literature on international JVs, and in particular those in mature market economies ]...[ of Killing (1983) and Harrigan (1985) is that a demarcation line between the formation and operation phases in the model cannot be drawn. Instead, the operation phase in a Sino-foreign JV is a continuation of the formation phase of such a venture.

## Notes

<sup>1</sup> In his work of 1985, Beamish distinguished between countries based on their state of development. For details see the characteristics in Beamish (1985). Additional characteristics are: origin of investment, announced JVs actually enacted, use of JVs versus other modes of involvement, use of JVs with a pre-determined duration.

<sup>2</sup> Two dimensional matrix with two poles, JV status and content.

<sup>3</sup> The number of studies was 32.

<sup>4</sup> The study was carried out in 1996 by Jan Bülk and analysed and written up by the candidate. It was finally published by the Delegation of German Industry and Commerce Shanghai in 1997.

<sup>5</sup> Published as 'Direktinvestitionen in China - ein Handbuch für den Mittelstand' in 1997, jointly by the Delegation of German Industry and Commerce Shanghai and the German Association of Chambers of Commerce (DIHT), Bonn.

<sup>6</sup> The literature on Sino-foreign JVs has suggested a variety of advantages, including a faster realisation of sales volumes, compared with WFOEs, greater revenues, lower costs and less risk, creation of power vis-à-vis competitors, faster project approval through the help of a local partner, preferential treatment with regard to raw material sourcing, and with the recruitment of personnel and managers (Newman, 1992; Gledhill, 1994; Delegation of German Industry and Commerce Hong Kong, 1995; Osland and Cavusgil, 1996). The Delegation of German Industry and Commerce Hong Kong (1995), in its survey of 165 German companies of which 120 were already active in China, also insisted on the preferential treatment of Sino-foreign JVs with regard to taxes, importation regulations and legal conditions. However, during the past few years preferential treatments have been gradually withdrawn by the Chinese government. The latter study's emphasis on German firms in Hong Kong with operations in mainland China, its all-embracing approach (investment forms, location analysis, industry and regional focus, motivations) and its exclusive positivist approach, limit the applicability of its findings.

On the Chinese side, JVs are welcome since they co-develop China's economy through the transfer of technology, the acquisition of managerial skills, influx of capital, infrastructure development and generation of foreign exchange (Daniels et al., 1985; Stofan and Stultz, 1991; Tang et al., 1992; Woodward and Liu, 1993; de Bruijn and Jia, 1993; Dong et al., 1993; Delegation of German Industry and Commerce Hong Kong, 1995; Osland and Cavusgil, 1996). Thoburn et al. (1990) argue that, compared with compensation trade arrangements, JVs introduce to China new, instead of second-hand, equipment. To this end, von Glinow and Teagarden (1988) as well as Dutta and Merva (1990) highlight the Chinese' exclusive interest in 'state-of-the-art' technology. The Chinese feel cheated, so found Köhler and Wäscher (1989), if the foreign partner wants to bring in older, though more adequate, machines. It is not surprising perhaps that Davidson (1987) and de Bruijn and Jia (1993b) found that US and Japanese firms, respectively were reluctant to transfer technology to China since they fear that China, once it has the 'state-of-the-art' technology, could become a competitor. On the other hand, Bennett and Zhao (1995) in a study of 207 UK companies of which 75 were already engaged in transferring technology to China and the others having expressed an interest in doing so, discovered that UK companies were much more willing to transfer their technology and believed that the conditions for doing so have improved.

In fact, technology transfer into China has attracted considerable interest among the research community (Duscha, 1987; Roessner et al., 1992; Woodward and Liu, 1993; Jia, 1993; de Bruijn and Jia, 1993, b; Tsang, 1994). Duscha (1987) investigated the characteristics, forms, locations and consequences of transferring technology to China through co-operation between Chinese and foreign enterprises, focusing on 22 Sino-foreign equity JVs. Duscha's (1987) study, while responsible for opening the discussion into a variety of issues of FDI in China, is rather dated, like Campbell's (1989) work. These studies carried out in the 1980s cannot be more than a starting point for research in many aspects, although Campbell (1989, p.2) refers to his work as the "most comprehensive analysis of equity JVs in China yet

published." The investment framework in China has since changed drastically: investment priorities have changed and so have preferential treatments for foreign investors, labour regulations, etc. as well as the conditions for expatriates, for instance. Furthermore, Campbell's (1989) work does not provide a distinction in the data of, for instance UK and German investments, or even between European and other OECD investors.

Later, Tsang (1994) established a framework for analysing the factors which influence the mode of international technology transfer, defining the best strategic options for transferring technology for large enterprises as well as SMEs. He found that, unlike WFOEs, JVs enable the Chinese to share the management with the foreign partner and to receive comprehensive on-the-job training in corporate management. Equally, JVs are the only vehicles of technology transfer that allow foreign firms to participate in the Chinese market while keeping control over the activities. Lan (1996) criticised the low efficiency of JVs in transferring technology to China. However, the general applicability of Lan's statement must be challenged: the study is confined to a sample of 172 investors (JVs and WFOEs) from Hong Kong, Macao and Taiwan, 115 from Japan and 74 from western nations in the Northeastern Chinese city of Dalian, exclusively. Legal aspect studies on technology transfer include Seid (1996), Hill and Evans (1996), Simpson (1996), Birden (1996) and Savona (1996).

De Bruijn and Jia (1997), on the contrary, shed light on the JV in China of the late 1990s where such a strategy faces new economic and legal conditions which require changes in the way existing JVs operate and new JVs are structured.

<sup>7</sup> For a discussion of the advantages and disadvantages of both strategies see Kaiser and Grimm et al. (1997, chapter nine).

<sup>8</sup> Another study that investigates the negotiation process involving US executives is Adler et al. (1996). However, the study does not offer relevant new insight.

<sup>9</sup> A comprehensive set of negotiating recommendations for preparing, carrying out and concluding negotiations is provided in Shenkar and Ronen (1993).

<sup>10</sup> The total sample consisted of 840 JVs.

<sup>11</sup> See also and Darby (1995) on 'management and customer orientation in Sino-foreign JVs'.

<sup>12</sup> Eitemann (1990) surveyed 25 US companies that were involved in negotiations with Chinese. 18 firms eventually established a JV. Of those, one firm abandoned it before an assessment was possible.

<sup>13</sup> Three UK companies had a JV and one a compensation trade agreement.

<sup>14</sup> Hewlett-Packard China Ltd., Ramada Renaissance Guilin, Hubei Pig Improvement Company Ltd.

<sup>15</sup> Companies other than those with a totally domestic business. 31% of the companies have already invested in China. 37% plan to do so. 53% of the investors have done so with JVs.



## Chapter Seven

# Survey Results

### 7.1 Introduction

This chapter presents the findings from the questionnaire surveys carried out in the UK and in Germany. In cases (UK-2, UK-6 and UK-7), the survey findings are supplemented by in-depth information derived from interviews with managerial personnel at these small and medium-sized enterprises (SMEs).<sup>1</sup> The structure of this chapter follows the research pattern of the JV framework that has been developed in chapters three and six. The data from the questionnaire surveys in the UK and in Germany are analysed two-dimensionally: first, with respect to the nationality of the SMEs and, second, with respect to the firm size of the companies. Thereby two size categories are established as in earlier research by Braun (1982), for instance. The firm size category one (Size One) has between one and 200 employees and the firm size category two (Size Two) between 201 and 500 employees. The distribution of the UK and German SMEs, according to this categorisation is indicated in table 7-1. Contingency analysis of the data shows that there is no significant relationship between the criteria 'nationality' and 'firm size'.<sup>2</sup>

Table 7-1: Distribution of SMEs according to nationality and firm size.

Firm size category	UK SMEs	German SMEs	Σ
Size One (1- 200)	4	6	10
Size Two (201 – 500)	4	5	9
Mv	1	1	2
Σ	9	12	21

Note: mv = missing value.

For reasons of confidentiality, the names of the UK and German SMEs have been disguised. Instead, these companies are referred to as UK-1 to UK-9 and GER-1 to GER-12, respectively, and these companies' joint venture (JV) operations as UK-1-JV to UK-9-JV and GER-1-JV to GER-12-JV. Equally, the German case study firm (see chapters four and eight) is referred to as GER-0 and its JV as GER-0-JV. The individual products and locations of the JVs have been disguised, too. This has been considered necessary due to the (perceived) relatively small number of UK and German SME investment projects in China.

The survey data presented in this chapter is analysed applying frequency analysis. Similarities and differences between the responses of each of the two groups of SMEs (UK - German; Size One - Size Two) are analysed for their significance by applying Spearman's Rank Correlation Coefficient.<sup>3</sup>

The subsequent chapter eight cross analyses four cases of UK and German SMEs with JVs in China, including GER-0, UK-3, UK-4 and UK-8. In chapter nine, the survey and case study findings are discussed.

It is worth noting the respondents have not always consistently answered all questions, particularly when they were asked for financial information which included turnovers, investment figures and expatriate remuneration. In these cases, missing values were accepted and these are indicated in the tables containing the survey data by 'mv'.

## **7.2 Survey results**

### **7.2.1 SME background information**

#### ***Ownership***

Of the nine UK SMEs, eight were limited liability companies and one was a public limited company. In contrast, nine of the 12 German SMEs were organised as limited liability companies (German equivalent = GmbH) and three as limited partnerships (German equivalent = KG).

#### ***Industry***

All nine UK SMEs were engaged in manufacturing; seven of those in mechanical engineering, one in electronics and another one in construction. Ten of the German SMEs operate in manufacturing and two in services. Of the manufacturers, six were active in mechanical engineering, three in electronics and one in textiles. Kaiser and Grimm et al. (1997) suggest that investments in the automotive, machine building and electronics industries are relatively most frequently represented by German companies. For instance, of the total of 293 German-funded investment projects in China that were examined, 18 per cent were active in the machine building industry and 17 per cent in electronics. A further 4 per cent of the companies were operating in the textiles industry. Comparison of the empirical findings in this thesis and the earlier findings by Kaiser and Grimm et al. (1997) suggest, therefore, agreement in their individual distribution of investment projects, particularly as many automotive investments in the Kaiser and Grimm et al. (1997) classification could be classified as mechanical engineering investments in a broader sense.

A substantially different industry structure was identified by Thoburn et al. (1990) studying the experiences of Hong Kong firms in China. He discovered investment industry sectors, including footwear, textiles and clothing, food, metal products, services and electronics. This suggests that Hong Kong firms entered China more often due to its availability of cheap labour, rather than its market prospects.

### ***Number of employees***

On average, the UK SMEs employ more personnel than the German SMEs. The UK firms had an average workforce of 237 employees. In detail, four firms had up to 200 employees and four firms had between 201 and 500 employees.<sup>4</sup> One UK respondent refused to release information. The eleven German SMEs that provided information employed, on average, 217 staff. In detail, six companies had up to 200 employees and five had between 201 and 500 employees.

### ***Countries of activity***

Of the UK SMEs, none was active in fewer than ten countries. Detailed statements are not possible, however, since the respondents did not specify which countries, exactly, they were doing business in. Instead they indicated that they were active in more than ten, more than 40, 60, 100 countries or active worldwide. The same applies to the German SMEs. For instance, three German SMEs indicated that they were active worldwide, two were operating in Europe and another two specified Europe by adding West and East. Two SMEs were operating in the US and Europe and, additionally, in Africa and Asia, respectively. Only three respondents quantified their answers, suggesting that they were active in more than ten, more than 40 and more than 50 countries, respectively.

With regard to size of the participating firms, the data do not suggest a meaningful trend. Although, within the UK SMEs, Size One SMEs were active worldwide or in more than 40 countries, similar answers were provided by the larger firms and the same applies to the German SMEs.

### ***Foreign operations***

The JV in China was the sole foreign operation for three UK SMEs. The remaining firms had either a second JV, a representative office or a wholly foreign-owned enterprise (WFOE), in addition to their China-based JV. In contrast, most (six) of the German SMEs only had their JV in China. The other SMEs had a representative office, another JV or a WFOE. As the literature in chapter two suggests, the smaller SMEs have fewer foreign operations compared with the larger firms. None of the smaller UK SMEs had a WFOE. Less clear is the relationship in the case of the German SMEs. Whereas four smaller SMEs have one JV, only one has, in addition, a representative office and another one has a second JV. Comparable findings result from the German Size Two SMEs with the notable exception that one of these firms had two WFOE and two JVs (table 7-2).

Table 7-2: SME background information.

Dimension	UK SMEs	German SMEs
Ownership	8 * Ltd.; 1 * Plc	9 * GmbH; 3 * KG
Industry	7 * mech. eng.; 1 * electr.; 1 * construct.	6 * mech. eng.; 3 * electr.; 1 * textiles; 2 * services
Number of employees	237 (average)	217 (average)

### 7.2.2 China experience

Of the UK SMEs, one had 17 years of business experience with China prior to engaging in its JV while others had ten, eight and five years. One SME did not specify this, but indicated that it had been "exporting machinery for several years." Three UK companies had no prior experience with China. Of the German SMEs, all but two had previous experience of doing business with China in the form of exporting (4), exporting and licensing (3), licensing (1), joint venturing (1) and buying (1). The smaller UK SMEs did not have considerable experience with China prior to engaging in their JV. This appears to contradict the staged approach of internationalisation examined in chapter two. There it has been outlined that especially smaller firms would gain experience through other marketing servicing means before engaging in a JV. The German SMEs did not specify the length of their export commitment, making it impossible to correlate firm size and the duration of the enterprises' China commitment.

### 7.2.3 Joint venture formation

#### *Joint venture planning*

The eight UK SMEs that answered the question of how they had planned their China JV, insisted that they planned their JV project in about the same way as their other projects elsewhere. The mean value was 3.4 on a scale from one to five, whereas one indicated that the project was planned much better than its operations are usually planned. Five SMEs stated that the JV project in China was not planned as well as operations are usually planned. The JVs of the eight German SMEs that answered this question, were also planned in a similar manner as the German SMEs' other operations elsewhere. However, the mean rating here was 2.6 suggesting a tendency that the German SME JVs were perceived to be planned slightly better than the UK SME JVs. The analysis of the data further showed that Size Two firms perceived that the planning of their operations was slightly better (mean rating = 2.9) than their usual operations, than Size One firms did (3.1). This confirms findings in the literature (chapter three) suggesting that there is a tendency that the accuracy of planning diminishes with decreasing firm size.

UK-7's company executives carried out on-site research (market and environment) while participating in a UK department of trade and industry (DTI)-sponsored trade mission to China. UK-2 which intended to target industrial clients, merely thought that "you need to test your material and products if you want to manufacture in China." A formal business plan, however, was never produced. This was also the case with UK-6 whose business plan estimated that there was a market that would absorb 40 units of equipment in the first year and 100 units in the second year. However, the figures were rather vague and not based on any solid market evaluation.

### ***Motivations for production in China***

This question consisted of two parts, to satisfy the requirement of motivation exploration outlined in sections 3.2.1 and 6.3.1 of chapters three and six, respectively. While the first question asked why the SMEs engaged in an FDI project, the second explored why they had chosen a JV instead of a WFOE.

### Motivations to engage in an FDI project

As table 7-3 reveals, the most important motivation of both the UK and German SMEs was access to the vast Chinese market. The market motive was also suggested in chapter two as motivation for SMEs to seek a foreign investment project. Of a total of 21 UK and German SMEs, only two companies sought local manufacture to service export markets exclusively. A further important motivation for the SMEs was the fact that an FDI presence in the Chinese market would allow them to enter the market faster. Reaction times are much shorter if a firm is present locally. Consumer needs can be recognised and implemented faster than with exporting, since the flow of information through the export channel takes much longer.

Table 7-3: Motivations for engaging in an FDI project in China.

Motivations	UK SMEs			GER SMEs			Size One			Size Two		
	I	R	n	I	R	n	I	R	n	I	R	n
Potential market	1.3	1	9	1.8	1	12	1.3	1	10	1.8	1	11
Strategic Asia-Pacific position	1.8	2	9	2.2	4	11	2.0	3	10	2.0	2	10
Cheap labour	2.2	3	9	1.8	1	12	1.9	2	10	2.1	3	11
Faster market entry	2.4	4	9	2.3	5	12	2.1	4	10	2.5	5	11
Necessary to be there	2.9	5	7	1.9	3	11	2.4	5	9	2.1	3	9
Overcome import duty	2.9	5	8	3.4	7	10	3.1	8	9	3.2	7	9
Following customers	3.0	7	7	5.0	9	9	4.1	9	7	4.1	9	9
Raw materials	3.1	8	8	2.5	6	11	2.9	6	9	2.7	6	10
Approached by PRC	3.1	8	7	3.8	8	9	3.0	7	7	3.9	8	9

Key: I = importance, R = rank, n = respondents.  $r_{sp\_nat} = .7792$ ;  $r_{sp\_size} = .9292$ ;  $r_{sp\_crit} (\alpha = .05) = .5833$ ;  $r_{sp\_crit} (\alpha = .01) = .7667$ .

The SMEs further considered the necessity 'to be there' as an important motivation for engaging in FDI activity in China. Also the UK and German SMEs considered the availability of cheap labour as important. Cost competitive manufacturing in the

Chinese market would also allow the SMEs to establish a strategic position from where to service neighbouring markets in Asia.

Both UK and German SMEs considered the bypassing of the imposition of import duties to be moderately important. Also, the UK and German SMEs would, as a trend, not shift production to China for reasons of raw material availability. Equally, most SMEs did not move to China because of the approach by a Chinese organisation. Finally, the UK and German SMEs did not move to China-based production because they followed a customer.

Overall, the perceived importance of the motivations of the UK and German SMEs for establishing an FDI presence is statistically similar at the 5 per cent significance level ( $r_{sp\_nat} = .7792$ ).

The Chinese market's vast potential, the establishment of a strategic position within the Asia-Pacific region and the availability of cheap labour were also amongst the most important motivations for establishing an FDI presence of both Size One and Size Two SMEs. With a correlation coefficient of  $r_{sp\_size} = .9292$  the ranking of the importance of the individual FDI establishment motivations suggests similarity at both the 5 per cent and the 1 per cent significance levels.

This suggests that neither nationality nor firm size significantly influence the perception of the importance of motivations for establishing a direct investment operation in China. However, nationality is more likely to be a discriminator between the SMEs.

#### Motivations to form a joint venture

Table 7-4: Motivations to form a JV instead of a WFOE.

Motivations	UK SMEs			GER SMEs			Size One			Size Two		
	I	R	n	I	R	n	I	R	n	I	R	n
Partner's China business knowl.	1.8	1	9	2.8	12	11	2.6	10	9	2.2	1	11
Required by PRC	2.0	2	8	2.7	10	10	2.2	5	9	2.8	8	9
Smooth way through bureacr.	2.2	3	9	2.2	4	10	1.8	2	10	2.7	6	9
Partner's knowledge of customer	2.3	4	9	2.1	3	12	2.2	5	10	2.2	1	11
Less financial input	2.4	5	9	1.7	1	10	1.6	1	8	2.4	3	11
Strat. action to pre-empt compet.	2.4	5	9	3.0	15	8	2.0	3	8	3.1	11	9
Favourable government treatm.	2.6	7	9	2.6	9	9	2.3	7	9	2.8	8	9
Limitation of risk	2.6	7	9	2.4	5	8	2.3	7	8	2.7	6	9
Less management input	2.8	9	9	2.0	2	10	2.1	4	9	3.0	10	10
Overcoming national. prejudice	3.0	10	9	2.4	5	9	4.7	16	7	2.5	5	13
Access to raw materials	3.1	11	8	2.5	7	11	3.0	12	10	2.4	3	9
Political insurance	3.2	12	9	2.8	12	9	2.9	11	10	3.1	11	8
Sharing of distribution channels	3.3	13	8	2.5	7	11	2.5	9	10	3.2	14	9
Access to partner's skills	3.7	14	9	2.7	10	10	3.2	13	9	3.1	11	10
Trade union relationship	4.1	15	9	4.2	16	11	4.1	15	10	4.2	16	10
Access to partner's technology	4.2	16	9	2.9	14	12	3.5	14	10	3.5	15	11

Key: I = importance, R = rank, n = respondents.  $r_{sp\_nat} = .3412$ ;  $r_{sp\_size} = .3415$ ;  $r_{sp\_crit} (\alpha = .05) = .4265$ ;  $r_{sp\_crit} (\alpha = .01) = .5824$ .

The reasons for the UK and German SMEs to exploit the Chinese market potential and cheap labour in the form of a JV (table 7-4) were substantially different at the 5 per cent significance level ( $t_{sp\_nat} = .3412$ ). The UK SMEs decided, first and foremost, to joint venture because of the potential Chinese partner's business knowledge, its ability to smooth the way through the Chinese bureaucracy and its knowledge of customers. In other words, the UK SMEs sought attributes of their potential Chinese partners. The SMEs believed that their potential Chinese partners would contribute something to the JV that the SMEs could not provide themselves.

UK-6 had considered the alternative of setting up a WFOE for "about five minutes only." The main reason for rejecting this strategy was the lack of knowledge of the Chinese market and the culture which would have meant recruiting "a lot of Chinese management capacity." From engaging in a JV, the UK SME expected cultural guidance through local operation conditions, local labour laws and factory regulations and better access to local customers. Also UK-2 sought the Chinese element which could open doors for the UK SME that "would otherwise be closed."

An interesting aspect is that the UK SMEs engaged in JV activity because they felt that this was required by the Chinese government. This argument ranked surprisingly high (second).

The German SMEs' most important motivations for engaging in a JV were rather different from the UK SMEs'. It seems that the German SMEs were seeking, first and foremost, assets rather than the attributes of their potential Chinese partners. In detail, the German SMEs considered establishing a JV because they could save financial and managerial resources as established in chapter two, as the critical 'ingredients' for SME internationalisation. The empirical findings within the group of UK SMEs suggests that for them, the resource inputs of the potential Chinese partners are less important. This contradicts the findings in the literature in chapter six.

For some UK SMEs the Chinese partner's potential resource contribution was an important argument. UK-6, for example, hoped to be able to expand with only a reduced management commitment and UK-7's prime reason for not going it alone in China was that a WFOE would have required a large amount of capital. However, UK-7 also lacked the essential contacts and did not have the management talent in order to "run the show on the spot." This particular case confirms the opinion of the literature in chapter two, as why enterprises engage in a JV rather than a WFOE.

With regard to the partner's knowledge of customers and its ability to smooth the way through bureaucracy, the attitudes of both UK and German SMEs towards JVs were

similar. However, what was most important for the UK SMEs (business knowledge and the requirements of the Chinese government), was only of medium importance to the German SMEs.

Both groups of SMEs further sought to limit financial and business risk and hoped to be granted favourable government treatment through joining forces with a Chinese company. UK-6 believed that the Chinese government would grant favourable treatment in terms of tax reductions, protective tariffs, foreign exchange regulations and input permits. However, the respondent could not specify where exactly these favourable treatments had appeared. Apparently, the potential Chinese partner had indicated this or the SME had done some reading about investment locations in China. It appears also that the UK SME had no sound understanding of the provision of location incentives, revealing a clear lack of in-depth research on the part of the SME.

The UK and German SMEs showed further similarities: they do not desire the Chinese partner's technology, do not appreciate the potential partner's trade union relationships nor the Chinese company's skills and they do not believe that having a Chinese partner works as political insurance. However, UK-6 feared the risk of expropriation and considered the JV as political insurance. The SME anticipated political conflicts, such as escalating disputes with the US over issues of intellectual property rights.

Also Size One and Size Two SMEs showed significant differences at the 5 per cent significance level with respect to the ranking of the perceived importance of individual motivations for engaging in a JV, instead of a WFOE ( $r_{sp\_size} = .3415$ ). Whereas for Size Two SMEs the partner's China business knowledge is the most important, it is only the tenth important for Size One SMEs. Equally important for Size Two SMEs was the partner's knowledge of customers and the third most important motivation for this group of SMEs was the fact that joint venturing demands less financial input and an easier access to raw materials. On the other hand, the most important motivation for Size One SMEs was the partner's contribution of finance and its ability to smooth the way through bureaucracy. Size One SMEs also considered their JV establishment as a move towards pre-empting competition.

With regard to the least important motivations for engaging in a JV, both Size One and Size Two SMEs showed considerable agreement. They did not engage in a JV solely to get access to the partner's skills or its technology or because of the partner's relationship with trade unions.

### ***Partner selection***

#### **Finding the partner**

According to table 7-5, for both the UK and the German SMEs, the approach by a Chinese company was the most important way of finding a partner, although a Chinese



company's approach was only of minor importance for engaging in an FDI project in the first place (see table 7-3).

UK-7 was approached by Chinese authorities that were searching for a company to team up with to manufacture INFRASTRUCTURE SYSTEMS. The idea of joint venturing with a Chinese company that was sought by the port authorities of CITY [North China] with help from the relevant Chinese ministry was so new for UK-7 and inevitably linked with one particular Chinese company that an alternative partner was never considered.

Table 7-5: Ways of finding the partner.

Way of finding partner	UK SMEs		GER SMEs		Size One		Size Two	
	F	R	F	R	F	R	F	R
Approached by Chinese side	3	1	4	1	2	2	5	1
Partner was agent	2	2	2	2	2	2	2	2
Chinese organisation helped	2	2	2	2	3	1	1	5
Home organisation helped	1	4	0	6	1	4	0	6
Other	1*	4	2	2	1	4	2	2
Partner met at trade fair in China	0	6	2	2	0	6	2	2
Partner met at trade fair at home	0	6	0	6	0	6	0	6
Alternative partners for choice	6		9		7		8	

Key: F = frequency, R = rank, n = respondents. Comment: \* "sought them ourselves."  $r_{sp\_nat} = .5136$ ;  $r_{sp\_size} = .2075$ ;  $r_{sp\_crit} (\alpha = .05) = .6786$ ;  $r_{sp\_crit} (\alpha = .01) = .8571$ .

An important way of finding a partner for a later JV for both the UK and the German SMEs was also the teaming up with a former agent of the SME. This strategy saves time, management and finance. One of UK-2's two partners in the JV, a Taiwanese company, had been a good agent acting on behalf of the UK SME in Taiwan. The Taiwanese company had carried out "one or two businesses" in China. Thus, UK-2 relied on the Taiwanese company to find a potential Chinese partner to team up with. UK-2 did not consider alternatives itself. A similar situation applies to UK-7 that also has two partners. The SME had known its Singaporean partner as an agent "long and well and the Singaporean company introduced the whole thing to us." Both UK SMEs relied on their Taiwanese and Singaporean partners, respectively, to select an appropriate Chinese partner company.

The UK and German SMEs also reported the helping hand of a Chinese organisation as having contributed to finding the JV partner. However, this proves a risky strategy since Chinese organisations represent their own interests, rather than those of UK or German SMEs when proposing a Chinese partner company to them.

Whereas UK-2 and UK-7 had their Taiwanese and Singaporean partners, respectively, who searched for, and selected, a Chinese company to team up with, UK-6 did its own

homework. Although the SME had been exporting machinery to China for some years, it had not established any relationship with its current partner prior to forming the JV. However, the county where UK-6 is located has close ties with the government of the Chinese partner's province and had sent various UK delegations to China. During such visits, managers of UK-6 had met the Vice Governor of PROVINCE and established contacts. Later, the UK SME had been sent a list of machine tool companies obtained from the central government from which the company selected and visited three.

Overall, a correlation coefficient of  $r_{sp\_nat} = .5136$  suggests that the ranking of the importance of ways of finding a partner as perceived by the UK and German SMEs is rather different at a significance level of 5 per cent.

The analysis of the perceived importance of ways of finding a Chinese partner with respect to firm size suggests, at the 5 per cent level, an even more significant difference with a coefficient of  $r_{sp\_size} = .2075$ . Whereas the approach by the Chinese side and the partner being a former agent were similarly suggested rather frequently by both groups of SMEs, the helping hand of a Chinese organisation was accepted more often by Size One SMEs than by Size Two SMEs. However, in cases where a partner was met at a trade fair in China, the situation was reported to be the reverse. No Size One SME met its later partner during such an event in China, whereas two Size Two SMEs did so. In none of the cases was the partner met at a trade fair in the home countries of the UK and German SMEs. This applies to both Size One and Size Two firms.

#### Partner selection criteria

Table 7-6: Partner selection criteria.

Selection criteria	UK SMEs			GER SMEs			Size One			Size Two		
	I	R	n	I	R	n	I	R	n	I	R	n
Trust between top management	1.7	1	6	1.8	1	11	1.4	1	9	2.1	1	8
Reputation	2.0	2	6	2.4	6	9	1.8	2	8	2.9	6	7
Links to officials	2.1	3	7	2.1	3	11	1.8	2	8	2.4	4	10
Location of partner	2.2	4	6	1.9	2	12	1.8	2	9	2.2	3	9
Size of partner	2.3	5	6	3.1	8	12	2.6	7	9	3.1	8	9
Products of partner	2.3	5	7	2.1	3	12	2.2	5	9	2.1	1	10
Provision of local currency	2.3	5	7	2.9	7	12	2.6	7	9	2.8	7	10
Complementary resources	2.4	8	7	2.3	5	12	2.3	6	9	2.6	5	10
Access to technology	3.5	9	6	3.9	9	10	3.4	9	7	4.0	9	9

Key: I = importance, R = rank, n = respondents.  $r_{sp\_nat} = .6457$ ;  $r_{sp\_size} = .7441$ ;  $r_{sp\_crit} (\alpha = .05) = .5833$ ;  $r_{sp\_crit} (\alpha = .01) = .7667$ .

As table 7-6 reveals, the most important criterion for partner selection for the UK and German SMEs was trust between the top management teams. Trust was deemed to be even more important than certain assets or attributes. As has been established

above (see table 7-5) past favourable association was the second most important way of finding the later JV partner. The UK and German SMEs also show similarities when they value a potential partner's links to officials or its location or the partner's range of products. All these selection criteria were important to both groups of SMEs.

The UK and German SMEs show discrepancies with respect to criteria such as partner reputation and size of the partner. The reputation of the Chinese partner is more important and its size considerably more important to the UK SMEs than it is to the German SMEs to whom size is only of medium importance. Findings with respect to motivations for JV activity suggest that the German SMEs looked more at the Chinese partner's complementary resources than did the UK SMEs, although in both cases this criterion was important for partner selection. Surprisingly, however, the potential Chinese partner's ability to provide local currency was considered to be more important a selection criterion for the UK SMEs than for the German SMEs. This is surprising since, when asked for the motivations for joint venturing, the German SMEs suggested that they would joint venture because they expect the Chinese to contribute finance (table 7-4). The UK and German SMEs were unanimous, in that, they not considered access to the partner's technology as an important criterion for partner selection.

For UK-7 it was crucial to have a partner with contacts in the particular specialised business and a partner with experience in the business. UK-6 assessed the manufacturing facilities of its potential Chinese partners and, purely on engineering grounds, made the decision of whom to select as its partner. The UK SME did not apply criteria, such as the potential partner's profitability. UK-6 further sought the "Chinese partner's ability to manufacture our product," mechanical and electrical engineering skills and the ability to understand and operate software.

Overall, the perceived importance of the selection criteria of the UK and German SMEs suggests a similarity which is significant at the 5 per cent level ( $r_{sp\_nat} = .6457$ ).

The analysis also suggests significant similarities between Size One and Size Two SMEs in their perception of the relative importance of partner selection criteria ( $r_{sp\_size} = .7441$ ). As a matter of fact, compared with the coefficient regarding the nationality, the coefficient regarding firm size is bigger, suggesting an even stronger correlation between the perceptions of the two groups of SMEs. For both groups, trust between the top managements is the most important partner selection criterion as are the partner's location and links with officials. Discrepancies in the ranks between the groups appear with regard to the Chinese partner's reputation and its products. Whereas Size One firms consider the partner's reputation as the second most

important criterion, Size Two enterprises thought this was only sixth important. With respect to the products of the partner, the reverse is the case. The provision of local currency, complementary resources and access to technology provided by the potential partner were not perceived as important selection criteria by either group.

### ***Partner characteristics***

#### Number of partners

The vast majority of SMEs have joined forces with only one partner, with the exception of UK-7 and UK-2 which have, in addition to their Chinese, a Singaporean or a Taiwanese partner, respectively. UK-2 has two partners and for major decisions to be made, all three partners have to be in agreement, since a 70 per cent agreement is necessary. In other words, no two partners can make a major decision for the JV without the support of the third party. Not surprisingly, therefore, decision-making in this JV can take long.

#### Partner size

There is no significant trend to be read from the data provided by the UK SMEs, although partnering with a company with a similar turnover appeared only relatively less frequently (one similar, one smaller, two much smaller, one larger, one much larger than the UK SME). It is equally difficult to detect a clear trend within the group of German SMEs (four with similar turnover, two larger, two much larger, two smaller). Nevertheless, German SMEs tend not to joint venture with Chinese companies that are smaller (in terms of turnover) than they are themselves.

Within the group of UK SMEs only one company indicated that its Chinese partner has a workforce of similar size to its own and the remaining results are not sufficient to read a particular trend (one similar workforce to UK SME, one smaller, one much smaller, three much more). Within the German SME JVs, however, the workforce of the Chinese partners tend to be larger than that of the German SMEs (two similar, three more, three much more, two fewer).

Firm size analysis suggests that two Size One SMEs had a Chinese partner with a perceived turnover that was smaller, one much smaller, two of similar size, one larger and one that had a much larger turnover than the SMEs. Of the Size Two SMEs one had a Chinese partner with a smaller turnover, one with a much smaller turnover, three with a similar turnover, two with a larger and three with a much larger turnover. One SME within this group could not estimate its partner's turnover. Overall, this does not suggest a particular trend within the group of Size One SMEs. The larger Size Two SMEs had relatively less frequently partners with a smaller (or much smaller) turnover.

With regard to the number of employees, of the Size One SMEs, one Chinese partner had less, three similar, one more and two much more employees than the UK firm. Of Size Two SMEs, two had a Chinese partner with less employees and one with much less. Two indicated that their Chinese partner would have more and five that it would have much more staff. One SME could not estimate the number of employees of its Chinese partner. What has been said above with regard to turnover, also applies to the employee criterion. The larger Size Two firms relatively more frequently joint ventured with a company that had more or much more employees than the SMEs themselves.

#### Partner company type

The findings with regard to the group of UK SMEs do not suggest a clear trend. It was expected that the majority of JVs would be formed with Chinese state-owned enterprise (SOE) partners, since the vast majority of Chinese enterprises are SOEs. Earlier it has been reported (Rainalter, 1995) that only a few private firms have entered into Sino-foreign JVs. The empirical results show that three UK SMEs have a private company partner and four an SOE. There is more of a trend, however, within the group of the German SMEs, where eight out of ten companies joined forces with a Chinese SOE and only two with a local private firm.

The analysis with regard to firm size shows that of the Size One SMEs, four SMEs each partnered with an SOE and a private enterprise, respectively, whereas within the group of Size Two SMEs eight were partnering with an SOE and one with a private one. This suggests that the larger SMEs in the samples show a distinct preference for SOEs as partners in their JVs.

### ***Joint venture negotiation process***

#### Negotiation contents

Table 7-7: Contents and conflict areas of the negotiation process.

Content and conflict aspects	UK SMEs		GER SMEs		Size One		Size Two	
	C/C	R*	C/C	R*	C/C	R*	C/C	R*
Valuation of assets	8/6	1/1	12/6	1/1	9/0	1/10	10/4	3/5
Financing	8/5	1/2	12/6	1/1	8/0	6/10	9/6	4/2
Equity shares	8/2	1/8	11/2	4/9	9/5	1/1	11/2	1/11
Technology selection/transfer	7/3	4/6	9/3	10/4	3/1	12/4	6/2	12/6
General manager appointment	7/2	4/7	11/3	4/6	3/0	12/10	5/0	13/13
Composition of BoD	7/1	4/13	11/3	4/6	7/3	8/2	9/3	4/6
Distribution of responsibilities	6/3	7/3	11/3	4/6	5/1	11/6	7/1	11/12
Staffing issues (nos, salaries)	6/3	7/3	10/0	9/12	9/0	1/10	9/4	4/3
Training of staff at home	6/1	7/11	2/0	13/12	9/2	1/5	9/3	4/6
Intellectual property rights	6/1	7/11	6/1	11/10	7/1	8/7	9/2	4/10
Royalties	5/1	11/9	4/2	12/1	7/1	8/7	8/2	10/9
Market priorities	5/1	11/9	12/4	1/4	9/4	1/3	11/8	1/1
Expat. Issues (nos, salaries)	4/2	13/3	11/1	4/11	8/1	6/9	9/4	4/3

Key: C/C = content/conflict, R = rank. \* The second value in this column is the result of the ratio of aspect conflict/aspect content; the higher the ratio the higher the rank.  $r_{sp\_nat\_content} = .2279$ ;  $r_{sp\_nat\_conflict} = .1877$ ;  $r_{sp\_size\_content} = .8082$ ;  $r_{sp\_size\_conflict} = .0290$ ;  $r_{sp\_crit} (\alpha = .05) = .4780$ ;  $r_{sp\_crit} (\alpha = .01) = .6429$ .

Table 7-7 indicates that the valuation of assets and the financing of the JV were the most frequently cited contents of the negotiations of the UK and German SMEs. Since the SMEs had only a limited amount of resources to contribute to the JV, they had to negotiate the highest possible value of this contribution and in turn had to try to negotiate the value of the Chinese contribution as low as possible. In other words, with the smallest possible input, the SMEs attempted to get the highest possible equity share in the JV. Ownership often does, as has been argued in chapter six, correlate with control, though it is not a necessary pre-condition. Of equally high importance to the SMEs was the financing of their businesses. Again, the SMEs had only scarce financial resources with which to finance the JV in China. As is known from chapter two, finance is a critical issue within SMEs and it was, therefore, given considerable attention in negotiations.

The distribution of equity shares in the JVs was also an issue that was negotiated by nearly all of the SMEs (eight UK, eleven German firms). UK-6's Chinese partner was very insistent on a stake of 51 per cent and since UK-6 did not want to risk the negotiations failing it did not push for a majority stake in the JV, even though the firm was keen to be the majority owner. UK-6's bargaining position was too weak to demand a higher share of the equity.

Furthermore, control issues were of similar importance to both UK and German SMEs. It was fairly important to both groups what the board of directors would look like and who would have the right to appoint the general manager of the JV. With these two 'instruments' a partner can co-determine the JV's strategies and policies. Technology selection and transfer issues were negotiated for seven UK and nine German SME JVs. This suggests that, especially in the case of German SMEs, many other issues were negotiated more frequently.

However, with regard to the importance of issues such as market priorities and expatriation, the two groups display considerably different attitudes in their perceptions. Whereas market priorities was the content of negotiations in only five cases within the group of UK SMEs, it was discussed by all 12 German SMEs and their negotiation partners. All but one German SME started manufacturing in China because they wanted to service the Chinese market. The SMEs had to make clear the market focus before they signed the contract. Further, expatriate issues were the content of the negotiations of only four UK SME JVs making it the least important issue within the group of UK SMEs. In contrast, eleven German SMEs wanted to discuss with their Chinese negotiation partners the issue of expatriating staff to the JV,

including the number and the coverage of costs. With regard to the actual expatriation of German personnel, this emphasis on expatriate issues is rather surprising.

Amongst the least frequently discussed negotiation contents in both groups of SMEs was the royalty issue. Royalties are usually paid when patents are licensed. As will be seen later in this chapter (table 7-14), patents were amongst the least frequently provided contributions of the UK and German SMEs.

With respect to the other contents of negotiations, a clear statement is not possible and further attempts to read from the data would result in analytical wasteland. Overall, the analysis suggests that the UK and German SMEs do not reveal any statistically significant correlation in their frequency of stating individual negotiation contents ( $r_{sp\_nat\_content} = .2279$ ).

Important contents of the negotiations of UK-2-JV (UK-2's outstanding bargaining position was its product) were the product programme, ie which machines to manufacture, how many sales outlets to establish and where, the selection of the personnel, time scales and projections for the next three years, and the financial side "which is very different from ours." For UK-7 it was very important to keep the contents of the agreement "as simple as possible" since later court actions were not regarded as a solution. In the negotiations, the parties agreed that the UK side would do all the exporting, and that UK-7 would supply the know-how and should get an up-front payment for this.

When employing the criterion 'firm size', however, the rank correlation analysis suggests significant (1% significance level) similarity between Size One and Size Two firms ( $r_{sp\_size\_content} = .8082$ ) with contents, such as the valuation of assets, equity share distribution, market priorities and training of staff ranking rather high. On the other hand, aspects, including the distribution of responsibilities, technology selection and transfer as well as the general manager appointment were the least frequently discussed negotiation contents by both Size One and Size Two enterprises.

The comparison of  $r_{sp\_nat\_content}$  and  $r_{sp\_size\_content}$  suggests that is rather the criterion 'nationality' than 'firm size' that discriminates between two groups of SMEs.

#### Negotiation content conflict

Interestingly, the valuation of assets and the finance issues of the JV that were amongst the most frequently discussed issues in negotiations, were also the negotiation contents that were relatively most conflicting for both groups of SMEs. For instance, although UK-6's outstanding bargaining position was its technology which "the Chinese partner had no access to," the Chinese refused to accept the proposed

valuation of this technology contribution. UK-7 stressed that the only issue that came near a major problem was the valuation of its know-how contribution. "The Chinese said it was too high, but they did not really know the value of the know-how." And neither did UK-7. Instead, "it was a horse trading." UK-7 signalled its unwillingness to compromise, and the Chinese side eventually accepted the value suggested.

Royalties for technology provision to the JV were the greatest area of conflict for the German SMEs. However, they are amongst the least frequently conflicting negotiation contents for the UK SMEs. Within the group of UK SMEs, five negotiated royalties and only one firm experienced conflict. Within the German SMEs only four negotiated royalties and two of those had difficulties. This suggests that royalties were amongst the relatively most conflicting issues - every second negotiation was in conflict. The reason is clear again: where market prices are missing, the price is subject to tough negotiations.

Equity distribution was, although frequently negotiated, relatively rarely a conflict issue in the negotiations of the JVs. UK-6 was in conflict over distribution of equity. The Chinese partner insisted on the majority stake and the UK SME did not want to risk failure of the negotiations. Thus, it did not push for a 51 per cent plus stake, even though it was keen to be the majority owner. The negotiation of market priorities was relatively unproblematic for the UK SMEs, while it was an issue for the German SMEs. Relatively more German SMEs discussed the market focus of their JVs. Consequently, they were more often prepared to argue with the Chinese side about this.

There is no significant similarity to be read from the data in table 7-6 ( $r_{sp\_nat\_conflict} = .1877$ ) and the dissimilarity between the SMEs is greater even when analysed with respect to the criterion 'firm size' ( $r_{sp\_size\_conflict} = .0290$ ). Firms of both size groups have experienced conflicts when negotiating their JVs in considerably distinct areas. For instance, whereas the equity distribution was relatively most frequently the issue that caused conflict within Size One firms, it ranked only eleventh within the larger SMEs. In contrast, whereas the larger firms relatively frequently had to argue with their partners about financing and personnel, these issues caused less conflict within the group of Size One firms.

#### SME negotiation team

As a trend, the UK and German SMEs had more than one manager involved in negotiations with their Chinese counterparts. Three UK SMEs each had two or more than two managers involved. A single manager held negotiations in two UK SME cases. Of the German SME JVs, five were each negotiated with two or more than two managers, respectively (table 7-8).



UK-6 had five managers involved in the negotiations and UK-2 had two of its staff involved, the managing director and the chairman of the company plus one of its staff from its Singapore office. UK-7 negotiated its JV with two UK managers and its Singaporean agent, who speaks Chinese and acted also as an interpreter.

As a trend, the smaller and larger firms had two or more directors involved in negotiations; differences between the two groups could not be detected.

Table 7-8: SME negotiation team.

Size of SME negotiation team	UK SMEs	GER SMEs	Size One	Size Two
	F	F	F	F
Single director	2	0	1	1
Two directors	3	5	3	4
More than two directors	3	5	4	5
$\Sigma$	8	10	7	10

Key: F = frequency.

#### Location of negotiation

From chapter six (section 6.3.1) it is known that negotiating in China can take an inordinate amount of time. This applies to the majority of the six UK SMEs that held the entire negotiations in China, and to UK-2 which negotiated its JV in Taipei in the first place and later in CITY [East China] with no meeting between all three parties in the UK. Only two UK SMEs held negotiations both in China and in the UK. One of those was UK-6: after signing a memorandum of understanding in China, the Chinese company sent representatives to the UK for negotiations and, indeed, most of the negotiations were carried out in the UK.

With the German SMEs, the situation was reversed: the majority of the six SMEs negotiated their JV in China and in Germany, although five were negotiated exclusively in China. Surprisingly, one German SME JV was negotiated in Germany solely.

When analysed the location of negotiations with respect to firm size, it becomes evident that Size One enterprises carried out relatively most of their negotiations exclusively in China, whereas Size Two SMEs employed a strategy of holding negotiations both in China and at home (table 7-9).

Table 7-9: Location of negotiations.

Location of negotiations	UK SMEs	GER SMEs	Size One	Size Two
	F	F	F	F
PRC	6	5	7	4
PRC/at home	2	6	2	6
At home	0	1	0	1
Taiwan/PRC	1	0	1	0
$\Sigma$	9	12	10	11

Key: F = frequency.

#### Duration of negotiations

For the majority of five UK SMEs, negotiations had taken longer than expected and two UK SMEs indicated that the duration of negotiations was as expected. One of those was UK-2, whose negotiations lasted for nine months. Two SMEs perceived the

duration of the negotiations to be shorter than expected, including UK-6. There, the deal was agreed after only three months. The other SME that considered negotiations being shorter than expected was UK-7. In this case, negotiations took place in three phases, starting in CITY [Northeast China] where "we went over and where discussions commenced." After participating in a trade mission to China, the parties signed a simple version of an agreement during a third visit of UK-7 staff to China. Eventually, from the first approach by the Chinese until the signing of the agreement, a period of approximately 18 months to two years was needed.

Four German SMEs perceived negotiations to be longer than expected and four SMEs expected it to take the amount of time it actually took. Two German SMEs perceived the negotiation process to be shorter than expected.

There is no difference to be read in the data between the perceptions of Size One and Size Two enterprises (table 7-10).

Table 7-10: Duration of negotiations.

Duration of negotiations	UK SMEs	GER SMEs	Size One	Size Two
	F	F	F	F
Longer than expected	5	4	4	5
As expected	2	4	3	3
Shorter than expected	2	2	2	2
$\Sigma$	9	10	9	10

Key: F = frequency.

#### Language of negotiations

For both the UK and the German SMEs a combination of English and Chinese was the most frequently used language of the negotiations. In addition, three UK JVs were negotiated exclusively in English and two exclusively in Chinese. Of the German JVs, three each were negotiated exclusively in English or Chinese, respectively (table 7-11).

Table 7-11: Language of negotiations.

Language of negotiations	UK SMEs	GER SMEs	Size One	Size Two
	F	F	F	F
English	3	3	5	1
English/Chinese	3	6	3	5
Chinese	2	3	1	4
$\Sigma$	8	12	9	10

Key: F = frequency.

The analysis suggests further that Size One SMEs had more often carried out JV negotiations in English, compared with Size Two SMEs which have, relatively more often negotiated their JVs in both English and Chinese or exclusively in Chinese.

### Use of interpreters

Negotiating a JV with Chinese counterparts who do not speak German, and frequently, English, was a challenge for the SMEs from the UK and Germany. Not surprisingly, therefore, all eight UK SMEs that answered the question, had used one or more interpreters. For the negotiations of UK-6's JV, interpreters were provided by both the UK SME and the Chinese partner. Since the Singaporean partner spoke Chinese and none of the Chinese team English, negotiations were held in Chinese. For the negotiation of their venture, UK-6 and the Chinese side provided interpreters. Moreover, the Singaporean participant in the negotiations spoke Mandarin which helped communicate as the UK team spoke no Chinese and the Chinese no English.

Of the German SMEs, ten used the services of one or more interpreters, whereas one did not employ an interpreter. There, both the German and the Chinese teams negotiated the JV in English. This is dangerous, however. When contracting, the Chinese authorities demand a Chinese version of the JV contract which has authority over an English translation (table 7-12). With regard to use of interpreters there is no considerable difference between Size One and Size Two SMEs to be read in the data.

Table 7-12: Use of interpreters.

Use of interpreters	UK SMEs	GER SMEs	Size One	Size Two
	F	F	F	F
Yes	8	10	8	10
No	0	1	0	1
$\Sigma$	8	11	8	11

Key: F = frequency.

The cultural differences between the European and Chinese negotiators manifest themselves in language problems, problems with the negotiation styles, the slow pace of the negotiations and other cultural issues. These were the problem areas of negotiating a JV in China most frequently cited by both the UK and the German SMEs. The problems appear similarly to the smaller and larger firms alike. UK-6 and its partner communicated well with respect to the engineering business. The biggest difficulty experienced by UK-6 were business and cultural issues. Thus, difficulties in mutual understanding between UK-6 and its Chinese partner were programmed. Another difficulty was that UK-6's Chinese partner had no understanding of dealing with customers and marketing the product, "since its only customer was the government." Three UK and German SMEs did not make any comments on this issue.

### Factors for successful negotiations

Both the UK and German SMEs cited patience of the SME team as the most important factor for successful negotiations, as was the sincerity of the SME team and a good

personal relationship. This reflects basically what has been found with regard to factors for JV performance and partner selection.

Table 7-13: Factors for successful negotiations.

Successful negotiation factors	UK SMEs			GER SMEs			Size One			Size Two		
	I	R	n	I	R	N	I	R	n	I	R	n
Patience of SME team	1.3	1	8	1.4	1	11	1.2	2	10	1.3	1	9
Good personal relationship	1.4	2	8	1.7	5	11	1.4	3	10	1.8	2	9
SME team's sincerity	1.5	3	8	1.4	1	12	1.1	1	10	1.8	2	10
Good interpreter on SME side	1.5	3	8	1.6	3	11	1.4	3	10	1.8	2	9
SME's technical expertise	1.6	5	8	2.0	8	11	1.9	8	9	1.8	2	10
Knowledge of PRC bus. practice	1.8	6	8	1.6	3	12	1.6	6	10	1.9	6	10
Partner's need for SME product	1.8	6	8	1.7	5	11	1.5	5	10	2.0	7	9
Preparation of SME team	2.0	8	8	1.7	5	10	1.7	7	9	2.0	7	9
Uniqueness of SME product	2.1	9	8	2.0	8	9	1.9	8	8	2.2	10	9
Offer good financing	2.1	9	8	2.0	8	10	2.1	10	9	2.0	7	9
Familiarity with social customs	2.4	11	8	2.4	11	10	2.4	11	9	2.3	11	9
Knowledge of PRC pol./soc. sit.	2.6	12	8	2.5	12	10	2.5	13	8	2.6	12	10
Past reputation in selling to PRC	2.9	13	7	2.5	12	12	2.4	11	9	2.8	13	10

Key: I = importance, R = rank, n = respondents.  $r_{sp\_nat} = .8704$ ;  $r_{sp\_size} = .8260$ ;  $r_{sp\_crit} (\alpha = .05) = .4780$ ;  $r_{sp\_crit} (\alpha = .01) = .6429$ .

For reasons outlined earlier in this chapter (tables 7-11 and 7-12), the UK and German SMEs considered, also, the use of a good interpreter as important for successful negotiations. Also of importance to both groups, were their own technical expertise, although this was considered less important by the German SMEs. Knowledge of Chinese business practices was considered more important by the German SMEs than their UK counterparts and of less importance to the success of negotiations were the uniqueness of the SMEs' product, willingness to offer good financing, familiarity with social customs, knowledge of China's political and social situation and the SME's past reputation in selling to China. However, only past reputation and knowledge of China's political and social situation were considered moderately important by the UK SMEs whereas other factors were considered important (table 7-13).

UK-2 emphasised the importance of being polite, not putting the Chinese down in any way, and showing strength since "negotiating is a diplomatic exercise." The UK SME also stressed the importance of being sure of the facts and protecting oneself. "We made sure to have 70 per cent agreement before any decisions could be made."

Rank correlation analysis ( $r_{sp\_nat} = .8704$ ) suggests that both the UK and German SMEs display a significant similarity of their perceived importance of negotiation success factors. Also when calculated for Size One and Size Two enterprises, the coefficient ( $r_{sp\_size} = .8260$ ) suggests a significant similarity between the two groups of SMEs, both at the 5 per cent and the 1 per cent significance levels. Comparing the two correlation coefficient values suggests that the SMEs show a greater similarity in their perception

of the negotiation success factors when distinguished between nationality, rather than firm size. In other words, SMEs of different sizes display a somewhat greater dissimilarity in their perceptions of factors for successful negotiations.

For instance, the SME's technical expertise was considered relatively more important for successful negotiations by Size Two SMEs than by Size One SMEs, ranking second and eighth, respectively. Also, the need to offer the Chinese side a good financing deal was considered more important by Size Two firms.

### ***Partner contributions***

This section looks at the contributions of both partners in the JV as well as the importance of the Chinese contributions as perceived by the SMEs.

#### SME's contribution

The most frequently observed contributions of the UK and German SMEs were cash, SME technology, management expertise and technical training. Apart from the scarce resource capital (all SMEs used their working capital to finance the JV) the UK and German SMEs contributed their technology to the joint undertaking. In many cases this is special technology which the SMEs attempt to exploit in the Chinese market rather than licensing it to a Chinese company. Since most of these technologies are 'high-context' technologies the SMEs also have to provide the necessary training.

Table 7-14: Contributions of the SMEs.

SME contribution	UK SMEs		GER SMEs		Size One		Size Two	
	F	R	F	R	F	R	F	R
Cash	7	1	12	1	9	1	9	1
Technology	7	1	9	2	9	1	9	3
Management expertise	5	3	9	2	5	4	8	2
Technical training	5	3	7	4	6	3	5	4
Machinery	4	5	6	5	5	4	5	4
Access to world markets	4	5	4	7	4	7	4	6
Patents	3	7	5	6	5	4	2	7

Key: F = frequency, R = rank.  $r_{sp\_nat} = .8929$ ;  $r_{sp\_size} = .6725$ ;  $r_{sp\_crit} (\alpha = .05) = .6786$ ;  $r_{sp\_crit} (\alpha = .01) = .8571$ .

On the other hand, machinery, access to world markets and patents were the least frequently contributed assets and attributes by both the UK and the German SMEs. The vast majority of UK and German SMEs came to China to exploit the potential Chinese market, but not to open their traditional export markets to the output of the JVs (table 7-14).

Contrary to the existing opinion not to expect a cash contribution from the Chinese partner, all (originally) four partners in UK-7-JV contributed a bit over US\$156,000 (£100,000) in cash. Additionally UK-7's contribution was know-how and the Chinese

contributed contacts. After all partners had put in their contributions, UK-7 received an up-front payment for its technology supplied to the JV. It was further agreed that UK-7-JV could send six Chinese staff to the UK SME for training. Those would be paid by the JV and UK-7 would provide accommodation and also a small amount of pocket money. UK-2's contribution was "a lot of test equipment" and US\$230,000 (£147,436) in cash. "They have equipment already to do this and they have reasonable technical expertise." UK-6's main contributions to the JV were access to technology and the design of machinery.

The similarity in the ranking of the SME contributions that appears at a first glance is supported by the Spearman rank correlation coefficient which suggests a significant similarity at the 1 per cent level ( $r_{sp\_nat} = .8929$ ). However, there is no statistically significant correlation between the responses of Size One firms and Size Two SMEs ( $r_{sp\_size} = .6725$ ). In other words, with regard to firm size, the UK and German JV entrepreneurs display dissimilarities in their behaviour.

For instance, whereas cash and technology were cited most frequently as contributions by Size One SMEs, only cash was also cited most frequently by Size Two SMEs, whereas these firms contributed technology only third most frequently. On the other hand, management expertise was relatively more often contributed by Size Two firms than by Size One enterprises. A considerable difference also appears with regard to the contribution of patents: whereas it ranks fourth within the group of Size One firms it only ranks seventh (or last) within the Size Two firms.

#### Chinese partner's contribution

Table 7-15: Importance of Chinese partner's contributions.

Chinese partner contribution	UK SMEs			GER SMEs			Size One			Size Two		
	I	R	N	I	R	N	I	R	n	I	R	n
Local labour	1.9	1	8	2.0	2	11	1.9	1	10	2.0	2	9
Contacts to customers	2.0	2	8	2.0	2	12	2.0	3	10	2.0	2	10
Access to markets	2.1	3	8	1.9	1	12	2.0	3	10	2.0	2	10
Machinery and facilities	2.3	4	8	2.5	6	11	2.6	6	9	2.3	5	10
Contacts with government	2.3	4	8	2.3	4	9	1.9	1	7	2.6	6	10
Land	2.5	6	8	2.3	4	11	2.8	9	10	1.9	1	9
Plant	2.6	7	8	2.7	8	11	2.6	6	9	2.8	8	10
Cash	2.7	8	7	2.8	9	12	2.2	5	10	3.3	9	9
Materials	2.7	8	7	2.5	6	10	2.6	6	7	2.6	6	10

Key: I = importance, R = rank, n = respondents.  $r_{sp\_nat} = .8417$ ;  $r_{sp\_size} = .0582$ ;  $r_{sp\_crit} (\alpha = .05) = .5833$ ;  $r_{sp\_crit} (\alpha = .01) = .7667$ .

Local labour, contacts to customers, access to markets and government contacts were amongst the most important Chinese partner contributions to both the UK and German SMEs. This suggests that Chinese partner attributes rather than assets were most appreciated by the UK and German SMEs. Of less importance to the SMEs were

Chinese partner asset contributions, such as plant or cash. To expect cash from the Chinese partner would not have been very realistic since it is exactly this contribution that is sought by the Chinese side (table 7-15).

Overall, the UK and German SMEs show similarities in the perception of the importance of the Chinese partner's contributions ( $r_{sp\_nat} = .8417$ ).

However, when analysed with respect to firm size differences, the Spearman rank correlation coefficient ( $r_{sp\_size} = .0582$ ) suggests considerable dissimilarities between Size One and Size Two firms. Although local labour, contacts to customers and access to markets were regarded as similarly important by both groups of SMEs, the Chinese contribution of land was ranked first within Size Two firms whereas it ranks only ninth (or last) within the group of Size One firms. This big discrepancy heavily influences the calculation of the correlation coefficient and apart from this huge discrepancy, the results within both groups do not suggest too many differences in the firms' perceived perceptions of the importance of certain Chinese contributions.

## **7.2.4 Sino-foreign joint venture operation**

### ***Joint venture background information***

#### Joint venture establishment

The UK SME JVs were established between 1987 and 1996. The German JVs are more recent, having been formed between 1990 and 1996.

#### Total investment

Six UK SME respondents answered this question. The investment volumes span a range between US\$0.39m (£0.25m) and US\$14.0m (£9.0m). Of the ten German SMEs that answered this question, the smallest investment was US\$0.56m (£0.36m) and the highest US\$10.8m (£6.9m).

In the UK sample, the smaller SMEs had the smallest total investment JVs and the same applies to the German SMEs (without an exception).

#### Number of employees

The eight UK SMEs providing information on this aspect, employ on average 102 staff with one employing fewer than ten, five employing between ten and 100 and two employing between 100 and 500 staff. The JVs of the seven German SMEs that commented on their JVs' workforce employ on average 56 staff. Four JVs employ up to 50 staff, two between 50 and 100, and one more than 100, but less than 200.

As a trend, also the UK Size One SMEs employ less personnel in their JVs than Size Two SMEs do (with one exception), whereas the positive correlation between the size of the German SMEs and the number of employees in their JVs is clear.

#### Joint venture location

The following categorisation of locations in China was applied for the presentation of the disguised locations of the JVs (table 7-16).

Table 7-16: Disguised locations of the UK and German SME JVs.

Region	Provinces, municipalities and autonomous regions
Northeast	Heilongjiang, Jilin, Liaoning, Beijing, Tianjin, Hebei
East	Shandong, Jiangsu, Anhui, Shanghai, Zhejiang, Jiangxi
Southeast	Jiangxi, Fujian
South	Guangdong, Guangxi, Hainan, Yunnan
Remote	Mongolia, Shanxi, Henan, Hubei, Hunan, Guizhou, Sichuan, Chongqing, Shaanxi, Ningxia, Qinghai, Tibet, Xinjiang Uygur

Five UK SME JVs were located in East China, three in North China, one in South China and one in China's remote area. Of the German SMEs, three were located in East China, five in Northeast China, one in Southeast China, two in South China and another one in China's remote area. This suggests that both the UK and the German SMEs sought investment locations in the more privileged areas of China, compared with the under-developed West of the country.

Size One firms show no particular trend with respect to location distribution and are about equally located in North, East and South China. Size Two firms, on the other hand, are located rather in North and East China than in South China. Also, the two SMEs that established their JVs in China's remote area, are Size Two firms.

#### Choice of location

In several cases, the selection of a particular Chinese partner pre-determined the choice of location *a priori*. Accordingly, three UK SMEs could choose the location of their JV, three had no choice and three did not answer this question. Of the German SMEs, six had a choice of location, three had no choice and three did not provide information on this aspect.

Table 7-17: Criteria for choice of location.

Criteria for choice of location	UK SMEs			GER SMEs			Size One			Size Two		
	I	R	n	I	R	n	I	R	n	I	R	n
Availability of trained labour	1.3	1	3	1.5	1	12	1.4	1	7	1.5	1	8
Location of partner	2.0	2	3	2.7	6	12	2.9	6	7	2.1	3	8
Availability of cheap labour	2.0	2	2	2.2	3	11	2.5	5	6	1.9	2	7
Infrastructure	2.3	4	3	2.0	2	12	1.6	2	7	2.5	4	8
Proximity to target market	2.7	5	3	2.5	4	11	2.0	3	7	3.1	7	7
Sources of raw material	2.7	5	3	3.0	7	12	3.1	7	7	2.8	5	8
Investment incentives	2.7	5	3	2.6	5	8	2.0	3	4	3.0	6	7
Advised to go there	--	--	0	4.5	8	2	--	--	0	4.5	8	2

Key: I = importance, R = rank, n = respondents.  $r_{sp\_nat} = .6220$ ;  $r_{sp\_size} = .2054$ ;  $r_{sp\_crit} (\alpha = .05) = .6786$ ;  $r_{sp\_crit} (\alpha = .01) = .8571$ .

The most important criterion for the choice of location was the availability of trained labour, for both the UK and the German SMEs. Inevitably linked with the availability of trained labour as a factor influencing the choice of location was the availability of cheap



labour. Important for both groups of SMEs was the state of the infrastructure available at the individual locations where JV activity could take place (table 7-17).

Divergent opinion exists about the importance of the partner's location which was more important to the UK SMEs than it was to the German SMEs. A look at the frequency of the SMEs choosing a green-field or take-over operation, might provide insight into this aspect. For UK-7 this criterion was important and further, the location of a galvanising plant nearby was considerably convenient for the SME. The reason for UK-7's preference of this argument was that the firm delegated the task of finding a location to its Chinese partner.

Of minor importance to both groups were further proximity to target markets (though it was more important to the German SMEs), sources of raw material and investment incentives.

UK-2 had made its choice of East China as location of its JV on the grounds of market considerations. The SME considered the location of its JV "quite convenient for the company with a lot of development in place and a great need for our products." UK-2 had also investigated a neighbouring province north of its eventual location and one in CITY [North China]. Eventually, UK-2 had chosen the location because of market considerations. A fact that considerably contributed to UK-2's choice, however, was that its Taiwanese partner had an operation already where the JV was later set up.

UK-6 considered the investment incentives provided by individual provincial governments as helpful, though they did not affect the SME's decision-making. They were considered to be largely the same in all provinces. A stronger factor affecting UK-6's choice of location was the fact that its county has close ties with the government of PROVINCE where UK-6-JV is located. During a delegation visit to China - "at a time when nobody was seriously considering the setting up of a plant in China" - UK-6 managers had met the Vice Governor of PROVINCE and this "friend in a high place" was considered a crucial factor for the choice of location.

Overall, the perceived importance of criteria for the choice of location is dissimilar between the UK and German SMEs ( $r_{sp\_nat} = .6620$ ). More dissimilarities appear when the SMEs are grouped with respect to firm size. With a correlation coefficient of  $r_{sp\_size} = .2054$  the group responses are dissimilar even at the 10 per cent significance level. For instance, whereas the location of the Chinese partner ranked third within the group of Size Two firms, it ranked sixth within the Size One enterprises and the reverse is true with regard to investment incentives, suggesting that they were more important to the smaller firms than to the larger enterprises. Considerable differences also appear with

regard to proximity to target markets: whereas this criterion is the third most important within the group of the smaller firms, it is the second least important within the larger enterprises.

#### Production site

Of the eight UK SMEs that provided information on this aspect, five took over the existing production facilities of their Chinese partners and only three established their operations on a green-field site. Of the 12 German SMEs, seven took over existing premises from their Chinese partner, three erected buildings on a green-field and two rented office space.

UK-2-JV commenced production in a building that was contributed by the Chinese partner. UK-7, on the other hand, erected its own building since its Chinese partner is a design company that only had an office building. This had taken the SME no less than 18 months. Also UK-6-JV needed to erect a new factory since older premises were not equipped with air conditioning that was essential for precise manufacturing.

Analysis with regard to firm size suggests that Size One SMEs had a take-over in four cases, a green-field operation in three and an office in two cases. Size Two SMEs preferred a take-over in eight cases and they had green-field sites in three cases only.

#### Product range

Of the UK SME JVs, four produce the same product range as their UK parents, whereas five manufacture only a limited product range, compared with that of the UK SME parents. Of the German SMEs three JVs produce the same product range as the German parent and nine a more limited range.

For instance, UK-7's JV produced only the INFRASTRUCTURE SYSTEMS and UK-6's JV manufactured a product range that was restricted to two types of machines, although there were plans for a future product range expansion. Restricted also was the range of equipment that UK-2-JV manufactured.

Of Size One SMEs, four manufacture the same range of products, and six a product that is limited compared with what is produced at home. Of Size Two SMEs, three manufacture the same range and eight a limited one. Thus, firm size does not reveal any differences between the groups.

#### Target market

With their JVs, six UK SMEs target the domestic Chinese market, one both the Chinese and export markets and one investor manufactures exclusively for export. One UK respondent refused to provide details on this aspect. Of the German SME

JVs, eight target the domestic Chinese market, three both the domestic and export markets and one exports its entire output.

Also firm size analysis suggests that both groups of SMEs target the domestic Chinese market first and foremost. Of the Size One SMEs, seven target the domestic market, one export markets and one both the domestic and export markets. Of the Size Two SMEs, seven also target the domestic market, three target both the domestic and export markets and one SME targets export markets exclusively.

#### Market share in China

Five UK SMEs were able to specify their 1996 share of the Chinese market: one company had a market share of approximately 4 per cent, two of 10 per cent and the other two of 30 and 35 per cent, respectively. Two German SMEs could specify this: their shares were 10 and 15 per cent, respectively. Seven respondents did not answer this question and three indicated that it was unknown. In fact, it is difficult for SMEs to determine their absolute market shares. This was established earlier by Simon (1996).

#### ***Joint venture ownership***

The nine UK SMEs own, on average, 46.4 per cent of their JVs in China. In detail, three SMEs hold majority stakes, three have minority stakes and three share the equity with their partners equally: in one case an SME holds 50 per cent, in another two cases (UK-2-JV, UK-7-JV) 33.33 and 25 per cent, respectively. UK-7 had originally three partners in its JV and the equity was equally split over the four participating companies. In due course, one Chinese partner has sold its stake to the other Chinese company and the Singaporean company sold 10 per cent of its share to UK-7 and 5 per cent to the Chinese partner. UK-7 was very eager to increase its share in the venture and thus agreed to take over from the partner that was pulling out.<sup>5</sup>

There is more of a trend in sample of German SMEs: six have accepted the minority position in their JVs, four JVs are equally owned by the German and the Chinese partners and only one German SME holds a majority equity stake of 51 per cent. The average equity of the eleven German SMEs that answered this question is 47 per cent.

The average equity share holding of Size One SMEs accounts for nearly 43 per cent. The larger Size Two SMEs had, on average, 51 per cent ownership. Further, whereas within the group of Size Two firms there was an equal distribution of majority, minority and split equity SME ownership, the smaller Size One SMEs had more often a minority equity position. This was both relative to a majority and split ownership position and relative also to minority shares holding SMEs within the Size Two group of firms.

#### ***Joint venture control***

The JVs of the UK SMEs had, on average, 5.7 members on their board of directors (BoDs). In detail, one BoD has three members, four BoDs have five directors, one six,

two have seven members and one eight. In four of these cases control was shared with an equal number of directors (three each or one each, respectively) on the board, in two cases the UK side had one director more than the Chinese side and in three cases the relationship was reversed. The chairman of the BoD was nominated by the UK side in two out of seven cases and by the Chinese side in the remaining five cases.

The JVs of the ten German SMEs that provided information on this had, on average, 5.1 directors on their BoDs. In detail, one JV BoD had seven members, two had six, five had five members, one had four and another BoD had three directors. In three firms the seats were equally distributed, in one the German side had more seats than the Chinese and the reverse applied in five cases. In one case the German and the Chinese sides had an equal number of seats on the BoD and a third-country national had another seat on the board. The chairman of the BoD was nominated by the German side in nine cases and by the Chinese in three. However, the Chinese partner nominated the general manager of the venture in eight cases and the German side in only four. The distribution of functional responsibilities are shown in table 7-18.

Table 7-18: Distribution of responsibilities.

Company function	UK SMEs		GER SMEs		Size One		Size Two	
	UK	PRC	Ge	PRC	1	PRC	2	PRC
Production	4	3	6	2	7	1	6	2
Marketing	4	4	4*	9*	3	5	5	3
Finance	4	3	4	3	5	2	6	2
Personnel	5	3	4	6	4	5	5	4
R&D	6	2	8	0	7	1	7	1

Key: UK = UK directors, PRC = Chinese directors, Ge = German directors, 1 = directors of SMEs in size category one, 2 = directors of SMEs in size category two, n = respondents. \* responsibility shared in two JVs.

Firm size analysis shows that Size Two enterprises have on average 6.5 directors on their BoDs, whereas Size One firms have only five on average. With regard to the nomination of the chairman of the JV, there is no clear trend to be read from the data provided. Within the group of Size One firms the Chinese nominated the chairman in four cases and the foreign side in five. Within the group of Size Two SMEs, the chairman was nominated by the Chinese in four cases and by the foreign party in six.

Most significantly, the majority of the UK (six out of eight) and the German SMEs (eight out of eight) were not prepared to give away research and development responsibility. Also with regard to the personnel function the distribution of responsibility is considerably unbalanced: the UK SME was in charge in five cases, the Chinese side in only three. Within the German SMEs, the personnel function was more frequently in the hands of the Chinese side (six cases) than the German side (four cases). By and

large, the production function rests within the foreign side (four UK vs. three Chinese; six German vs. two Chinese). The finance function is in the hands of the foreign side in the majority of JVs (four UK vs. three Chinese, seven German vs. three Chinese).

For instance, UK-2 considered it extremely difficult to make its partner produce accounts in a meaningful way and to send these sets of accounts on a bi-monthly basis. Subsequently, UK-2 even had to insist that the JV's management produces monthly accounts because of the Taiwanese partner's reluctance to strictly oversee the business and demand the accounts. "We have now taken on what the Taiwanese should have been doing," the managing director of UK-2 said.

Marketing is the responsibility of the Chinese. Within the group of UK SMEs in four cases each are the UK or the Chinese side in charge of it. Within the group of German SMEs, the distribution of responsibilities is unbalanced and rests with the Chinese in seven out of eleven JVs. In only two JVs is the marketing responsibility shared.

The analysis further revealed that both Size One and Size Two enterprises preferred to keep responsibility of research and development as well as of production in their JVs. This is not different to the findings when the data is analysed according to the criterion 'nationality'. An unbalanced distribution of responsibilities can also be detected in the finance function. Again, both Size One and Size Two firms were keen to be in charge of this. With regard to the marketing and personnel functions, the Chinese side was slightly more frequently in charge within the group of Size One firms, whereas the control constellation was reversed within the group of Size Two SMEs. Responsibility of the marketing function was shared in one case between the Chinese side and a Size One firm and in two cases between the Chinese party and Size Two enterprises.

All seven of the UK SMEs that answered this question, suggested that there was joint decision-making in their ventures' boards. Of these seven companies, three remarked that decision-making was a problem (of those, one remarked that it was a problem "sometimes") and four insisted that it was not a problem. Of the 12 German SMEs that answered this question, eight insisted that there was joint decision-making in their ventures in China and four that this was not the case. Of the eight that had joint decision-making, three faced problems. Four did not answer this question and the remaining five respondents did not experience any problems with decision-making.

Joint decision-making was employed about equally frequently in the JVs of Size One and Size Two firms. The question of whether joint decision-making was a problem did not provide a meaningful answer within Size One firms and the distribution of answers was considerably unbalanced within the group of Size Two firms: six had no problems

and only two experienced problems with decision-making in the JV (four Size One firms had difficulties with joint decision-making and three did not).

### ***Joint venture management***

#### General manager

The general manager was nominated by the UK side in five out of seven cases and by the Chinese side in two cases. Interesting, none of the JVs that were majority-owned by the UK or German SMEs (UK-1, UK-5, UK-10, GER-10) had a general manager appointed by the Chinese partner company [with the notable exception of GER-0].

Firm size analysis suggests considerable differences between Size One firms and Size Two enterprises with regard to the nomination of the general manager. Whereas within the group of Size One firms, the Chinese side appointed the general manager twice as often as the foreign side did (six vs. three), within the group of Size Two firms the reverse applies (four vs. six).

#### Expatriates sent to China

The eight UK SMEs that answered this question, had sent, on average, 0.9 expatriates to China. In detail, three SMEs expatriated no employees, three expatriated one employee each and two expatriated two employees. The question of the costs of expatriate staff was answered rarely. One UK SME suggested that the costs for its expatriate were US\$62,400 (£40,000) in total. Another UK SME faced expatriate costs of US\$62,400 (£40,000) for remuneration, US\$18,720 (£12,000) for allowances and US\$70,200 (£45,000) for accommodation, totalling US\$151,320 (£97,000) per year. In another JV, an expatriate costs US\$200,000 (£128,205) for salary and allowances. Earlier this UK company purchased a house at the cost of US\$300,000 (£192,308). Comparing these costs for expatriate staff, the total cost of US\$62,400 (£40,000) seems to be rather low. In three cases the costs of the expatriates were covered by both the UK SME and the JV; in two other cases the JV covered the expatriate costs.

Ten German SMEs provided information: five sent expatriates to their JVs in China. In detail, four had expatriated one manager and one had expatriated two managers. When asked about the cost of expatriation, only three respondents provided information. The three companies suggested US\$300,000 (£192,308), US\$250,000 (£160,256) and more than US\$300,000 (£192,308).

Not surprisingly (with regard to the literature in chapter two), the larger Size Two firms had more than twice expatriated managers or even more personnel to their JVs to China. On the other hand, Size One firms sent personnel in three cases, and seven Size Two firms expatriated staff to China.

UK-2 which at the time of interviewing, had no expatriate in China, considered it essential to have its own staff there. "Although we frequently go out to China (once a year! and its Singaporean partner six times per year) you need a European out there," said the managing director of UK-2. "We do not know, what they are doing. Production in China is a long way away." UK-2's original idea was that the JV's Taiwanese president would visit the JV on a regular and frequent basis to oversee the operation. To the anger of UK-2, "unfortunately, this has not happened." It was finally agreed by UK-2 that the UK SME would send a European to China since the JV's business is not proceeding "as quickly as we thought it would."

### 7.2.5 Joint venture problems

Table 7-19: JV problems.

Problem area	UK SMEs			GER SMEs			Size One			Size Two		
	I	R	n	I	R	n	I	R	n	I	R	n
Concept of quality	1.5	1	8	1.7	2	11	1.6	2	10	1.7	1	9
Recruiting personnel	1.6	2	8	2.4	10	12	2.4	11	10	1.8	2	10
Personnel motivation	1.9	3	8	2.0	6	10	2.1	6	9	1.8	2	9
Repatriation of profits	1.9	3	7	1.4	1	7	1.5	1	8	1.8	2	6
Local sourcing	2.0	5	9	2.8	18	12	2.4	11	10	2.4	11	11
Insuff. training of PRC managers	2.0	5	7	2.4	10	10	2.1	6	9	2.4	11	8
Low labour productivity	2.1	7	8	3.0	21	12	2.7	17	10	2.6	17	10
Communication with local staff	2.1	7	7	2.3	8	9	2.4	11	8	2.1	5	8
Technology transfer	2.3	9	9	1.7	2	12	1.7	3	10	2.2	8	11
Loss of control	2.3	9	8	2.3	8	10	1.9	5	9	2.7	17	9
Mismatch in management styles	2.3	9	7	2.4	10	8	2.3	9	8	2.4	11	7
Dividend policy	2.3	9	6	2.9	19	9	2.9	21	8	2.4	11	7
Damaging reputation	2.4	13	7	2.0	6	7	1.8	4	9	3.0	21	5
Bureaucracy	2.4	13	7	2.6	16	8	2.6	16	9	2.5	15	6
PRC commercial practices	2.4	13	8	3.0	21	10	2.8	18	9	2.7	17	9
Corruption	2.4	13	8	1.9	4	8	2.1	6	8	2.1	5	8
Foreign exchange restriction	2.6	17	7	2.5	15	6	2.8	18	6	2.3	9	7
Transfer pricing	2.6	17	8	2.4	10	9	2.6	15	7	2.5	16	10
Infrastructure	2.7	19	7	2.4	10	11	2.3	9	10	2.8	20	8
Restriction on sales and import	2.7	19	7	2.6	16	8	2.9	21	9	2.3	9	6
Unfair competition	2.7	19	7	1.9	4	8	2.4	11	8	2.1	5	7
Political risk	2.9	22	7	3.8	24	8	3.3	24	9	3.3	23	6
Absence of detailed invest. Law	3.0	23	7	2.9	19	10	2.8	18	10	3.1	22	7
Creating a new competitor	3.1	24	8	3.5	23	12	3.2	23	10	3.5	24	10

Key: I = importance, R = rank, n = respondents.  $r_{sp\_nat} = .4778$ ;  $r_{sp\_size} = .4376$ ;  $r_{sp\_crit} (\alpha = .05) = .3435$ ;  $r_{sp\_crit} (\alpha = .01) = .4748$ .

As table 7-19 suggests, the Chinese partner's concept of quality was the most striking issue of the JV activity for both the UK and German SMEs. The UK and German SMEs came to China with quality expectations the Chinese manufacturing environment did not want to, or could not, meet. In many cases insufficient quality of the products manufactured in China hampered the SMEs' efforts to service the domestic, but also overseas markets. For instance, UK-2 considered manufacturing low quality products dangerous since this could eventually damage the SME's reputation worldwide.

Further, if product quality would not be sufficient, domestic customers (genuine Chinese and foreign manufacturers) would continue buying from abroad.

A matter that does not concern all of the JVs, but several is the fact that in order to be able to export goods manufactured in China and, thus, to meet export ratios, products must meet a certain standard of quality. UK-7-JV is required to export as much as 30 per cent of its output. However, at the time of this investigation the JV experienced problems with product quality and could, thus, not meet its target. UK-7-JV is considerably interested in being able to meet its export target and perhaps even increase it since this would bring in foreign exchange which could be used to capitalise the JV (which was at the time of investigating under-capitalised).

Also of importance for both groups of SMEs was the issue of repatriating profits. Whereas this was important for the UK SMEs (rank 3) it was very important for the German SMEs (rank 1). However, neither the UK nor the German case SMEs could provide meaningful comments on this problem that would have further advanced its understanding.

A further problem of considerable importance to the German SMEs was the transfer of technology, although this was only rated as being ninth important to the UK SMEs. An important aspect here is that it was criticised (UK-6) that although the Chinese engineers' standards are sufficiently high to understand the technology transferred, they would have problems in transforming theory to practice.

The reverse constellation has been observed with the recruiting of personnel. Whereas this was second most important for the UK SMEs, it was only the tenth most important JV problem for the German SMEs. Personnel motivation, on the other hand, appeared to be rather important for both groups of SMEs with a mean value of 1.9 and 2.0, respectively. Of equal, relative, importance to both groups of SMEs were further the problem of communication with staff, the potential loss of control and a mismatch in management styles. All these problems were regarded as nearly equally important by the UK and the German SMEs, ranking between seven and ten on a list with a total of 24 problems.

For instance, for UK-2 that manufactures test equipment, the loss of control of its technological know-how (dissemination) "is at the back of my mind," said the managing director of the SME. This managing director's main concern was that "overnight, someone who you have trusted, produces your product." As a strategy, the SME does not transfer cutting-edge technology. "It's a question of trust." UK-7 that had trusted its



Chinese partner stressed that the Chinese company decided "not to play fair any longer even though they rely on our know-how."

The remaining problems (on the list of JV problems) were either relatively unimportant to the SMEs (including the creation of a new competitor, political risk, absence of a detailed investment law) or showed major discrepancies in the perceptions of the two groups of SMEs. For instance, local sourcing and insufficient training of Chinese managers were perceived the fifth most important problems for the UK SMEs, whereas they ranked only eighteenth and tenth, respectively on the German side (for the UK SMEs this latter was an important problem, for the German SMEs it was only of medium importance).

At the time of the investigation, UK-6-JV was assembling the parts supplied by UK-6 and eventually, most of the machines should be produced in China using also local supplies. However, UK-6 fears that after two years even critical components would have to be imported from Japan, for instance, where UK-6 was at the time of interviewing, purchasing certain materials and components. Also to UK-2, the availability of quality components is very important since it can use only high quality components for the manufacture of its equipment in the JV.

Similar applies to the low productivity of local labour. Whereas the UK SMEs considered this problem as important (mean = 2.1, rank 7), it was only medium important for the German SMEs, ranking twenty-first (mean = 3.0) and thus amongst the least important. UK-6 criticised the low efficiency and therefore the pace things happen in its JV. This is "the only area that worries me. I would like have things done faster." UK-6 believes that it could change (increase) the pace of operation in the venture if it had the majority in the JV. Although UK-6 could appoint the general manager in the JV, a Taiwanese manager from its partner, this manager apparently does not represent the interests of the UK SMEs as it had hoped when it made the decision to appoint this general manager ]...[ and considered it an alternative to expatriating a UK manager who would have been too expensive for the SME.

On the other hand, problems that were perceived by the German SMEs as important, were unfair competition, corruption and damaging reputation, whereas these problems ranked only considerably lower on the list of JV problems of the UK SMEs.

Overall, a Spearman rank correlation coefficient of  $r_{sp\_nat} = .4778$  suggests that the UK and German SMEs perceived the importance of JV problems similarly. This is true on the 1 per cent significance level even, whereas group similarities between Size One firms and Size Two enterprises exist on the 5 per cent significance level only ( $r_{sp\_size} =$

.4376). The gravest differences between Size One and Size Two firms exist with regard to the recruiting of personnel that ranked second within the group of Size Two firms though only eleventh within the group of Size Two firms. Differences are also considerably with regard to loss of control (which is more feared by the smaller firms), infrastructure and restrictions on sales and imports which was considered a more important problem by the smaller firms than by the larger.

A comparison of  $r_{sp\_nat}$  and  $r_{sp\_size}$  suggests that the size criterion is a more important discriminator than nationality.

## 7.2.6 Joint venture evaluation

### *Joint venture performance*

On average, the UK SMEs were more satisfied with their JVs than were the German SMEs. Whereas the most satisfactory performance criterion of UK SMEs were supply fees, for the German SMEs it was local market share, followed by return on investment (RoI) and export performance, management and supply fees and 'in comparison with competitors' (competitors' performance). The least important criteria for German SMEs were growth and royalty fees. Comparison with competitors and management fees, however, were the second most satisfactory success criteria for UK SMEs, followed by local market share, RoI, growth, export performance and royalty fees (table 7-20).

Table 7-20: JV performance.

Performance criteria	UK SMEs			GER SMEs			Size One			Size Two		
	S	R	n	S	R	n	S	R	n	S	R	n
Overall satisfaction	2.4		7	2.9		9	2.4		7	2.9		9
Supply fees	2.7	1	3	3.0	5	7	2.7	2	7	3.3	6	3
Management fees	2.8	2	5	2.8	4	4	2.9	4	7	2.5	1	2
Compared with competitors	2.8	2	5	3.0	5	4	2.8	3	6	3.0	3	3
Local market share	3.0	4	5	2.5	1	4	2.5	1	6	3.3	6	3
RoI	3.3	5	6	2.7	2	7	2.9	4	7	3.2	4	6
Growth	3.5	6	6	3.2	7	6	3.5	6	6	3.2	4	6
Export performance	3.6	7	5	2.7	2	3	4.0	7	4	2.5	1	4
Royalty fees	4.0	8	3	4.3	8	4	4.2	8	5	4.0	8	2

Key: S = degree of satisfaction, R = rank, n = respondents. Three companies indicated that it was too early to make any comments on the success of their ventures.  $r_{sp\_nat} = .1905$ ;  $r_{sp\_size} = .0446$ ;  $r_{sp\_crit} (\alpha = .05) = .6190$ ;  $r_{sp\_crit} (\alpha = .01) = .8095$ .

The managing director of UK-2 was "quite disappointed with what they have achieved so far. They have not shown that they can do this." At the time of interviewing, the JV was not manufacturing. The seven employees of UK-2-JV, in 1995, turned over mere £70,000. For 1996, UK-2's managing director expected nearly double this turnover.

Spearman rank correlation analysis suggests that the UK and German SMEs did not display significant similarities with regard to their degrees of satisfaction with JV

performance ( $r_{sp\_nat} = .1905$ ). With regard to firm size differences, the dissimilarities are more distinct ( $r_{sp\_size} = .0446$ ). For instance, whereas Size Two firms are most satisfied with their JVs' export performance, this ranks only seventh within the group of Size One firms and a reverse situation appears with regard to local market share. Overall, the smaller firms are more satisfied with the performance of their JVs than are the larger firms.

### **Factors for joint venture success**

For success of a JV in China, the UK and German SMEs perceived the following attributes as important (table 21).

Table 7-21: Attributes for JV success.

Success attribute	UK SMEs			GER SMEs			Size One			Size Two		
	I	R	n	I	R	n	I	R	n	I	R	n
Patience	1.3	1	8	1.5	2	10	1.3	1	8	1.5	1	10
Sincerity	1.5	2	8	1.3	1	12	1.3	1	10	1.5	1	10
Good business connections	1.5	2	8	2.0	6	10	1.5	3	8	2.0	6	10
Good product	1.6	4	8	1.9	5	11	1.7	5	10	1.9	3	9
Adapting to the Chinese market	1.8	5	8	1.7	3	10	1.6	4	10	1.9	3	8
Relationships with PRC officials	1.9	6	8	2.1	7	9	2.0	7	9	2.0	6	8
Familiarity with PRC bus. pract.	2.0	7	8	1.8	4	10	1.9	6	10	1.9	3	8

Key: I = importance, R = rank, n = respondents.  $r_{sp\_nat} = .4554$ ;  $r_{sp\_size} = .5916$ ;  $r_s (\alpha = .05) = .6786$ ;  $r_s (\alpha = .01) = .8571$ .

Patience and sincerity were considered most important attributes for success with JVs in China by both the UK and the German SMEs. Good business connections were perceived as second most important by the UK SMEs, but only sixth most important by the German SMEs. Instead, the German SMEs perceived the ability to adapt to the Chinese market as third most important attribute for success in a Sino-foreign JV. The UK SMEs perceived this factor as fifth most important only, following a good product (rank four). Relationships with Chinese officials and familiarity with Chinese business practices were the least important attributes for JV success for the UK SMEs. Familiarity with Chinese business practices ranked fourth with the German SMEs, followed by good product, good business links and relationships with Chinese officials.

In the case of UK-2 that manufactures testing equipment, the fact that the SME has moved on-site with service capabilities meant considerable orders for the firm. However, the managing director of UK-2 also suggested the need to be patient and "to give them support, service support and information."

According to the calculation of the Spearman rank correlation coefficient of  $r_{sp\_nat} = .4554$ , the UK and German SMEs did not show significance similarities with respect to attributes of JV success. However, inter-group correlation is stronger when the

criterion firm size is applied ( $r_{sp\_size} = .5916$ ). Whereas both Size One and Size Two firms regard patience and sincerity as the most important attributes for JV success, their perceptions differ considerably with regard to the factor 'good business connections' and 'familiarity with Chinese business practices'. Whereas the former is more important to smaller firms, the latter is more to larger firms. In summary, the criterion 'nationality' is stronger a discriminatory factor than firm size.

### ***Joint venture as resource commitment relief***

The managers of the UK and German SMEs were also asked whether and to what extent joining forces with a local Chinese company would reduce their own resource commitment to the market entry strategy with respect to management, financial and information resources. Table 7-22 shows the results: for the UK SMEs joint venturing with a local Chinese company meant a medium relief to their commitment with equal regard to management, financial and information resources. The German SMEs perceived the JV as not being a relief with regard to management and financial resources and a medium relief with regard to information needs.

Table 7-22: JV as resource commitment relieving strategy.

Chinese partner contribution	UK SMEs		GER SMEs		Size One		Size Two	
	R	n	R	n	R	n	R	n
Management resources	3.4	8	3.7	10	3.4	9	3.7	9
Financial resources	3.4	8	3.6	9	3.3	8	3.9	9
Information needs	3.1	8	3.0	11	2.9	9	3.2	10

Key: R = perceived degree to which JV partner helped reduce the SMEs' resource commitment for the FDI market entry strategy.

As a trend, the smaller Size One firms regard the JV strategy more as a strategy that eases the resource scarcities of SMEs than the larger Size Two enterprises. The smaller firms suggest that in terms of management and financial resource ease, the benefits from joint venturing are moderately whereas the larger firms cannot see such an ease. Although with regard to information needs, the smaller firms appreciate the JV more than the larger firms do, though also they regard the provision of essential information by the JV strategy as moderately easing the resource situation of SMEs.

In conclusion, five of the nine UK SMEs would again engage in a JV, two suggested that it was too early to answer this question and one did not know at the time of the survey. One respondent did not answer this question. Of the German SMEs seven would again engage in a JV in China, one indicated that it did not know and four SMEs did not provide an answer to this question. There is no dissimilarity between the responses of Size One and Size Two SMEs.

## **7.3 Conclusion**

This chapter has revealed the details of the joint venturing in China of nine UK and 12 German SMEs. Making a distinction between UK and German SMEs as well as Size

One and Size Two SMEs is sensible since both nationality and firm size facilitated differences between two groups of SMEs. On the other hand, various dimensions of the JV process applied to all SMEs on an equal basis. For instance, the market motive was the prime motivation for UK and German and large and smaller SMEs to set up an FDI presence in China. As is known from the literature in chapter six, this applies to large MNEs alike. Differences were significant in areas in which the resource situation of firms was a major influencing factor, eg in the planning of a JV, partner selection, and negotiations. Also, the smaller firms are more satisfied with their JVs than their larger counterparts, suggesting that the smaller firms did not have expectations laid out as detailed and as the larger firms in the sample. Again, with regard to the JV's ability to relief the resource commitment of the SMEs when entering the Chinese market, the smaller firms were more likely to support this argument than the larger firms. In those cases, it was more difficult for the Chinese partners to contribute assets or attributes which the larger SMEs needed since they did not have them themselves.

## Notes

<sup>1</sup> A 50 minutes interview was held with the managing director of UK-2 on 2. October 1996. An interview was also held with the managing director of UK-6 on 30. September 1996, lasting one hour. A further 45 minute interview was carried out with the managing director of UK-7 on 3. October 1996.

<sup>2</sup> Contingency analysis would indicate whether differences are significant or not [ $H_0$ : firm size category and nationality are independent;  $H_1$ : firm size category and nationality are dependent].  $\text{Chi}^2_{\text{emp}} = .04$  and  $\text{Chi}^2_{\text{crit}} = 6.63$ , thus  $H_0$  **not** rejected.

<sup>3</sup>  $r_{\text{sp}} = 1 - [6 \sum D_i^2 / (n^3 - n)]$

<sup>4</sup> One company had 550 employees and another one 515. Both were accepted as SMEs.

<sup>5</sup> At the time of interviewing, UK-7 held 35% in the JV, the Chinese partner 55% and the Singaporean partner 10%.

# Chapter Eight

## Cross Case Analysis

### 8.1 Introduction

The previous chapter has presented, and analysed, the results obtained from two questionnaire surveys. Additionally, qualitative findings from in-depth interviews with managers of selected UK companies were analysed. Chapter eight analyses the experiences and strategies of one German and three UK SMEs with a joint venture (JV) in China - according to the research framework that has been established in chapters three and six. Four cases were chosen since cross case analysis allows the investigator to progress from description and partial analysis to an interpretative level of analysis (Miles and Huberman, 1984). Explicitly, this chapter studies the JV formation and operation phases of the four cases, evaluates their performance and identifies problems that occurred while joint venturing in China. The subsequent chapter nine discusses the overall findings of the questionnaire surveys and interviews as well as the insights of the case studies against the background of the body of literature discussed in chapters two, three, five and six. Appendix VII contains the detailed cases of the four SMEs with a JV in China. These are presented in the same format as the cross case analysis executed in this chapter.

Table 8-1 presents an overview of the four cases, including aspects such as industrial sector, year of establishment, volume of investment, number of employees and location of the JVs. Names, specific products and locations have been disguised.

Table 8-1: Summary of the cases studied.

	GER-0	UK-3	UK-4	UK-8
<b>Industry</b>	Mech. Engineering	Mech. engineering	Electronics	Road infrastructure
<b>Established</b>	January 1995	May 1996	March 1994	March 1995
<b>Investment</b>	£2.77m	£2.09m	£0.11m	£0.78m
<b>Employees</b>	95	25	20	54
<b>Location</b>	East China	East China	East China	South China

### 8.2 Basic facts about the cases

#### 8.2.1 The case SMEs

All four SMEs were established as limited companies. Whereas both GER-0 and UK-3 are active in the mechanical engineering business, UK-4 operates in the electronics industry and UK-8 in road infrastructure. The companies have in common, however, that they are important players in their respective industries. For instance, as much as GER-0 considers itself as the second most important manufacturer of MECHANICAL

COMPONENTS worldwide with a market share of 13 per cent (GER-0 Annual Report '94, 1994) so insists UK-3 to have an international reputation for its commitment to high engineering standards and quality production. Further, UK-8 holds no less than 80 per cent of the market for ROAD INFRASTRUCTURE PRODUCTS in the UK. Finally, the managing director of UK-4 estimates his market share being "fairly high" since the products of UK-4 are niche market products. In terms of company size (number of employees) GER-0 is the largest of the four case companies, with a workforce in excess of 500. The other three companies have a workforce of distinctly less than 500 employees. In detail, at the time of the investigation, UK-3 employed 210 staff, UK-8 90 and UK-4 ten in their operations in the UK.

### **8.2.2 International business activities**

Although international markets are very important to the four SMEs, the ways the four companies generate their foreign turnovers vary considerably. For instance, GER-0, at the time of the investigation, had subsidiaries (wholly foreign-owned enterprises [WFOEs] and JVs) on four continents except Africa. On the other hand, UK-3's business activities limit themselves to exporting and the installation of INFRASTRUCTURE SYSTEMS. For UK-3 the JV in China is the only investment project abroad. The same applies to UK-4 and UK-8 that had also pursued only export activities prior to engaging in their foreign direct investment (FDI) projects in China. However, in the course of the research project, UK-8 bought a 50 per cent stake in a Singapore-based enterprise. In addition, UK-8 has two agents in Hong Kong and one in Dubai which acquire business on behalf of the SME.

### **8.2.3 The SMEs' China experience**

Of the four SMEs, only two were experienced in doing business with, or in, China. One of those is GER-0. Its first commitment in the Chinese market was a know-how transfer agreement with a state-owned enterprise (SOE) signed as early as 1982. UK-3 had prior experience with China through exporting to the country since 1985. In other words, both SMEs had approximately 15 years of China experience before they started committing funds into a joint investment project in the country. On the other hand, neither UK-4 nor UK-8 were engaged in China business prior to establishing their JVs in China. UK-8 would not have even undertaken the step towards business in China without the impetus from the Chinese side. In this particular case the Chinese were, in 1992, searching the world markets for suitable ROAD INFRASTRUCTURE PRODUCTS and companies in the West they could team up with to manufacture and install such products in China. Only after the Chinese company had initially



approached the UK SME had it started to develop a business interest in entering and developing the Chinese market.

## **8.3 Joint venture formation**

### **8.3.1 Joint venture planning**

The JV planning procedures employed by the four SMEs were considerably different. There was, on the one hand, GER-0 whose planning efforts were considerably intensive and sophisticated. The company started as early as 1990, with the active search for opportunities of contracting with a potential Chinese partner company. During the entire process, the director for overseas affairs of GER-0 proceeded along his set of criteria established in his so-called 'JV evaluation handbook'. During its evaluation process, GER-0 relied on country-specific information provided by the BfAI, the German government-funded body that provides information about market and investment opportunities abroad. Also, the German SME was the only company out of the four SMEs studied in-depth, that looked thoroughly into opportunities of financing the investment project through a national or a supra-national grant or loan. For instance, the German SME applied for, and obtained, finance from the German Development Bank (KfW) at an interest rate of 2.5 per cent. This is considerably lower than the market interest rate. The director for overseas affairs of GER-0 also looked into the possibility of financing the project through ECIP, the investment financing flagship of the European Community (European Community Investment Partners). Eventually, this was not considered appropriate for no further reasons given.

On the other hand, there was UK-3 whose planning is best described as a 'gut-approach', ie anything but scientific and professional. The SME aimed at setting up a company first and would only then look how the market works. UK-4 put more effort into the planning of its operation in China than UK-3 did. Originally, UK-4 intended to enter into a contract manufacturing agreement with a local company. Initially UK-4's managing director contacted the British embassies in various Asian countries and asked them for basic information about companies that would be able to manufacture ELECTRONIC DEVICES on its behalf. After assessing the company details he had received, according to his set of criteria (basically quality-of-labour considerations), UK-4's managing director subsequently shortlisted two companies and inspected them. At the end of this process he decided to shift production to China because production would be cheap and quality of labour sufficient.

As was said above, UK-8 was approached by the Chinese side. Interestingly, all the information that the SME used during the planning and assessment process, was provided by the SME's potential Chinese partner. All the figures that helped the UK SME estimate the vast potential for its INFRASTRUCTURE PRODUCTS were based on figures created by the Chinese side exclusively. However, UK-8 insists that it had carried out independent market research.

### **8.3.2 Motivations for production in China**

#### ***Motivations to engage in an FDI project***

The reason of three out of the four SMEs (GER-0, UK-3, UK-8) to engage in an FDI project, was the potential which the Chinese market would hold for the companies. Only UK-4 was, at the time of the investigation, not primarily interested in servicing the Chinese market. Instead the SME intended to manufacture cheaply in the country. This would make the UK SME cost-competitive with respect to its competitors. As a matter of fact, for UK-4 low cost production was the only feasible strategy to withhold the increasing competitive pressures in its traditional markets.

The other SMEs, GER-0, UK-3 and UK-8, agreed in that it was perceived difficult, if not impossible, to utilise the vast potential of the Chinese market by pursuing export strategies exclusively. The higher price of the exported products, compared with locally produced goods, would make continued penetration of the Chinese market difficult. Also, reaction times would be too long and transport costs too high. These three SMEs considered being present on-site with an operation as necessary and essential to succeed in the Chinese market.

#### ***Motivations to form a joint venture***

The motivations of the SMEs to establish a JV with a local Chinese company were rather different. For GER-0 the 'following-the-customer'-motivation was the prime driving force behind, and the initiator for, its decision to establish a JV instead of a WFOE. In concrete, GER-0 followed one of its main customers in Germany, KMP<sup>1</sup> that was about to set up a JV with a Chinese SOE based in CITY [East China]. KMP's plan was that it would join forces with one division of the SOE and GER-0 with the other division of the SOE which manufactured both ENGINEERING PRODUCTS and MECHANICAL COMPONENTS. The distinct advantage for GER-0 of following this customer was that KMP would create the market potential which GER-0 could exploit, initially at least. This constituted a high business security factor for the German SME.

The UK SME, UK-3, sought, first and foremost, the Chinese element, the links and customer knowledge of its potential partner, from a commitment in a JV. The Chinese

element was the prime reason also for UK-8. For this SME it was necessary to acquire, with the establishment of a JV, knowledge of both the Chinese language and the business environment. UK-8 considered further as necessary to obtain valuable contacts which are essential in the infrastructure business in China. Also UK-8 hoped that its Chinese partner would bring links to Chinese authorities and potential customers. For these reasons, the UK SME did not pursue the idea of setting up a local manufacturing facility on its own. UK-8's managing director considered the going it alone as "simply impossible." Finally, and this was put forward only by UK-8, the SME revealed that it did not have the financial and managerial resources, which are necessary to set up a WFOE.

Interesting is also the case of UK-4. This SME joined forces with a Chinese company and established a JV only because its Chinese business partner insisted on that. UK-4's initial intention was to manufacture high quality ELECTRONIC DEVICES at low cost in the form of contract manufacturing. Clearly, thus, UK-4 had never considered the possibility of setting up a WFOE.

### **8.3.3 Partner selection**

#### ***Finding the partner***

Interestingly, in two out of the four cases (GER-0, UK-8) the SMEs' way of finding the later Chinese partner was somewhat pre-determined. For instance, GER-0 held negotiations with the SOE ABC<sup>2</sup> that was also in negotiations with GER-0's customer KMP: As established above, KMP wanted GER-0 to join forces with a division of ABC. In the case of UK-8 it was the initiative of a Chinese enterprise that the JV, in the end, came into existence. Would the Chinese company not have approached UK-8, a JV would not have been established. Also UK-8 was likely not to have entered the Chinese market even without the initial approach by the Chinese. From the very beginning, UK-8 was thus somehow 'attached' to this particular Chinese company that was to become its later partner in the joint undertaking.

The other two SMEs, UK-3 and UK-4, undertook partner search processes. UK-3 approached various potential partners in North, South and East China. UK-4 sought the assistance of the British embassies in various countries of Asia before personally examining the short-listed companies on-site. However, apart from the embassies, UK-4's managing director did not approach any other organisations that could have provided contacts with potential business partners in these countries. Had he done this, he could have possibly identified a company that would have agreed to UK-4's originally proposed contract manufacturing business. Due to limited time and finance,

and due to only limited knowledge of the means available to search for partners, the UK SME ended up being restricted in its choice of its partner company in CITY [East China] and thus restricted to the mode of contracting.

#### ***Partner selection criteria***

If there was an SME defining a set of criteria to select its later partner in the JV, then it was GER-0<sup>3</sup> and, to some extent, also UK-3. GER-0 used a set of criteria that was previously successfully applied for the establishment of GER-0's other overseas operations.<sup>4</sup> Eventually, GER-0 had to choose between a manufacturer of ENGINEERING PRODUCTS based in a provincial capital in North China and the state-owned ABC that was said to have a good reputation in and out of CITY [East China].

For UK-3 it was important to select a partner that would bring in the desired Chinese element (ie local business knowledge, contacts, guanxi, etc.) and that would have a large market share in China. Also, UK-3 wanted a partner that was interested in the business and in the proposed collaboration. However, of hidden, though considerable interest of UK-3 was the fact also that the potential Chinese partner "had no idea about the product." UK-3 hoped that its Chinese counterpart would be a silent partner that would not participate in the management of the JV. From this, it became clear that UK-3 needed its Chinese partner exclusively for getting business out of the Chinese market. Without the necessity of finding a way to acquire the essential 'guanxi' and since it was believed that a JV is the best way to do so, UK-3 would have very likely decided to set up a WFOE. This inherent reluctance of joint venturing becomes evident in the subsequent course of the JV formation and operation process.

UK-4 had found only one Chinese company that would produce its ELECTRONIC DEVICES. It did, therefore, not have the choice of selecting its Chinese partner from a pool of potential partner companies. In the case of UK-8 it is not clear whether the UK SME's decision to join forces with a particular Chinese enterprise resulted from the difficulties the SME experienced when searching for alternative partners, or the actual assessment of the Chinese partner. It cannot be reconstructed whether it applies, what UK-8 insists on, namely that the Chinese company met approximately 80 per cent of UK-8's partner requirements, such as having a reputation as a manufacturer of ROAD INFRASTRUCTURE PRODUCTS, contacts and credibility amongst customers, etc.

#### ***Partner characteristics***

All four SMEs have been teaming up with only one Chinese company each. In all four cases, also, had the Chinese partner a considerably larger workforce than the partnering SME. Only UK-4's Chinese partner is a privately owned company. The other

SMEs' Chinese partners are SOEs (partners of GER-0 and UK-8) or an authority under a particular Chinese ministry in the case of UK-3.

Interestingly, in only two of the four cases were the Chinese partners familiar with the industry the JVs would operate in (GER-0, UK-8). GER-0's partner, ABC, was engaged in the manufacture of ENGINEERING PRODUCTS as well as MECHANICAL COMPONENTS. UK-8's partner manufactures machinery for the road and bridge construction industry as well as bridges and bridge furniture. In contrast, UK-3's partner was a port authority in CITY [East China] and UK-4 teamed up with a company engaged in the manufacture of knitting yarn feeders. For instance, UK-4's partner considers itself as the largest Asia producer of Yarn feeders for knitting machines.

UK-3 took advantage of the fact that its partner had no expertise in the industry the JV would be operating in. Due to this fact UK-3 insisted on appointing the general manager of the JV. So the SME would be able to control daily operations of the JV.

#### **8.3.4 Joint venture negotiation process**

##### ***Negotiation contents and conflict***

The main negotiation issues of the four SME cases were rather different. For instance, GER-0 had the product programme of the JV-to-be on top of its list. The German SME offered approximately 65 per cent of its entire MECHANICAL COMPONENTS production programme and the Chinese partner selected what should be manufactured in the JV. Further issues in the negotiation process were the planning of future operations, contents of the feasibility study, the distribution of the JV's equity, and the valuation of both partners' contributions. The latter was, initially at least, a major negotiation problem.

The valuation of both partners' contributions was also an issue of interest and a point of conflict in the case of UK-3-JV negotiations. The remarkable difference was, however, that, in this particular case, the conflict could not be solved easily. The Chinese side simply insisted on its proposed value of the UK machinery. The UK SME, on the other hand, refused to agree to this. However, since UK-3 did not want to risk the business licence, it eventually obeyed to the Chinese company's dictate.<sup>5</sup> An important issue for UK-3 was further the supply of material. This had to be ensured in the course of negotiations since the availability of cheap input factors was one of the reasons for UK-3 to commence production in China. Another negotiation content which was of interest to the UK SME was the market focus of the JV. Also, this caused dispute between UK-3 and its Chinese partner. The Chinese side wanted to export as much as 50 per cent of the JV's output, whereas it has been the objective of UK-3 to develop a new, ie the Chinese, market, but not to sell as much as 50 per cent of production in overseas markets. Eventually, UK-3 had to agree to a 50 per cent export

share. In this particular case, the Chinese party's bargaining position was too strong for the UK SME to withhold. The market focus was also a problem in the case of GER-0. Also GER-0 came to China to develop, first and foremost, the domestic market. As opposed to GER-0, UK-3 had also difficulties with negotiating its equity stake in the JV. The UK SME was not permitted holding the majority stake in the joint undertaking.

An important aspect in the negotiations of UK-8-JV was the status of the UK SME as provider of a certain component whose formulation was to be kept secret. This was a chemical component which absorbs the shock of the traffic when it hits the ROAD INFRASTRUCTURE PRODUCTS and it was considered an essential one for the uniqueness of the entire product. The Chinese side accepted the UK SME's standpoint without major discussions and agreed also to the importation of equipment for the manufacturing and installation of ROAD INFRASTRUCTURE PRODUCTS. UK-8 insisted on that, although the price of the equipment purchased in the UK was considerably higher compared with buying it in China. UK-8 insisted on that the UK-sourced equipment would guarantee higher efficiency and quality of the products manufactured and installed.

The SME cases show clearly that companies with a strong bargaining power can press more through negotiations than firms with less bargaining power. UK-8 had a clear firm-specific advantage (replace ROAD INFRASTRUCTURE PRODUCTS without closing the individual bridge) and could thus impose more pressure on negotiations. Repeatedly the Chinese side agreed to what the UK SME demanded or desired. At only one occasion, namely when UK-8 opted for a majority stake in the JV, the Chinese side opposed vehemently.

Also GER-0 was able to press most of its demands through negotiations: the product programme, the majority stake, and the fact that the German director for overseas affairs was appointed chairman of the JV. Overall, compared with its other operations worldwide, GER-0's JV in China seems not to be an organisational exception. The only issue GER-0 had to agree with, although it did not like the idea, was the long duration of the JV. Originally, GER-0 eyed at a JV duration of 15 years, but eventually agreed to a duration of 50 years. Overall, GER-0 had its clear idea of what would be acceptable and what not as the outcome of negotiations. The SME was prepared even to withdraw from its proposal to joint venture. The SOE ABC offered GER-0 even a 60 per cent equity share in the JV. Would the investment have been larger, ABC's opinion of the foreign equity share and that of the municipal government would have been different. Osland and Cavusgil (1996) found that the extent of control that is desired is affected

by the size of the JV. However, GER-0's strategy was to have an equity share as large as necessary, but low enough to keep the partner interested in the joint business.

The durations of the JVs vary considerably across the four cases. Whereas GER-0-JV has a duration of 50 years, UK-3-JV should last for 30 and UK-4-JV for 20 years. UK-8-JV was established as the JV with the shortest duration: it is due to expire after 12 years. All JVs are extendable depending on the mutual agreement of the partners and the approval of the respective municipal authorities. Whereas for two SMEs JV duration was not an issue of conflict, for two other SMEs it was: GER-0 initially insisted on 15 years, but later agreed to the Chinese proposal of 50 years, because the Chinese side insisted on such a long duration. In the case of UK-3-JV it was the reverse: here UK-3 opted for the longer duration of 30 years whereas the Chinese side wanted only 15 years. Eventually, the parties agreed at 30 years. 15 years were considered not long enough by the UK SME as duration of the JV.

UK-4 did not report any issues in negotiations that caused conflict between it and its Chinese partner. This was certainly due to the reason that UK-4's deal was a manufacturing agreement in which the JV produces according to orders from the UK SME. JV issues were, thus, not really relevant to the UK SME.

***SME negotiation team, location, duration, language of negotiations, interpreters***

The negotiation teams altered on both sides, the foreign and the Chinese. In the case of GER-0, managers of the overseas business division prepared the JV formation up to the signing of the so-called 'letter of intent'. The final talks and the signing of the contract were accomplished by GER-0's director for overseas affairs.

This was rather different in the cases of UK-3, UK-4 and UK-8 where the managing directors of the SMEs initiated the preparations of the investment projects themselves. The reason is certainly that the UK SMEs were smaller in size and had nothing like an overseas affairs department as had GER-0. In the case of UK-3 the managing director initiated the deal and prepared and carried out negotiations. Only towards the end of the process was the expertise of Price Waterhouse's local office in CITY [East China] consulted. Jointly with UK-3 it worked out the final documents. The story of UK-4 reads similarly: here the managing director of UK-4 carried out the preparations and negotiations and received some legal support from Hong Kong-based solicitors towards the end of JV preparations. In the case of UK-8-JV negotiations were carried out between three parties: UK-8, the potential Chinese partner and a Chinese commercial organisation based in Beijing. UK-8-JV was negotiated, initially, by the managing director of UK-8 who later delegated negotiations to his technical director

who went to China to get ROAD INFRASTRUCTURE PRODUCTS installed on-site. This was necessary to get the JV approved.

Three out of the four JVs (GER-0-JV, UK-3-JV, UK-4-JV) were approved by the local authorities, due to their relatively small investments. Only UK-8 was approved by the Administrative Bureau for Industry and Commerce in Beijing.

Whereas UK-8-JV needed approximately two years of preparation and negotiation (four meetings) and UK-3-JV eight negotiation meetings spread over a total of 18 months, the actual sorting out of details in the case of UK-4-JV had taken approximately six months, although UK-4 commenced thinking about overseas production in 1992 already. Also GER-0-JV became operational after only about six months of preparations and negotiations. This was due to GER-0's determined approach towards the undertaking and its professional proceeding through preparations. Further, the Chinese side could manage to get the JV approved by the municipal government so quickly for two main reasons: first, ABC had close links with the municipal government of CITY [East China]. Secondly, the Chinese partner wanted the deal. ABC certainly refrained from delaying or even jeopardising its deal with GER-0 since this could have affected its main deal with KMP to form the proposed (bigger) KMP-JV to produce ENGINEERING PRODUCTS. This certainly saved GER-0 funds that would have been necessary otherwise for extended negotiations, additional travel to China, etc.

Long negotiation periods as in the case of UK-8-JV are resource demanding and expensive. In this particular case, the SME first had to install successfully one of its ROAD INFRASTRUCTURE PRODUCTS on-site and had to get this approved by the Chinese Ministry of Transport. Only then did the authorities approve the JV.

### **8.3.5 Partner contributions**

#### ***SME's contribution***

The UK and German SMEs whose cases were studied in-depth contributed, first and foremost, cash to their JVs. GER-0 and UK-8 additionally contributed know-how and the former also drawings. Apart from know-how, UK-3 brought into the JV machinery. On the other hand, the exclusive contribution of UK-4 was cash which, together with the cash contribution of the Chinese partner, was used to purchase machines for the production of ELECTRONIC DEVICES.

#### ***Chinese partner's contribution***

GER-0's partner, ABC, contributed its own MECHANICAL COMPONENTS programme, machinery, land, warehouse facilities. It was also responsible for the staffing of the JV. Also in the case of UK-3-JV the Chinese partner contributed land



and the building in which the JV commenced its operations. UK-3's partner contributed, however, no cash to the JV, but instead 'guanxi' that were considered as very important by the UK SME.

In contrast to the notion not to expect cash from the Chinese partner, UK-4's Chinese partner poured in cash (twice as much as the UK SME). Also UK-8 contributed financial resources to the JV, apart from knowledge of the local business community, contacts, and the responsibility for staffing the JV. As in the case of UK-3-JV the Chinese partner's knowledge of the business environment, contacts and links to officials were very important for the UK SME.

In the case of GER-0-JV there exists contradictory opinion with regard to a Chinese partner's cash contribution. According to GER-0-JV's German production and quality assurance manager, the Chinese partner had not contributed any money to the JV. On the other hand, his assistant insisted that the Chinese side also poured in local currency. The production and quality assurance manager of the JV considers land to be the most important contribution of the Chinese partner since, "as a foreigner you never have the right to acquire land." Instead, China knows the system of land leasing of up to 99 years. Subsequently, the land and buildings on it fall back to the Chinese people. A problem that relates to the Chinese partner's contribution of land is that, frequently, foreign direct investors failed to reassure themselves when establishing a JV: the Chinese partners bring into the JV land and later, a third party starts claiming money on the basis of its right which it holds in the land. This problem was confirmed by Mr. Gotschlich of the German Centre for Industry and Commerce in Shanghai (interview on 5.11.96). However, this is not the case in GER-0-JV - at least it had not been detected at the time of the investigation.

A major contribution of UK-4's partner to the JV was the Chinese firm's municipal government connections. This good relationship to the municipal government of CITY allows the Chinese partner company to pledge that "we complete all the formalities and after five days, the JV can be set up."

## **8.4 Joint venture operation**

### **8.4.1 Joint venture background information**

#### ***Joint venture establishment, total investment and workforce***

All four SME JVs were established as equity JVs and in the legal form of a limited liability company according to Chinese law. The total investment in the JVs ranges from £108,974 (UK-4-JV), £0.77m (UK-8-JV) and £2.09m (UK-3-JV) to £2.8m (GER-0-JV). At the time of the investigation, the workforces of the JVs ranged from 20 (UK-4-JV), 25 (UK-3-JV) and 54 staff (UK-8-JV) to 95 employees (GER-0-JV).

#### ***Joint venture location***

All four JVs are located along China's East coast in economic and technological development zones where they can enjoy special treatment in terms of tax

concessions, for instance. Also, from their locations, the JVs have relatively easy access to road, air and sea transport infrastructures as well as to electricity, communication and social infrastructures.

Three out of four JVs (GER-0-JV, UK-3-JV, UK-8-JV) are located in close proximity to their respective markets. UK-4 is the exception. This JV's sole client is its SME parent in the UK. Further commonalities appear: all four JVs are located on the factory sites that originally belonged to their Chinese parents. In the cases of GER-0, UK-3 and UK-4 the Chinese parent companies are still operating in neighbouring buildings on the site shared. In the case of UK-8, the Chinese parent company has erected a building which hosts the JV's operation and where the JV pays rent to the Chinese company.

### ***Choice of location***

GER-0 had chosen to locate in CITY [East China] due to reasons, including proximity to target markets, the location being a civilised area, tax concessions granted in the economic and technological development zone with no taxes to be paid in the first two years and half the rate from year three to five. Also UK-3 based its decision to locate near CITY [East China] on the proximity to target markets, although for UK-3 the availability of a suitable factory building, the availability of skilled labour and cheap material (steel) and access to river and sea shipping were of further relevance.

Access to river and sea shipping was also of importance to UK-4 when deciding to locate in CITY [East China]. As is known from above, UK-4 did not have a great deal of a choice between various partners and no choice with regard to location at all. On the other hand, it could be argued that UK-4 would have refused to team up with its current Chinese partner, in case its JV location had not offered access to a harbour.

As in the cases of GER-0 and UK-3 so was UK-8's location decision determined by the potential market argument, but also by the possibility to access a major port of the country which makes the supply of the special chemical component convenient, fast and cheap. In addition, UK-8's choice of location was influenced by lower production costs, relative to elsewhere, the availability of trained labour and the preferential treatments granted in the economic and technological development zone. However, with regard to economic and technological development zones it must be noted that the concessions granted in one of the numerous zones are the same all over the country. They are, thus, not really a discriminating factor when choosing a location for FDI activity.

### ***Production site***

After a period of one-and-a-half years when it had to operate in an old building that belonged to the Chinese parent, GER-0-JV has been operating in a new, purpose-built

building erected on the site that was contributed by the Chinese parent. The advantage of this location for GER-0 is that it is in the immediate neighbourhood of GER-0-JV's customer KMP. This saves time and money for transportation of GER-0-JV's output and makes thus GER-0-JV's products attractive to the KMP-JV.

UK-3-JV, on the other hand, operates, as UK-4-JV does, in a building that existed already when the JV was formed. The difference, however, is that in the case of UK-3 the Chinese partner contributed the building, whereas in the case of UK-4-JV, the building is rented off the Chinese parent company. The advantage in both cases is that the JVs could start their operations relatively early after being established. This was different in the case of UK-8-JV where the new company had to wait approximately one year before it could start manufacturing ROAD INFRASTRUCTURE SYSTEMS in the purpose-built building outside of CITY [South China].

The case of UK-3 presents a situation that is problematic for many foreign investors in China. UK-3 had agreed that its Chinese partner contributes a building to the JV. The UK SME had hoped to be able to commence production considerably earlier than in the case where a building had to be erected first. Secondly, if the Chinese partner brings in an existing building, cash funds could be saved up for other investments, foreign machinery, for instance, or special components or parts. However, since the state of the contributed building in the case of UK-3-JV was rather poor, a lot of funds and time had to be spent to refurbish the building. In this particular case, the managers had assumed the building would do what it should do." This, however, turned out to be a big mistake. The concepts of quality of Chinese and UK (or German) managers are different. Especially the concept of quality is very subjective and there is no standard measure that would facilitate comparison.

### ***Product range***

In all four cases the JVs in China manufacture only a fraction of the range of products that is produced in the SMEs' home plants. For instance, in the case of GER-0-JV, the product programme is restricted to MECHANICAL COMPONENTS for the power and chemical industries. The same applies to UK-3: although UK-3-JV produces the full range of standard INFRASTRUCTURE SYSTEMS, compared with the full range of products manufactured by the SME in the UK, the JV's product range represents only a fraction. This is true also for UK-4-JV and UK-8-JV. The JVs have in common also that the SMEs intend to extend the JVs' product ranges gradually.

### ***Target market***

Apart from UK-4, the German and UK SMEs came to China to engage in a JV in order to service, first and foremost, the domestic Chinese market (Sino-foreign customers and Chinese clients) and, in cases also neighbouring Asian markets. This would help

to establish a position in Asia and also to generate, through exports, foreign exchange that would be needed to purchase materials, machinery, etc. The SMEs did not intend to target also their traditional export markets with products manufactured in the JV. However, in various cases had the SMEs agreed to export a certain share of their JVs' production. For instance, in its fifth year of operation, GER-0-JV must export as much as 30 per cent of its entire output which is considered a lot by GER-0. Had GER-0 not a network of subsidiaries that is able to absorb parts of the production of the SME's China-based JV, absorbing as much as 30 per cent of the annual JV production could become an even more difficult task.

UK-3-JV should export 50 per cent even of its annual output, according to its JV contract. As in the case of GER-0-JV also here the foreign parent helps the JV meet this goal. For instance, at the time of the investigation, UK-3-JV was processing an order from UK-3. Advantageous in the case of UK-3-JV is that if the JV can attract one of UK-3's clients it is able to offer a better deal than UK-3 could and UK-3 would not object to this. UK-8 managed to include in the JV contract a "we will try" phrase. This means the JV is encouraged to export, but will not be penalised if it cannot meet a certain target. Although not required, UK-8 has been looking into the possibility of exporting certain components to the UK, such as finished steel components.

What all of the JV entrepreneurs (except UK-4) have learned is that, in order to target the domestic market, a network of contacts and connections is essential. Without knowing the right people, a JV cannot operate successfully. This is particularly true for UK-3-JV and UK-8-JV which are both in the infrastructure business. There, orders have to go through planning bureaux, etc. The statement of UK-3-JV's general manager hits the point: "In China you do not necessarily have to offer the best product at the best price, but, instead, having the right contacts is more important."

#### ***Market share in China***

The only SME that could roughly estimate its market share in China was GER-0. It suggested 3 to 5 per cent as at the end of 1995. For subsequent years (fifth year of operation) the assistant sales manager estimated approximately 10 to 15 per cent. UK-8-JV could only estimate its local market share in CITY [South China], at 20 per cent, but not for the whole of China. UK-3 had no idea whatsoever about the size of its market share, neither that of its competitors. This, again, reflects the poor preparation of the JV project which is rather characteristic of the UK SME JV cases in this study.

#### **8.4.2 Joint venture ownership**

The ownership constellation in the four SME JVs is substantially different. Whereas GER-0 holds a majority share of 51 per cent in its JV, UK-3 shares the equity equally with its Chinese partner. Both UK-8 and UK-4 have minority positions in their JVs, with

UK-8 having 49 and UK-4 having only 33 per cent. The negotiations behind these equity stake distributions are interesting. For instance, GER-0 that insisted on the majority share in the JV, could have easily gone for more than 51 per cent. The Chinese partner offered even 60 per cent equity. However, GER-0 preferred to have 51 per cent only. It hoped that so the Chinese partner would keep being interested in the joint undertaking. GER-0 did not want a Chinese company that understood its commitment in the JV as a portfolio investment. Instead, the German SME wanted the Chinese partner's contribution in terms of corporate skills. Also, GER-0's strategy was to combine a risk position as small as possible with a control position as big as necessary to avoid dissipation of its technological know-how.

As GER-0 so was UK-3 very keen to have the majority stake in its JV. However, 50-50 was as much as the Chinese side was prepared to go. Although UK-3 did not like the idea of sharing the equity equally, it eventually had to agree to it. UK-3's willingness to accept the equal equity JV was facilitated by the fact that the Chinese partner had no idea of the industry in which the JV would be operating in. UK-3 would so be able to control the JV. Also UK-8 intended to obtain the majority stake in the JV. However, in this particular case, the Chinese partner was not even prepared to share the equity equally. 49 per cent was the most the foreign SME could get. The Chinese negotiation partners were not prepared to discuss the issue of equity distribution further. Although previously they had agreed to various issues that had been demanded by the UK SME, in this respect they did not provide any room for negotiations. Eventually, UK-8's bargaining position was not strong enough to push through its desire for a majority position in the JV.

Also UK-4 holds the minority share in its JV. However, as opposed to UK-8, UK-4 never wanted to go for the majority stake in the venture. The UK SME was not even interested in an equal distribution of the equity. Since UK-4 had no intention of opting for a JV in the first place, but only wanted a contract manufacturing agreement, it welcomed its minority position of 33.33 per cent. Contractually, UK-4 could increase its equity share. On this the Chinese party comments: "If the English party wants to have more shares, it has to send a person to China." UK-4 expatriating a British manager to the JV in China, however, seems very unlikely, for the reasons outlined above.

### **8.4.3 Joint venture control**

According to the distribution of equity, the distribution of control varies in the four SME JVs under in-depth study. The number of seats in the boards of directors (BoDs) varies considerably, from four (GER-0-JV) and five (UK-4-JV; UK-8-JV) up to six (UK-3-JV).

GER-0-JV's BoD has four seats which are equally distributed amongst the partners. The German SME insisted that the general manager is a Chinese national, since a

German (or foreign) general manager was considered not effective in the Chinese environment. The director for overseas affairs of GER-0 has taken on the chairmanship of the JV and the Chinese side the vice-chairmanship. That one side holds the chairmanship and the other the vice-chairmanship is common in Sino-foreign JVs with equal ownership distribution or slight diversions from that. Clearly, its majority stake gave GER-0 the confidence to appoint a Chinese general manager, although the German SME had the right to send to China a German general manager. If there are arguments within the JV, the German SME can easily play out its 51 per cent.

This is different in the case of UK-3 that only has 50 per cent of the equity. Since UK-3 insisted, as compensation for not being granted the majority stake in the JV, to appoint the general manager, the chairmanship is held by the Chinese side. The managing director of UK-3 is vice-chairman of the JV. This will change after three years when the chairmanship will be handed over to the UK side. Responsibilities in the JV are not distributed according to a fixed structure. However, according to the managing director of UK-3, the Chinese side is in charge of selling to the Chinese market and of 'Chinese relations', whereas UK-3 would help the JV with selling and marketing in China. Additionally, the UK side is responsible for manufacturing, technology, sales and marketing in overseas markets.

The frequency of board meetings is rather similar across the different JVs. Both GER-0-JV and UK-3-JV hold meetings once every six months (to take place in China or England, as in the case of UK-3). On the other hand, the BoDs of both UK-4-JV and UK-8-JV meet once a year only either in the UK or in China. In addition, the foreign managers of all four SMEs go out to China if and when this is necessary. Going out to China for board meetings means a considerable financial and managerial resource effort for the SMEs. Thus, more meetings with their Chinese counterparts in China are hardly feasible. The demand on SME resources would become too great.

Contents of the board meetings are, apart from the future company policy, operating problems, investment decisions, appointments of additional foreign staff or senior Chinese personnel in strategic positions (GER-0-JV), or staff issues, marketing and selling, production, financing, accounting and further investment (UK-3), as well as component sourcing (UK-8-JV).

At the time of the investigation, none of the SMEs had experienced major problems with decision-making in the JV, though UK-3-JV shows tendencies of disputes. Interestingly, the fact that UK-3's Chinese partner is not familiar with the INFRASTRUCTURE PRODUCTS business, manoeuvres the UK SME into a position

where it is able to control the JV, although the equity share would not suggest so. Consensus decision-making as it is practised in GER-0-JV is, thus, not commonplace in UK-3-JV.

In the case of UK-4-JV, the equity distribution clearly reflects on who has control of the JV. Three out of the five members in the BoD are from the Chinese partner. The Chinese side holds both the chairmanship and the general management of the JV. Also the Chinese side is in charge of production, management of the entire company and of technology. UK-4 is responsible for the marketing of the JV's products and for new product development. Although control lies clearly within the Chinese parent, both parties in UK-4-JV have contractually agreed that, for major decisions regarding the JV's investment or management appointments, etc., UK-4 has to agree. Up to the time of the investigation, this agreement has worked well between the partners.

The number of seats in the BoD of UK-8-JV is distributed according to the equity distribution: the Chinese side holds three seats and the UK side two. In the JV the Chinese side is in charge of administration and the commercial issues while UK-8 oversees the technical side of the undertaking. For this reason, UK-8 expatriated one of its employees to China to look after the technical side of the JV and to supervise the installation of ROAD INFRASTRUCTURE SYSTEMS.

#### **8.4.4 Joint venture management**

In all JVs studied in-depth Chinese managers are in the key organisational positions. In three out of four cases (GER-0, UK-4, UK-8) a Chinese national is the general manager. Only UK-3 agreed with its Chinese partner that one of its British employees would be appointed general manager. Both GER-0 and UK-4 were not interested in providing the general manager to their JVs. The reasons for that have been established above.

Three out of the four SMEs had, at the time of the investigation, expatriated personnel to their JVs. UK-8 considers expatriating staff to the JV in China important since "otherwise we could lose it altogether." GER-0 wanted to have a German in China who looks after the technical side of the JV and so did UK-8 that needed a British engineer on-site to supervise the installation of ROAD INFRASTRUCTURE SYSTEMS. UK-3 had expatriated a British manager who took over as general manager of the JV. In all three cases the expatriation of a second manager was not planned. This was certainly due to the considerably high financial burden which an expatriate imposes on a business (the costs of one expatriate in UK-8-JV are about 40 times that of a local employee). For instance, the German expatriate costs some DM400,000 (£179,213)

per year and the general manager of UK-3-JV creates costs of between US\$187,200 (£120,000) and US\$234,000 (£150,000) per year. The respective shares of the costs that are born by the JVs (cost of living on-site) are only relatively small in the cases of GER-0 and UK-3. However, this is different in the case of UK-8-JV where the JV covers between 60 and 70 per cent of the expatriate costs.

Having foreign and Chinese managers in one company can cause difficulties. This is due to different management styles, concepts of work and quality, attitudes, etc. For instance, UK-3-JV's general manager recognised that active decision-making is in conflict with the Chinese authoritarian philosophy. Although this is not the case in GER-0-JV and also not in both UK-4-JV and UK-8-JV (since the entire JV management is in Chinese hands, there is no conflict in decision-making), there are major discrepancies in UK-3-JV. There, the British general manager and his deputy cannot co-exist as managers. The relationship between the two partners is characterised by distrust.

Interestingly, in all three cases where the Chinese side was originally responsible for domestic marketing and sales (GER-0-JV, UK-3-JV, UK-8-JV) the foreign expatriate or the foreign managers at home had gradually taken over and contributed to the marketing and sales task more than was originally intended. Since the Chinese side in these three cases did not perform satisfactorily in this discipline, the foreign side had to step in. Also, as is the case with UK-8-JV, the UK parent company was about to replace its technical supervisor (after his mission was completed) with an engineer who would also look after the commercial side of the JV, although this was given, originally, into the hands of the Chinese side.

## **8.5 Joint venture problems**

Apart from UK-4 that had, at the time of the investigation, no serious problems with its JV in China, the JV problems of the German and UK SMEs were various, ranging from the sourcing of components to production, marketing and managerial communication. In the case of UK-4 this is, to a very large degree, due to the constellation of the partners in the JV. UK-4 sought a cheap way of producing its ELECTRONIC DEVICES and found this in its JV. The managing director is required only once a year to come to China or even less frequently if the Chinese managers come to the UK for the board meeting. Inter-personal problems did not exist at the time of the investigation.

### **8.5.1 Production**

Production of goods locally is frequently a bottleneck in Sino-foreign JVs if the entire output, or parts of it, are to be exported. Often, the quality of the manufactured goods is not sufficient as that it would meet quality standards required by overseas markets. Previously it has been suggested that products manufactured by Sino-foreign JVs are



not easily exportable since they lack quality (Campbell, 1989; Trommsdorff et al., 1994; Schuchardt, 1994; Kaiser, 1997).

This was particularly the case with UK-4-JV whose output is exported to the UK exclusively. To ensure high and sufficient quality standards of its ELECTRONIC DEVICES manufactured in China, UK-4 had sent an engineer to CITY [East China] to train the workforce. Consequently, the managing director of UK-4 is satisfied with the quality standard of the output of the JV. Also UK-3 was very insistent on reaching a high standard of quality of the products manufactured in its JV operation in China. High quality is one of the marketing features of UK-3. In fact, the managing director of UK-3 was "quite surprised with the standard of quality amongst the workers" which "is as good as here." To get there, also UK-3 had sent a (welding) engineer to China to train the staff of the JV. In addition to that, the UK SME helped with the provision of sophisticated welding equipment.

Not producing goods of sufficient quality cannot only hamper the JVs' efforts to exports parts of the, or the entire, output, but it can damage the reputation for high quality which the SMEs enjoy in their traditional markets. Neither GER-0 nor UK-3 nor UK-8 could afford producing low quality goods under their names. The managing director of UK-8 hits the point: "Everyone gets a first order. But if the customer is not satisfied with the quality, you will not get another one." To avoid any complications with quality in production, UK-3 was even prepared to train two engineers in the UK, although the JV contract does not require UK-3 to bring Chinese JV personnel for training to the UK.

### **8.5.2 Local sourcing**

Offering the highest quality of products suggests not only having a quality-conscious workforce, but also high quality components and materials. The local sourcing of high quality products is not always possible in China. However, it is desirable since it allows to keep costs down and save foreign exchange.

All of the JVs were, at the time of the investigation, sourcing materials and/or components locally in China. The shares of components and/or materials sourced locally by the JVs of the components and/or materials sourced by the JVs in total, varied considerably. For instance, UK-3-JV sourced, at the time of the investigation, nearly 100 per cent (steel) and GER-0-JV as much as 90 per cent of components and materials locally. Certain components needed by GER-0-JV were not available in China (not of the required quality or not at all) and, thus had to be sourced overseas.

On the other hand, UK-8-JV sourced only approximately 30 per cent of the value of its components locally. The remaining 70 per cent in terms of value (= the special chemical component) were shipped over from the UK. In the future, this ratio should be reduced to 50 per cent to save further production costs and make so the product more competitive in the Chinese market. Equally, UK-4-JV had been sourcing only approximately 30 per cent of its parts locally. These were printed circuit boards and plastic materials. However, the vast majority of parts, ie resistors and capacitors, were being sourced in Thailand and Japan. In the future, UK-4-JV wants, as does UK-8-JV, to increase its local content. However, according to UK-4, "there will always be these 15 per cent of supplies that need to be sourced in Europe since they cannot be made in China." The non-availability of certain supplies in China is a rather common problem.

Apart from a low and sometimes not even sufficient quality of local supplies, a sourcing problem has been also the lack of reliable Chinese suppliers. This applies to GER-0-JV's local sourcing. However, the known problems of local sourcing had not been experienced by UK-8-JV. Also UK-3-JV that sources almost 100 per cent of its steel demand locally had not experienced major problems with local sourcing. This was, certainly, due to the fact that the quality of the steel needed for the JV's production of ROAD INFRASTRUCTURE SYSTEMS was sufficient. Would the JV have sought specially processed steel, for instance, substantial problems with quality could have appeared. This could have required the JV to source steel in Japan, for instance.

### **8.5.3 Productivity**

Although labour costs are considerably lower in China, relative to the UK or Germany (GER-0-JV pays approximately £4,979 per year for a Chinese worker) productivity is lower than in the UK or in Germany. For instance, productivity of Chinese workers in GER-0-JV is "somewhere around 30 per cent of ours," said the director for overseas affairs of GER-0.

Also UK-3 criticises that, in terms of productivity, UK-3-JV still has a long way to go. Also - and this is frequently overlooked by foreign entrepreneurs who consider manufacturing in China - there is a big gap between what Chinese workers earn and what they actually cost. In many cases, the basic salaries have to be topped by a factor of between 1.5 to 1.8 to arrive at the real costs of a Chinese employee (GER-0-JV: 1.48; UK-3-JV: 1.79).

### **8.5.4 Foreign exchange**

Foreign exchange had been a further problem for some of the SME JVs, primarily GER-0-JV. Although by the end of its second year of operation (= 1996) the JV should

have generated a foreign exchange surplus of some US\$200,000 (£128,205), it failed to do so. Fortunately for the JV, the JV contract provided for the German SME to help the JV with exporting and thus with generating foreign exchange. On the other hand, for UK-3-JV that sources predominantly locally and sells its products mainly in China, but also to overseas markets where customers pay in US dollars, foreign exchange is not much of a problem.

### **8.5.5 Collision of interests**

Whereas the collision of interests has obviously not been a problem in the cases of UK-3-JV<sup>6</sup> and UK-4-JV, it was an issue in the case of GER-0-JV. GER-0 did not come to China to serve, from there, its traditional export markets. Also, according to the JV contract, GER-0-JV should manufacture only a narrow range of products. The main goal of GER-0 was to service the domestic Chinese market with the products manufactured in the JV. At one occasion, GER-0-JV produced a special mechanical component and offered this to one of GER-0's customers at 60 per cent of the price demanded in Germany. Certainly, this became an issue of conflict.

### **8.5.6 Sales and marketing**

In many JVs sales and marketing has become, as outlined above, a problematic issue. Although the Chinese side was, initially, in charge of this function, increasingly the foreign side had taken on this function. For instance, although *guanxi* were considered important by the foreign managers, the sales strategies of the Chinese staff were criticised for being too defensive, reluctant as well as relying too much on *guanxi* solely. The production and quality assurance manager of GER-0-JV, for instance, points out that "aggressive customer acquisition as we know it in Germany is not commonplace in China and even disliked." Thus, the transfer of sales know-how to the JVs has been considered extremely necessary by the foreign managers of GER-0, UK-3 and UK-8.

GER-0-JV and UK-8-JV have in common that their products are located at the top end of the market. Customers have to pay more to be able to afford the products of these two JVs, compared with that of competitors – Chinese and Sino-foreign. Only UK-3-JV insists that its products are price-competitive, compared with the products of Chinese and also foreign companies. The higher price of the products of GER-0-JV is caused not only by higher wages to be paid in CITY [East China], but also due to the fact that GER-0 would not allow the JV to go too low with its prices.

The price issue is very important when selling into the Chinese market. Often, Chinese customers do not buy what is good, but what is cheap. This is an experience which was made by GER-0-JV, UK-3-JV and UK-8-JV. For instance, Chinese customers

would not buy the ROAD INFRASTRUCTURE SYSTEMS of UK-8-JV which have a life expectation of some 15 years. Instead they purchase those with a life expectation of approximately five years, which is only a third of these of UK-8-JV. The reason is that UK-8-JV products are approximately 1.5 to two times more expensive. The Chinese government is short of money and, thus, price is a major issue when negotiating the sale of the JV's sophisticated products.

### **8.5.7 Communication**

Communication between the foreign and the Chinese directors (on the board level) and between foreign and Chinese managers is a major problem only in the case of UK-3-JV. There, constructive communication between the general manager and his Chinese deputy has suffered a complete breakdown. Not only does this lack of communication in this particular case stem from a lack of awareness of cultural diversity, but also from inherent and developed distrust between the managers. This distrust culminates in the situation where the British general manager placed his vice-general manager at a position in the company where he can detect immediately "if anything is only slightly out of balance." Already earlier in the JV process, UK-3 had experienced considerable problems with its Chinese partner, including the valuation of its machinery contribution.

## **8.6 Joint venture evaluation**

The opinions on the performance of their JVs were rather different among the SMEs that were studied in-depth. For instance, GER-0 was rather content with the JV's performance. "It is a good success." GER-0 had planned two loss-making years and profits from the third year on. Surprisingly, the second year loss of GER-0-JV had fallen even below the planned. Sales volume by the end of August 1996 accounted for some RMB8.02m (£0.59m) which is an increase of 39.2 per cent over the same period of 1995. This is also 25 per cent more than what was planned for the year.

The managing director of UK-3 had estimated that within five years, "if everything goes well," the UK SME would make more profit in China than in the UK. However, at the time of the investigation, none of the interviewees (neither the general manager of UK-3-JV nor the managing director of UK-3) could specify the success of the JV, although there were orders in the pipeline. The JV was established only in May 1996 and the interviews were carried out in November and December 1996. In other words, the JV had less than six months time to generate results. Due to a lack of suitable financial performance assessment criteria, UK-3-JV was assessed along a set of other criteria.

For instance, although relationship business is very important in China, the general manager admitted that the JV had not done its homework sufficiently. "Building relationships takes a long time."

Both the Chinese directors and the managing director of UK-4 did not release information on the JV's turnover in the financial year 1995. However, it was indicated that orders had grown approximately 10 per cent in 1996 compared with 1995. Both parties showed satisfaction with their JV, though they did not quantify this. The Chinese partner repeatedly expressed his satisfaction with the performance of the JV, referring to UK-4-JV's profitability and added another assessment criteria of the venture's performance. "We made a lot of friends and friendship between two countries."

Neither the general manager of the JV nor the managing director of UK-8 were satisfied with the JV's performance in 1995. A reason was certainly that building works in the factory had just finished and the JV could only then start to conduct business. For this reason, in 1995, instead of 5,000 metres of ROAD INFRASTRUCTURE PRODUCTS, only 1,941 metres were produced and installed. A further reason was that the pledged funds of the two parties arrived only late at the JV. Looking into the future, the managing director of UK-8 was convinced that the JV would "run a lot better from now on" and for 1996, 1997 and 1998 he expected turnovers of some RMB16.0m (£1.2m), RMB27.0m (£2.0m) and RMB40.4m (£3.0m), respectively.

## 8.7 Conclusion

This cross case analysis has shown that the four cases studied in-depth vary, in places, considerably in their joint venturing in China. For instance, whereas UK-3, UK-8 and GER-0 came to China to exploit the potential of the vast Chinese market, UK-4 was interested, predominantly, in exploiting low cost production in China. Moreover, as opposed to the other three cases, UK-4 is a camouflaged contract manufacturing agreement. This becomes evident, again and again, throughout the entire JV formation and operation process: negotiations were not really a problem for UK-4, ie the distribution of equity and control, and so was not the management of the JV. Overall, UK-4 was interested first and foremost in the cheap production of high quality ELECTRONIC DEVICES, and this was as much as it was interested in. Other JV issues that were of considerable interest to the other SMEs studied in-depth, concerned UK-4 only marginally or not at all.

Another aspect that is striking is the difference in size between GER-0 on the one side and UK-3, UK-4 and UK-8 on the other. It has been established that GER-0 was the largest (in terms of number of employees) of the four SMEs. This became evident also throughout the JV preparation process. Both the planning and negotiating was given much more attention in the case of GER-0 than in the other cases. Also, GER-0 had much more bargaining power to play out during negotiations than the other SMEs had. However, in the particular case of GER-0 the reason that it had more bargaining power could also be found in the fact that its potential Chinese partner did not want to risk negotiations with KMP to form the more important (to it) KMP-JV than GER-0-JV would be. This remains open to speculation.

Apart from the differences, this cross case analysis has also shown that the four SMEs were more or less content with their JVs, despite the problems some of the JVs experienced. Whereas the directors of GER-0 and UK-4 expressed satisfaction with the present performance of their JVs, the directors of UK-3 and UK-8 were optimistic that their JVs would generate positive results in the future. In all cases were the JVs rather new and did not have enough time to exploit their full potentials.

## Notes

<sup>1</sup> Name disguised.

<sup>2</sup> Name disguised.

<sup>3</sup> Despite it was established that the SME's search process was somewhat pre-determined.

<sup>4</sup> Selection criteria included the partners' turnover (total and MECHANICAL COMPONENTS), market shares, number of employees, turnover per capita, industrial focus, location, range of MECHANICAL COMPONENTS, licences for ENGINEERING PRODUCTS and MECHANICAL COMPONENTS, sales and distribution networks, production, technical know-how and management.

<sup>5</sup> As a matter of fact, the SME had no choice but to finally agree to what the Chinese offered (for details see case studies in Appendix VII).

<sup>6</sup> The collision of interests between UK-3 and UK-3-JV is a latent problem. UK-3 does not want the JV to cannibalise its own export sales. UK-3-JV attempts to serve traditional customers of UK-3 with cheaper products, since "there is enough for all of us." In the long-term this attitude could create conflict in the relationship SME and JV.

## Chapter Nine

# Discussion

### 9.1 Introduction

In this chapter the empirical findings presented in chapters seven (survey results) and eight (cross case analysis) are discussed. The debate follows the framework that has been established in chapters three and six and that corresponds with the framework that has been applied for the analysis in chapters seven and eight. The empirical findings of this research are discussed against the background of the body of knowledge derived from the evaluation of the literature. This enables to identify to what extent the findings of this study confirm earlier findings by other authors. It also helps explain certain shifts in thinking about foreign direct investment (FDI) in China. The subsequent chapter (ten) concludes this study.

### 9.2 Joint venture formation

#### 9.2.1 Joint venture planning

In chapter two the concept of psychic distance was introduced. It has been suggested by authors, including Johanson and Wiedersheim-Paul (1975) and Buckley (1989) that countries with a dissimilar culture are psychically more distant to the home country than countries with a similar culture. From the work of Hofstede (1980, 1985) and Wilpert and Scharpf (1990) it has become apparent that European cultures, such as the UK and German, are distant to China's. The concept of psychic distance would explicitly argue that UK and German small and medium-sized enterprises (SMEs) serve other, psychically closer countries first and the Chinese market only when they have gained experience in servicing the psychically closer market(s). In the export literature the concept of psychic distance has been evaluated and accepted, though opponents exist who vehemently question its applicability (see chapter two, section 2.4.1). Authors, including Carlson (1975), Buckley and Mathew (1979) and Schmidt et al. (1995) insist that for SMEs psychic distance weighs more heavily than for large companies.

For instance, it has been suggested that German companies would engage in the markets of Eastern Europe with priority to the Chinese market (FT, 27.7.95, p.19, FT, 19.7.96, p.2). German companies perceive Eastern Europe being psychically closer than China. Moreover, the markets of Eastern Europe are also physically closer to Germany than is the Chinese market. For example, travelling to Eastern Europe is less time- and cost-intensive for German SMEs than is travel to China. This is an important



argument especially in anticipation of evolving problems with, or in, an investment project. The managing director of UK-7 hit the point: when asked for (anticipated) drawbacks of his joint venture (JV) operation in China, he pointed out that "if things go wrong, we are so far away."

The concept of psychic distance would suggest that the SMEs are expected to put more effort into the planning of their investment projects in China than they would in a psychically closer country. The findings in this study do not support this. Both the UK and the German SMEs planned their China JVs more or less the same way as their usual operations, though the empirical evidence suggests that the German SMEs believed that they had planned their China JVs 'nearly better' than their normal operations. As the German SMEs so the larger SMEs perceived more than the smaller SMEs in this study that the planning of their operations was better than their usual operations. However, the difference is only marginal.

Various authors (Bilkey, 1978; Buckley, 1979; Robinson and Pearce, 1984; Harrigan, 1985; Buckley et al., 1988; Stratos, 1990; Hamill and Hunt, 1993; Laughton, 1995) have suggested that SMEs employ methods of strategic planning to a limited extent only. Companies frequently do not carefully examine the market, competition, the venture's strengths and weaknesses, and its prospects (Killing, 1983), but take shortcuts (Buckley, 1979, 1997; Braun, 1982). Transferred to unfamiliar environments, this can have dangerous effects and one of the great dangers is that an external approach by a powerful customer, supplier or foreign official could induce SMEs to make investments without sufficient consideration of alternative modes of operation (Buckley, 1979). Stratos (1990) in a study of European SMEs showed that the larger the business, the more frequently it plans strategically. Equally, Simon (1992, 1996) found that only a few companies have marketing experts, let alone marketing departments, and as a rule, they do not engage in formal market research.

Overall, the majority of the SMEs in this study neglected what authors, such as Stewart and Keown (1989) and de Bruijn and Jia (1993b) have demanded, namely to take a special approach towards the Chinese market. Instead, the planning of the SMEs confirm Frankenstein's (1986) and Eiteman's (1990) experiences: foreign firms frequently misperceive the characteristics of the Chinese market.

How might the discrepancy in the perceived quality of planning of their JVs between the UK and German SMEs and the smaller and larger SMEs (to a lesser extent) be explained? SMEs that are active in a number of different foreign countries have collected experience in doing business there. Perhaps it is these companies that

cannot see a great necessity to plan their JVs in China more thoroughly than they plan their operations usually. Individual SMEs could experience themselves in international business and markets in more than 100 countries or on a worldwide scale even. Relatively more UK than German SMEs in this study operate in foreign countries. With regard to firm size, there is no meaningful trend to be read in the data. The larger SMEs were found having more foreign operations than the smaller SMEs. The larger SMEs had more opportunity than the smaller firms to make experiences in international business in host countries, though this constellation is more obvious in the case of the UK SMEs rather than the German SMEs.

Thus it is likely that those SMEs which made experiences in international business before (UK SMEs and Size Two SMEs) consider their planning of the China JV much more routinely than the other firms. For instance, the exporting preference of German companies has been observed previously by Klenner (1986) and Trommsdorff et al. (1994) who suggest that German companies export as long as possible before they engage in FDI. Further comparison between UK and German SME foreign market presence is difficult. Although Berger and Uhlmann (1984) established that German SMEs (with export ratios exceeding 20%) export, on average, to 12 industrial countries and 14 less developed countries (LDCs), comparable UK data are not available.

Not only were the SMEs experienced in international business in general. Five UK and ten German SMEs had, in addition, collected prior experience in doing business with China, through exporting as well as higher forms of market commitment, such as licensing and JV activity. This supports the evolutionary model of internationalisation empirically through which companies proceed when servicing foreign markets (chapter two, section 2.4.1). It also supports the argument that the German SMEs in this study perceived the Chinese market more distant and challenging than did the UK SMEs. With respect to firm size there appears contradiction with the theory. The smaller SMEs had, compared with the larger ones, less experience in doing business with, or in, China. Although the evolutionary model would suggest that resource weak, relatively inexperienced firms gradually develop their market presence before they enter into an FDI project, the smaller UK SMEs in this study appear to have established their JVs with only less prior experience in the Chinese market. They did not have sufficient resources to learn about the peculiarities of the Chinese market and took the opportunity to invest in the country without extensive preparation. With regard to the German SMEs, it is not possible to draw any conclusions in this respect.

A recent Commerzbank study (1995) found that all of the investigated 48 German direct investors in China were engaged in trading with, or licensing to, China prior to their FDI activity. Also, the three New Zealand SMEs with China JVs in Au and Enderwick's (1994) study had previous trading and investment experience in countries other than China and two had previous business relationships with China even. These companies learned about international business and markets and, in particular, the Chinese while going through less resource-demanding market entry strategies before committing substantial funds to an FDI project.

GER-0 that had a licensing agreement with a Chinese company before establishing its JV is an example for a company following the path of incremental learning about a foreign environment and increasing of resource commitment. The UK SMEs, however, did not benefit to a great extent from earlier experiences in doing business in, and with, China. With the exceptions of UK-7 and UK-6 (that had been exporting machines to China for several years), the UK SMEs that were studied joint ventured in China without previous China experience. However, they had collected considerable international business experience from business with other countries. Whereas pre-JV contacts with China would have benefited the joint venturing of UK-2, UK-3 and UK-8, this is different in the case of UK-4. This SME moved to China as a resource seeker that intended to utilise China's cheap labour resources in the form of a contract manufacturing agreement.

The UK and German SMEs reveal no clear trend with regard to the above psychic distance hypothesis. Although one UK SME (UK-1) that had been doing business with only ten countries indicated that its JV in China was planned better than its usual operations elsewhere, another UK SME (UK-3) that indicated equally ('planned better') had operations on a worldwide scale. And whereas UK-1 had other wholly foreign-owned enterprises (WFOEs) and JVs, apart from its China JV, UK-3 had no further project in addition to its China-based JV.

What the data clearly suggest, however, is the fact that the SMEs recognised the importance of planning their JVs. However, this was a very relative recognition which was met totally differently by the individual firms. Overall, the production of a sound business plan was the exception (UK-7, GER-0) rather than the rule.

The empirical data of this study suggest also that most of the UK SMEs studied relied heavily on information about market prospects or competitors that was provided by their potential Chinese partners. None of the UK SMEs carried out independent market research, for instance. At best, the research undertaken, was an accumulation of

exporting experiences. UK-2 and UK-3 made it clear: "We could not afford it." The entire planning of the majority of the SMEs was characterised by vagueness and a 'gut approach', rather than a scientific one.

To date, in the major Chinese cities various Chinese and international consultants offer their services to conduct market research, for example. Also, the UK and German chambers of commerce in China or the China-Britain Trade Group have basic information readily available and carry out, or commission, market research for SMEs that intend to explore the market before committing substantial funds. Further, with its support programme ECIP,<sup>1</sup> the European Union offers financial assistance towards the carrying out of market studies in LDCs especially to SMEs. None of the UK SMEs studied had approached such an institution for assistance. In most cases the SMEs were not aware of the existence of such programmes, in others the firms were not prepared to spend scarce funds on services for which they could not see a necessity.

A closer look at the ways the UK and German SMEs financed their JVs reveals this missing awareness of the availability of means of support. All nine UK SMEs financed their JV operations with working capital. Of those only one received support in the form of a UK or a European grant. The situation is similar with the German SMEs. There, all eleven firms that provided information, used their working capital and only two received a grant from a German or a European institution, respectively.

GER-0, for instance, that had carried out research into the available means of financing a JV, obtained finance from the German Development Bank (KfW) at an interest rate of 2.5 per cent which was lower than the market interest rate. The company also acquired financing through ECIP. However, this was not considered appropriate for the company.

The German SMEs with a JV in China in the earlier study by Kaiser (1997c) reflect this trend: only two applied for, and received, financial assistance from a national support organisation. The remaining SMEs indicated that they were not aware of the availability of such funds.

The shortcut approach applied by most SMEs in this study, is dangerous. Not having the relevant information available leads to inaccurate planning and wrong projections regarding revenues, profits, payback periods, etc. The heavy reliability on information from the potential Chinese partners exposes the SMEs to the risk that the Chinese partners create an – non-reflected - perception of the market opportunities for SMEs. In the cases of UK-7 and UK-8 where the Chinese side invited the SMEs for JV activity, the Chinese party was likely to pursue its own interests. These were getting capital and know-how transferred, rather than offering a huge market for the foreign

companies. This thinking can easier be understood when consulting Teagarden and von Glinow's (1990) argument. It suggests that for a Chinese company an indicator of success is the attraction of a foreign investor that transfers technology.

The rather passive, at best re-active, attitude of most of the SMEs with respect to information gathering is also captured in the fact that none of the UK SMEs that were studied in-depth, had taken on responsibility in preparing the feasibility study. However, just this feasibility study is the essential document in the JV approval process (see Kaiser and Grimm et al., 1997).

The SMEs' limited gathering of relevant information and the fact that they tend to take a shortcut approach confirms earlier findings by Buckley et al. (1988). There, only 15 out of 43 UK firms with a direct investment in Australia considered an alternative country for their investment and when searching for alternatives, the SMEs spent, on average, two to six months. Comparing search periods as done above, can be misleading, though. Some firms are more sophisticated and efficient at collecting and processing data than others. Further, 26 out of 43 firms in Buckley et al.'s (1988) study did not carry out any form of market research overseas. However, they consider, paradoxically, that the money and executive time spent on market research is likely to be one of the best investments before a commitment to FDI. Also Kaufmann et al. (1990) found that, as a rule, alternatives to co-operation often were not even assessed. An example for being not very well informed about the Chinese environment of their JVs are the cases of UK-6, UK-8 and UK-4. For instance, UK-4's managing director did not know who approved the JV and he also insisted that the signing of the JV contract and the operation of the business had started simultaneously. This, however, seems rather unlikely. A look at the approval procedures suggests this (see Kaiser and Grimm et al., 1997, chapter seven).

### **9.2.2 Motivations for production in China**

For reasons established in chapters three and six, this thesis distinguishes between motivations for engaging in an FDI project and motivations for JV activity, as opposed to establishing a WFOE. The SMEs in this study have provided insight to both of these separate, though related issues. The body of literature, however, has not executed this distinction, making comparison and analysis of the empirical findings with the findings of earlier research difficult.

#### ***Motivations to engage in an FDI project***

A physical presence in the Chinese market would help the UK and German SMEs to more effectively and faster access the vast potential market than through exporting. Buckley et al. (1988) stress as the benefits of being close to customers the opportunity

to overcome cultural and business naivety and to better understand consumers and competitors in target markets. Also Mr. Yang of the China-Britain Trade Group (interview, 11.11.1996) emphasised the importance of being present in the Chinese market if firms are interested in doing business on a long-term basis. Also, reaction times are much shorter if a company is present locally. Consumer needs can be recognised faster than with exporting since the flow of information through the export channel (particularly with direct exporting) takes much longer.

Also with respect to firm size, the potential of the vast Chinese market was the salient motivation for establishing an FDI presence.

Both above market seeker arguments detected as the main driving forces of the SMEs' Chinese market entry confirm earlier findings of various studies, including Au and Enderwick's (1994) and Kaiser's (1997c) studies of New Zealand and German SME JVs in China, respectively. The findings also resemble the results of other studies on large firms with investments in China, from different countries of origin, including the UK (Glaister and Wang, 1993; Gledhill, 1994), Germany (Köhler, 1987; Stofan and Stultz, 1991; Trommsdorff et al., 1994; Commerzbank, 1995), Europe (Dong et al., 1993), US (Daniels et al., 1985; Tang et al., 1992; Dong et al., 1993; Punnett and Yu, 1990), Canada (Punnett and Yu, 1990) and Japan (Dong et al., 1993).

The results also confirm findings on SME direct investment in the general context (see Buckley and Mathew, 1979 and Buckley et al., 1988 for UK; Braun, 1982; Berger and Uhlmann, 1984 and Schmidt et al., 1995 for Germany; Onida et al., 1985 for Italy; Bertin, 1986 for France).

It has been found that the UK and German SMEs also considered it necessary to be in the Chinese market. This argument needs consideration, however. In the early days of China's open door policy many foreign investors went to China because "they needed to be there" - regardless of what they could offer Chinese consumers. Surprisingly many of the UK and German SMEs considered this argument as important for establishing a foreign presence. This phenomenon is known as the 'two-billion-sock syndrome' or the 'one-billion-bottles-of-coke syndrome'. In other words: especially in the early days of China's open door era many foreign enterprises went to China because of the necessity to take part in the opening of this new, untouched market. Whether the product of the foreign enterprise was needed and wanted by the Chinese consumer was of secondary importance only.

The availability of cheap labour was further regarded important by the SMEs and it was more important to the German SMEs than it was to the UK SMEs. Continuously

increasing salaries and social costs have made manufacturing in the West very expensive. Whereas the cheap labour argument was important for the German SMEs, it was apparently not too important for the UK SMEs. Compared with Germany, as a manufacturing location the UK is considerably cheaper. UK firms are thus, compared with German firms, less frequently pushed to FDI. The availability of cheap labour manoeuvred these SMEs into a position where they could manufacture cost competitively and would so be able to combat domestic as well as other international competitors. By exporting goods to the Chinese market that are manufactured in the UK or Germany at a higher cost and whose transport adds additional costs, the long-term penetration of an increasingly competitive Chinese market was considered by all SMEs as a strategy no longer viable.

Interestingly, whereas the availability of local labour was the prime reason for UK-4 to establish its JV, it was only secondary for the other UK SMEs studied. These firms entered China in order to serve the vast Chinese market. Continuously increasing salaries and social costs have made manufacturing in Germany very expensive. Recently it has been shown that, on average, companies in the mid-1990s manufactured at a labour cost of US\$21 per hour in Europe, compared with US\$2 in the economies of Southeast Asia (Far Eastern Economic Review, 1.6.95, p.46).

Repeatedly, organisations such as the Association of the German Industry (BDI) have demanded that manufacturing becomes cheaper in Germany for two reasons: first, to prevent German manufacturers shifting their (entire) production to cheap-labour countries. Secondly, to attract direct inward investment into the country. So far, these voices have not been clearly heard or understood in Germany. At the time of writing this thesis, the number of unemployed people in Germany exceeded four million.

The analysis with respect to firm size reveals no difference between the SMEs as far as the availability of cheap labour is concerned.

As the market seeker motivation has been found to be an important motivation, so the resource seeker motivation (cheap labour) has been found previously as an important motivator for FDI or JV activity (Köhler, 1987; Tang et al., 1992; Dong et al., 1993; Kim, 1996). However, whereas the literature concludes that the market seeker motivation is the most important for foreign investors (apart from Kim, 1996 whose firms ranked it second), the position of the resource seeker motivation is not unchallenged. For instance, the UK firms in Glaister and Wang's (1993) study and the German firms in the studies by Commerzbank (1995), Delegation of German Industry

and Commerce Hong Kong (1995) and Kaiser (1997c) considered this motivation as less important than the market seeker motivation.

Inevitably linked with the ability to cost-effectively manufacture in China is that this manoeuvres the SMEs to establish a stable strategic position from where to service neighbouring Asian markets. Various foreign companies have established their Asian headquarters in China. There, they manufacture and from there they co-ordinate their activities in Asia. There is no clear opinion in the literature about the importance of this argument for establishing a market presence in China: whereas the UK firms in Glaister and Wang's (1993) research and the German firms in the Commerzbank (1995) study considered this motivation as important, less than half of the 25 German SMEs in Kaiser's (1997c) research engaged in FDI for this particular reason.

Where the literature clearly contradicts the findings of this study is with respect to the argument of bypassing import duties that were imposed by host governments. Whereas the UK and German SMEs considered this argument as only moderately important, both the US and western firms in the studies of Daniels et al. (1985) and Dong et al. (1993) considered this motivation as important.

As a trend, but with the exception of UK-3 that was looking for cheap steel supplies, the UK and German SMEs did not shift production to China because of access to raw materials. The Sino-foreign JV literature attached only secondary importance to access to raw materials (Daniels et al., 1985; Tang et al., 1992; Dong et al., 1993), though the UK firms in Glaister and Wang's study hoped to get materials and natural resources.

Also, being approached by a Chinese organisation to joint venture in China was not really regarded as a motivation by the SMEs to actually do so. However, without the Chinese approach in the cases of UK-7 and UK-8, these SMEs would not have engaged in a foreign production project. On the other hand, without the prospect of the vast potential market and of being able to manufacture at a low cost, these companies would not have accepted the Chinese companies' invitations.

The UK and German SMEs did not commend China-based production because they needed to follow a customer. This confirms findings by Dong et al. (1993) and Kaiser (1997c). UNCTAD (1993) research revealed only about a quarter of the multinational SMEs are subcontractors to large firms; the bulk of firms seems to be independent. O'Farrell et al. (1996) have suggested that client following is a "unique characteristic of service firms in its occurrence and importance." However, of the 21 UK and German SMEs participating in this survey, only two were service firms.

Interestingly though, the following-the-customer motivation was one of the main driving forces behind, and the initiator for, GER-0's move to China. It was GER-0's German



customer that initiated the thinking within GER-0 about JV activity in China. For GER-0 moving to China by piggy back meant a considerable business security factor.

Overall, neither nationality nor firm size significantly influence the perception of the importance of motivations for establishing an FDI operation in China. However, nationality is more likely to be a discriminator between the SMEs than firm size.

### ***Motivations for joint venturing***

The reasons for the UK and German SMEs to exploit the Chinese market potential and cheap labour in the form of a JV were substantially different. Whereas the UK SMEs sought attributes of their potential Chinese partners, such as their cultural guidance through the Chinese market, the provision of contacts, etc., it seems that the German SMEs were seeking, first and foremost, assets rather than the attributes of their potential Chinese partners. Also with respect to firm size, the SMEs showed significant differences: whereas the larger SMEs sought partner attributes, such as their partners' business knowledge or knowledge of customers, the smaller SMEs sought assets of their Chinese partners, including finance. However, the Chinese partner's ability to smooth the way through bureaucracy was also an important motivation for the smaller SMEs in the study.

Interestingly, similar to the analysis according to nationality, both the smaller and larger SMEs reveal similar attitudes with respect to the least sought attributes or assets of their Chinese partners. None of the firms would engage in a JV solely to get access to the partner's skills or its technology or because of the partner's relationship with trade unions.

Having a Chinese local partner who helps access potential Chinese customers, is not equally important to all foreign investors, however. Whereas it is of only minor importance to a foreign investment project operating in the consumer goods industry, it is of distinct relevance for foreign investors that operate in infrastructure industries, for instance. Without a Chinese local partner who has valuable contacts to the relevant planning bureaux at provincial levels, for instance, the selling of infrastructure products is difficult. This was suggested by a representative of Hong Kong Shanghai Banking Corporation in an interview in Shanghai in autumn 1996. UK-8's separate "do it ourselves" attempt to export and install ROAD INFRASTRUCTURE PRODUCTS has clearly shown that – it failed.

Both UK-3 and UK-8, that are active in the infrastructure business, highlighted the importance of having the 'Chinese element' in their organisations. The case of UK-8 that manufactures and installs ROAD INFRASTRUCTURE PRODUCTS highlights the

importance of establishing a close and beneficial relationship with the Chinese officials. If the essential relationship with the relevant bodies cannot be established, the order will go to a different manufacturer. A foreign manufacturer without the help of a local Chinese element would face extreme difficulties in finding its way through all the different instances and eventually establish such a beneficial relationship.

The literature is not clear about the importance of the potential partner's knowledge of the Chinese environment and customers. Whereas some studies detected the importance of this argument, including Raveed and Renforth (1983), Köhler (1987) and Kim (1996), others found this motivation not being too important for foreign investors (Punnett and Yu, 1990; Glaister and Wang, 1993).

The German SMEs considered establishing a JV because they could save financial and managerial resources. These are, as is known from chapter two (section 2.3.3), critical 'ingredients' for SME internationalisation. Wells (1973) established, for instance, that firms that are relatively small in their industry find a partner's contribution of capital and management more important than do large firms. Also for the UK firms in Glaister and Wang's (1993) study it is the potential Chinese contribution of capital that is the important motivation for JV activity. The importance of the local partner's (management) resource contributions as the motivation for a JV was also emphasised by Raveed and Renforth (1983) as well as Endres (1987). The remarkable distinction between the two studies is, however, that Raveed and Renforth's (1983) research is China-specific whereas Endres's (1987) later study refers to JVs in the general context. In other words this means that the local partner's management resource contribution has been found important to foreign investors regardless of the level of economic development of the host country.

Conversely, for the UK SMEs the resource inputs of the potential Chinese partners are rather less important, though the cases of UK-6, UK-7 and UK-8 suggested that they hoped their Chinese partners would contribute valuable resources. This UK SME pattern resembles very much what Young et al. (1989) suggest as contributions required by foreign MNEs of their local partners in LDCs. However, for both the UK and German SMEs the potential Chinese partner's financial input is more important than its management input.

Surprisingly high (second) within the UK SMEs ranked the argument that engaging in a JV was required by the host government. Although it is known from earlier studies (Beamish, 1985; Datta, 1988) of FDI activity and FDI in China (Köhler, 1987; Teagarden, 1990; Punnett and Yu, 1990; Aiello, 1991; Beamish, 1993; Glaister and Wang, 1993) that government mandate played an important role, this is more an issue of the past than of the present.

For the German SMEs in this study government mandate was a relatively unimportant motivation for JV activity, certainly compared with earlier findings by Köhler (1987) where 13 out of 17 German firms considered this 'very important'. It is possible that the differences may be a result of the fact that the firms in Köhler's (1987) research were large and the firms in this study are SMEs. However, there is no indication in the literature that would support such thinking. It is much more likely that the differences result from the time distance between these two studies. When Köhler (1987) carried out her study, China's open door policy had been 'in operation' for less than ten years. The law governing WFOEs was promulgated only a year prior to Köhler conducting her study. This suggests that the German firms in Köhler's (1987) study established their JVs at a time when engaging in FDI in the form of a WFOE was hardly possible or not possible at all (Köhler does not provide information on the establishment of the JVs).

However, the Chinese government's attitude towards WFOEs and majority foreign equity JVs has changed and is more relaxed, though various industries remain closed or restricted to FDI at all or investment in the form of a WFOE or a majority foreign equity JV (see chapter five). Comparison with the more recent results of the study of 25 German SMEs with JVs in China (Kaiser, 1997c) is not possible since there was no indication made by these SMEs with respect to government mandate.

The establishment of the majority of the UK SMEs in this study falls into this period of relaxation. All, but one of the UK SME JVs were established between 1992 and 1996 and one (UK-9-JV) in 1987.

The UK and German firms in this study showed considerable agreement with respect to the importance of their partners' knowledge of customers and the partners' ability to smooth the way through bureaucracy as motivation for JV activity. Bureaucracy has long been regarded as a great barrier to doing business in China (Fan, 1996). Thus, the SMEs hoped that teaming up with a local Chinese firm could help overcome this problem. The German and UK foreign investors, respectively, in the studies of Köhler (1987) and Glaister and Wang (1993) revealed the same attitudes.

The limitation of financial and business risk and the hope for favourable government treatment was important as motivation for both the UK and German SMEs. Especially for SMEs the move to FDI as the highest form of market commitment is a very risky strategy. This has been discussed in detail in chapter two of this thesis. Thus, for many SMEs failure of an FDI project abroad often means jeopardising the operation at home (Buckley et al., 1988; Buckley, 1989) because the proportion of financial resources committed to an FDI project is likely to be greater in an SME than in a large firm. Thus, SMEs seek to reduce their risk in a foreign undertaking through partnering with another company.

The findings of this study with respect to risk reduction do not confirm the literature. Whereas Datta (1988), Glaister and Wang (1993) as well as Dong et al. (1993) found the limitation of financial risk an important motivation for JV activity, Endres's (1987) early study on international JVs suggested differently. The discrepancy between Endres (1987) and Datta (1988) is difficult to explain since both authors elaborated on JVs in the general context and of large MNEs, at about the same time. In the Chinese context, however, it seems to be clear: risk reduction is an important motivation for teaming up with a local company (Glaister and Wang, 1993; Dong et al., 1993). If the venture fails, the loss can be born by two parties.

This aspect needs more consideration, though. As is known from chapter six, the Chinese contribution is only rarely in the form of cash, but rather in the form of land use rights, the provision of local contacts, cultural guidance, etc. Capital, on the other hand, is frequently the contribution of the foreign side. Whereas teaming up with a local Chinese partner does certainly reduce the risk of business failure (due to the contribution of the above stated essential attributes for Chinese market entry), the argument that joint venturing with a Chinese partner would share the risk, cannot be accepted for the reasons outlined above: how does it affect a business if it loses its contribution of being able to act as a cultural guide? How does it affect a business if it loses its contribution of knowing important people with the Chinese authorities? Whereas cash contributions and machinery (as the contributions by the foreign party) are lost in case of business failure, the Chinese partner will certainly not lose its knowledge of important people, for instance.

It has frequently been argued that teaming up with a local Chinese company would give JVs preferential treatment with regard to taxes and import duties, for instance. Dong et al.'s (1993) western respondents considered the provision of incentives as an important reason for JV activity, though this is not explained in more detail in Dong et al.'s (1993) study. However, this argument lacks plausibility: foreign investors establish their projects at certain locations because they may be promised exemptions from, or reductions of, tax payments, etc., or faster approval of a proposed project. However, any incentive of this kind is equally available for foreign companies that establish any kind of FDI project. The provision of certain incentives has often not been rated very important for whatever decision of a foreign investor desired by host government authorities. Also UNCTAD (1997) has shown this. Thus perhaps, the German investors in the Commerzbank (1995) study perceived this motivation as less important.

Another argument with respect to favourable treatment is that teaming up with a local partner would grant an FDI project in China a better allocation of scarce resources. Because of the centralised planning of raw material allocation, it can happen that once the set amount of raw materials, steel for instance, is distributed to 'special'

manufacturers, all the others in demand have to wait for new deliveries or have to identify suppliers elsewhere, or halt production. Having an influential partner might ensure that the flows of supply are not disrupted. The allocation system works similarly in the finance sector: once, the scarce financial funds are allocated to borrowers, no further projects can be funded through loans, however important they are. The increasing criticism of Chinese lending practice in connection with, for instance, China's imminent entry to WTO could lead also to an even more reduced amount of the credit funding. On the other hand, it could lead also to an improved evaluation of the creditworthiness of borrowers in order to avoid bad loans. Viable projects are then more likely to get funding than others do.

In agreement, the UK and German SMEs do not desire the Chinese partner's technology, neither his trade union relationships nor his skills and they do not believe that having a Chinese partner works as political insurance. For several years, especially the US, but also Europe and Japan, have been in dispute with the Chinese government over intellectual property rights violations. In 1995, China and the US were close to a trade war over this issue. The situation was only relaxed when China agreed to combat the illegal copying of intellectual property, eg music or computer software. The extent to which this was the Chinese paying lip service can only be speculated.

These empirical findings are rather contrary to the literature: for instance, the UK firms in Glaister and Wang's (1993) research hoped the Chinese partner would bring into the JV technology and patents. Datta (1988) and Kim (1996) stress that foreign investors could benefit from the Chinese partner's skills. Also contradictory to the empirical findings in this research, authors (Raveed and Renforth, 1983; Endres, 1987; Datta, 1988) considered the political insurance contribution as one of the most important contributions of a Chinese JV partner. Possibly these differences can be explained by the fact that the latter three studies were all conducted at a time when scholars were heavily concerned with political stability in China. Various authors (see Bloodworth, 1996) have speculated what would and could happen to foreign businesses if the Chinese government changed its attitude towards an open economy. With the death of Deng Xiaoping, the great architect of the Chinese socialist market economy in February 1997, the discussion seems to have calmed down. The Chinese government with president Jiang Zemin and prime minister Zhu Rongji is believed to continue this course towards economic reforms.

### **9.2.3 Partner selection**

#### ***Finding the partner***

The importance of finding a suitable and resourceful JV partner has been frequently suggested in the literature (see sections 3.2.1 and 6.2.1 of chapters three and six, respectively). However, according to Lassere (1984) few companies compare

alternative potential partners, and screen the motives and capabilities of candidates when choosing partners.

Being approached and invited by a Chinese company to joint venture was for both the UK and the German SMEs the most important way of finding a partner. It was, however, of only minor importance for engaging in an FDI project in the first place (see section 9.2.2). With regard to scarce SME resources in the form of finance and executive capacity, this was the easiest way for SMEs to find a local partner to join forces with. This passive or re-active strategy, at best, however, bears the danger of choosing a partner without proper assessment. Also, alternative partners might not even be sought. The cases of UK-7, UK-8, but also GER-0 provide empirical evidence for this statement.

For the SMEs in this study an important way of finding a JV partner was the teaming up with a former agent. The advantages of this strategy have previously been highlighted by authors, including Reynolds (1984), Endres (1987), Kraus (1989) and Campbell (1989), amongst others. In his early study of UK direct investors in India and Pakistan, Tomlinson (1970) found that favourable past association was the single most important criterion for the UK companies to choose a partner for JV activity. Also the majority of Campbell's (1989) firms had chosen partners who they had known from previous business relationships. However, although this strategy saves time, management and finance (as the cases of UK-2 and UK-7 have shown that relied on their Taiwanese and Singaporean partners, respectively, to select an appropriate mainland Chinese partner) and allows two companies to establish a relationship, to get to know each other and to develop mutual understanding and trust, it bears two distinct dangers: first, if one partner is good and suitable, this does not mean that there is not a better and more suitable one elsewhere. Secondly, as Lassere (1984) argues, having a good distributor is no guarantee for getting a good JV partner.

A further strategy that was employed by the UK and German SMEs in this study that helped save limited resources was to accept the helping hand of a Chinese organisation. However, also this strategy moves the SME into a passive position from where it has to rely too much on the goodwill and true intentions of the other party. Thus, Kaiser and Grimm et al. (1997) in their guideline for German SMEs have recommended to be cautious with this strategy.

Overall, the UK and German SMEs displayed significantly different ways of finding their partners for the later JVs. With regard to firm size, the difference in the perceived importance of ways of finding the Chinese partner were even graver. For instance, the

smaller SMEs have more than the larger SMEs accepted the helping hand of a Chinese organisation since this helped save resources.

### ***Partner selection criteria***

The selection criteria applied by the UK and German SMEs were significantly similar. Also with regard to firm size, the SMEs suggest significant similarities in their perceptions of the importance of partner selection criteria, which is even stronger than when analysed according to nationality. In both cases, trust was the most important criterion for partner selection for the SMEs in this study. This corresponds largely with the opinions expressed in the literature (Casson and Zhang, 1992; Glaister and Wang, 1993; Kaiser, 1997c). For the SMEs, this is of particular relevance. SMEs commit scarce funds to a JV. In many cases they take only a minority equity position and often they do not expatriate a manager to the JV to look after the business. In the majority of cases, the SMEs have to rely on the goodwill of their partners. The managing director of UK-8 made clear that "you have to trust them if you want the deal."

Important for the SMEs were further their valuations of the partner's links to officials, its location and range of products. Good connections to the Chinese authorities responsible for placing orders were amongst the most important criteria for UK-3, UK-7 and UK-8 that operate in the infrastructure business. There, without the necessary contacts, foreign (and local) enterprises cannot survive. The literature has not expressed a clear opinion on the issue of the importance of government links. Whereas the German companies in Schwantes' (1991) study and the UK companies in Glaister and Wang's (1993) work considered links to officials as important, for the western firms in Dong et al.'s (1993) and the German firms in the Commerzbank (1995) studies, links to officials were only moderately important. Further, only ten of the 25 SMEs in Kaiser's (1997c) study regarded the partner's connections as important.

Apparently, the UK and German SMEs in this study have understood to a greater extent than the firms that were reported in the literature (Dong et al., 1993; Commerzbank, 1995; Kaiser, 1997c) the importance of being well-connected in China.

The empirical findings in this research with respect to the importance of the partner's location as partner selection criterion are in line with the literature (Schwantes, 1991; Casson and Zhang, 1992; Dong et al., 1993; Delegation of German Industry and Commerce Hong Kong, 1995; Kaiser, 1997c). As will be shown in section 9.3.1 later in this chapter, most of the SMEs in this study have taken over an already existing production facility from their Chinese partners, and most of the SMEs valued their partner's links to customers, etc. With respect to the latter argument, it needs to be

added that China was used to a principle where a firm would carry out business in its home province only. An enterprise from the South rarely had a chance to develop contacts with potential clients in the North of China (see Vanhonacker, 1997).

With regard to the importance of matching product profiles, the literature shows divergence. This was an important selection criterion for the UK firms in Glaister and Wang's (1993) study. However, it was not important for the German firms in the research by the Delegation of German Industry and Commerce Hong Kong (1995) and of only minor importance to the German SMEs in Kaiser (1997c).

Whereas the UK and German SMEs have shown agreement with respect to the importance of the above partner selection criteria, with regard to the partner's reputation and firm size, discrepancies arise. Partner reputation is more important and its size considerably more important to the UK SMEs than it is to the German SMEs. For instance, the Chinese partner's reputation as a manufacturer of ROAD INFRASTRUCTURE PRODUCTS was an important selection criterion for UK-8. Contrary to the attitudes of the UK SMEs in this study, the UK firms of Glaister and Wang (1993) considered reputation as not a considerably important selection criterion and the partner's company size less important even. Company size was found least important by Delegation of German Industry and Commerce Hong Kong (1995) and Kaiser (1997c).

As the findings with respect to motivations for JV activity would suggest, the German SMEs looked more at the Chinese partner's complementary resources than did the UK SMEs (it was of importance for both groups of firms). The literature suggests a trend that would support the importance of the Chinese partner's resource contribution (Schwantes, 1991; Casson and Zhang, 1992; Glaister and Wang, 1993; Dong et al., 1993; Delegation of German Industry and Commerce Hong Kong, 1995). In contrast, the German SMEs in Kaiser (1997c) indicated they were less interested in their partners' resources.

In section 9.2.2 it was found that the German SMEs were motivated by the potential financial contribution of a Chinese partner to a greater extent than UK SMEs were. Surprisingly, thus, the Chinese partner's fitting with local currency is more important a selection criterion for the UK SMEs than it is for the German SMEs. The findings in the literature with respect to the partner's fitting with finance do not correspond, either. Whereas the German companies in the studies of Schwantes (1991) and Delegation of German Industry and Commerce Hong Kong (1995), the UK firms in Glaister and



Wang's (1993) research and the German SMEs in the study by Kaiser (1997c) considered it as important, Dong et al. (1993) suggested that it was of little importance. Access to Chinese technology was also not considered important for partner selection. The SMEs came to China to exploit their own technology, a technology which is, in many cases, their firm-specific advantage. In other words, if the potential Chinese partner had no technology to offer, this did not influence the partner selection choice. On the other hand, the SMEs would not select a partner whom they could not trust. It is difficult to identify a clear opinion in the literature with regard to the importance of the partner's technology. Whereas Glaister and Wang's (1993) UK firms and Kaiser's (1997c) German SMEs reflect the findings in this research, the companies in Casson and Zhang's (1992) work considered the partner's technology as important, though.

### ***Partner selection process***

Thiess (1994) proposed a three-stage partner selection process, including the application of so-called 'killer' criteria in the first stage, 'soft' criteria in the second stage and 'strong' criteria in the third. He defines killer criteria as products, location, size and type of enterprise, whereas a Chinese partner's willingness and ability to co-operate, credibility, company, image and capital situation are soft criteria. Company analysis and project analysis are strong criteria. To what extent have the UK and German SMEs in this study applied a selection process similar to this?

Of all the SMEs investigated, GER-0's partner selection process comes closest to Thiess's (1994) model. The remaining case (UK) SMEs displayed a partner selection process that was characterised by superficiality and shortcuts. This contradicts earlier findings in the literature. Glaister and Wang's (1993) UK firms undertook at least a reasonable level of analysis when selecting their partners: ten of the 21 companies carried out in-depth and exhaustive investigations and six investigated their potential partners reasonably thoroughly. The German SMEs in Kaiser (1997c) suggest similar: all but five companies had investigated their potential partner with regard to their own partner selection criteria. However, when approaching potential partners, the relative majority of these German SMEs had initial conversations with only one Chinese firm.

### ***Partner characteristics***

Various authors have argued that certain partner characteristics are crucial for the success of a JV (in China) (Tsang, 1994; Osland and Cavusgil, 1996; Pan, 1997), including the number of partners, partner size and company type.

#### Number of partners

Some scholars have examined the extent to which the number of partners in a JV affects its performance (Beamish, 1985; Endres, 1987). The more partners in a JV, it might be argued, the more parties want to be involved in decision-making and this

might complicate decision-finding or, indeed, make decision-making impossible. The case of UK-2 could, basically, serve as an example here. Osland and Cavusgil (1996) discovered an extreme scenario: a board meeting with US and Chinese directors lasted for 33 hours and ended without a decision made. The vast majority of UK and German SMEs have joined forces with only one partner, with the exception of UK-2 and UK-7 that have, in addition to their Chinese partner, a Taiwanese or a Singaporean partner, respectively.<sup>2</sup>

#### Partner size

Authors, including Killing (1983), Rugman et al. (1985) and Lane and Beamish (1990) recommend, for the creation of successful JVs, partners of similar size (in turnover **and** number of employees), though Kogut's (1988) (insignificant) data would suggest the reverse.

There is no trend to be read from the data provided by the UK SMEs, though partnering with a company with a similar turnover appeared relatively less frequently. It is equally difficult to detect a clear trend within the group of German SMEs. Nevertheless, German SMEs tend not to joint venture with Chinese companies that are smaller (in terms of turnover) than they are themselves.

Interestingly, only one UK SME indicated that it did not know the exact size of its Chinese partner company. However, the interviews revealed that the companies, with the notable exception of GER-0, did not carry out thorough partner examinations. It is thus unlikely that the companies which have indicated the relative size of their partners, did know how big their partners were - especially in terms of turnover. For instance, the managing director of UK-8 knew that the Chinese partner had a workforce of "around 1,000 employees." As a matter of fact, the company had 1,200 employees. It also appeared during the interviews that the SMEs were not very interested in this information. Company size was just another piece of information the SMEs could not make use of.

It was easier (at first glance) perhaps for the UK and German SMEs to assess their potential Chinese partners' workforce size. Only one UK SME indicated that its Chinese partner would have a workforce of similar size as its own and the remaining results are not sufficient to read a particular trend. Within the group of German SME JVs, however, the workforce of the Chinese partners tend to be larger than that of the German SMEs.

Firm size analysis suggests that the larger SMEs had relatively less frequently partners with a smaller (or much smaller) turnover, whereas within the group of the smaller

SMEs a particular trend cannot be read. The same applies to the employee criterion. The larger SMEs relatively more frequently joint ventured with a company which had more or much more employees than the SMEs had themselves.

#### Company type

It has been argued that private firms might behave totally differently from state-owned enterprises (SOEs) and that foreign firms would prefer private over government companies as partners in their JVs (Killing, 1982; Raveed and Renforth, 1983; Endres, 1987; Beamish, 1987). It has also been argued that JVs would be more stable when they are established with local private firms (Stuckey, 1983; Beamish, 1984, 1985; Young et al., 1989) or local authorities (Thoburn et al., 1990). The findings with regard to the group of UK SMEs do not suggest a clear trend: only a slight majority of SMEs have a state-owned partner. However, it is expected that the majority of JVs would be formed with Chinese SOEs since the vast majority of Chinese enterprises are still SOEs. Also, earlier it has been reported (Rainalter, 1995) that only a few private firms have entered into Sino-foreign JVs. There is more of a trend within the group of the German SMEs, where eight out of ten companies joint ventured with a Chinese SOE.

Thus, the results from the group of German SMEs rather than the group of UK SMEs tend to confirm the earlier findings in the literature: whereas none of Beamish's (1993) 22 JVs were with Chinese private sector firms, only one of Glaister and Wang's (1993) 21 UK firms joint ventured with a Chinese private enterprise. Osland and Cavusgil (1996) stress that their large US MNEs rarely attempted to partner with enterprises other than SOEs. 19 of the 25 German SMEs with JVs in China had chosen an SOE as partner (Kaiser, 1997c).

The analysis with regard to firm size suggests that the larger SMEs show a distinct preference for SOEs as partners in their JVs.

### **9.2.4 Joint venture negotiation process**

#### ***Negotiation contents***

For the SMEs in this study the valuation of their assets and the contribution of the Chinese partner as well as aspects of the financing of the JV were most frequently discussed in the course of establishing the Sino-foreign JVs. In both cases is the scarcity of SMEs reflected. Thus, the SMEs were obliged to 'turn around every penny' before agreeing on the value of certain contributions. Accordingly, also the financing aspect was given a high priority when negotiating the JV. Further of high importance was the distribution of the JV's equity amongst the partners. Whereas two out of three UK SMEs studied in-depth (UK-3, UK-8) and GER-0 insisted on the majority stake in

the JV, only UK-3 and GER-0 could push their desire through negotiations. In the case of UK-8 the Chinese side insisted on the majority stake and UK-8 had to agree eventually. Also UK-6 had to give in in its battle with the Chinese party for the majority 51 per cent. Both UK-6's and UK-8's bargaining powers were not strong enough.

Of similar importance to the UK and German SMEs were further control issues, ie the composition of the board of directors (BoD). However, basically, the composition of the BoD is determined by the distribution of the JV's equity. It is commonplace and also provided for in the JV legislation that the majority partner in a JV holds the majority of seats on the BoD. Further of interest to the UK and German SMEs was the aspect of who appoints the general manager. Again, the same applies as was said with respect to the composition of the BoD. However, some firms, amongst them GER-0, have adopted a policy to appoint a Chinese national, perhaps one from the Chinese partner, who is in charge for the day-to-day business of the JV. Many foreign investors (eg GER-0) are of the opinion that only Chinese nationals could create a good corporate culture in the JV and make the business successful. On the other hand, UK-3 would have aborted its negotiations if the Chinese side had not agreed that UK-3 would send an expatriate general manager.

Less frequently discussed by both the UK and German SMEs was the selection and transfer of technology.

Major discrepancy between the experiences of the UK and German SMEs appeared with respect to issues such as market priorities and the expatriation of SME managers which were more frequently discussed during the negotiations of the Sino-German JVs than during the establishment of the Sino-UK JVs. This surprises with regard to the actual expatriation of German personnel to the JVs in China.

Overall, the UK and German SMEs do not reveal any significant similarities with regard to the frequency of stating individual negotiation contents. However, when analysing according to 'firm size', the larger and smaller SMEs show similarity. Contents, such as the valuation of assets, equity share distribution, market priorities and training of staff rank rather high within both groups of SMEs. On the other hand, aspects, including the distribution of responsibilities, technology selection and transfer as well as the general manager appointment were the least frequently discussed negotiation contents by both Size One and Size Two SMEs. In summary, it is rather the criterion 'nationality' than 'firm size' that distinguishes the SMEs.

### ***Negotiation content conflict***

The valuation of the partners' contribution and aspects of financing the JV that were the most frequently negotiated issues, were also the negotiation contents that were relatively most conflicting for both groups of SMEs. The cases of UK-3, UK-6, UK-7

and GER-0 highlight the difficulty of know-how or technology valuation. For certain know-how and technologies there is no market price. Instead, the determination of contributions' values is often more a matter of tough negotiations.

The negotiation conflict with regard to financing and valuation issues was previously found by Frankenstein (1986) with price being the single most difficult term to resolve. Explicitly, the 26 companies in Frankenstein's research spent 17 per cent of their negotiation time discussing price issues. Financial matters were also discovered by Stewart and Keown (1989) to be important factors in the negotiation process.

The UK and German SMEs showed also agreement with regard to the conflict that arose when negotiating the distribution of the equity share in the JV. For both groups of enterprises this issue was only relatively rarely a matter of conflict. Exceptions are known, including UK-3 and UK-8. UK-6 that initially desired a majority stake in its JV, eventually agreed to a minority share since it did not want to risk failure of the negotiations. This corresponds with findings by Davidson (1987) and Kaiser (1997c).

With respect to royalties, the experiences of the UK and German SMEs are considerably different. Whereas they were the greatest area of conflict with the German SMEs, royalty conflicts occurred least frequently with the UK SMEs. Only four German SMEs negotiated the royalty issue and two of them regarded it as conflicting. Relatively, thus, the royalty issue is the aspect that is most conflicting. Discrepancies arose also with regard to market priorities. Whereas this aspect was relatively unproblematic for the UK SMEs (though UK-3 reports some conflict with regard to the target markets of its JV), it was conflicting in the case of the German SMEs. As established earlier, relatively more German SMEs discussed the market focus of their JVs in the first place. For them it was very important and, consequently, they were more often prepared to argue with the Chinese side about this. The occurrence of conflicts between the German SMEs and their Chinese partners with respect to the market focus of JVs confirms the opinion of the literature (Ruggles, 1983; Davidson, 1987; Tai, 1988; Beamish and Wang, 1989; Shenkar, 1990).

The conflict areas that confronted the SMEs are significantly dissimilar, both with regard to nationality and firm size. Whereas the distribution of equity caused conflict most frequently within the group of the smaller SMEs, it was rather non-conflicting within the larger SMEs. On the other hand, whereas the larger firms relatively frequently argued with their partners about financing and personnel issues, these were rather less conflicting within the group of the smaller firms.

### ***SME negotiation team***

The composition of the negotiation team has been considered a major success factor when negotiating with the Chinese (Eiteman, 1990). As a trend, the UK and German

SMEs had more than one manager involved in negotiations with their Chinese counterparts. As earlier reported in the literature (Simon, 1996), both the UK and the German SMEs were represented in the negotiations by their managing directors – owner-managers, in the majority of cases. The cases of the UK SMEs confirm this. In only a few SMEs was this delegated to an executive officer. On the other hand, as VobaRaiba (1996) and Grimm (1997b) have suggested, only a few SMEs can afford the specialist staff to carry out this task. There were no differences between the smaller and larger SMEs with respect to members of the negotiation team. Assertions, such as smaller SMEs could not afford to involve an equal number of managers in negotiations did not prove true.

### ***Location of negotiation***

For many of the managing directors negotiating the JV meant spending a considerable amount of valuable time on not only talking, waiting for decisions to be made and socialising with their Chinese counterparts, but also for travelling from Europe to China. In addition, this is expensive and it is, relative to large firms, more expensive to SMEs. The vast majority of UK SMEs had to accept this since their negotiations were carried out exclusively or also in China. In contrast, the German SMEs in their majority negotiated their JVs both in China and in Germany. This helped them save scarce SME funds in the form of capital and managerial capacity.

Overall, in the majority of cases, the negotiations of the SME JVs needed a considerable amount of SME firm resources. This was in the form of mainly the managing directors' time for preparation, travel and execution of negotiations, as well as communication, consulting, etc. This substantial amount of funds which is relatively larger in SMEs than in large firms, reduced the SMEs' strategic flexibility especially during the negotiations: after committing substantial resources, a decision to abandon a project due to negotiation difficulties, for instance, would have been very expensive. In other words, sunk costs would have been very high.

Eiteman (1990) proposed that negotiations should be carried out in the home country since this would save time and accustom the Chinese to the foreign business environment. This argument supports all the UK and German SMEs that have carried out their negotiations also, or exclusively, in the UK or Germany. It saves the SMEs' scarce resources and communicates the UK and German business environments to the Chinese. It is certainly an argument that needs consideration. However, in many cases, the Chinese negotiation team is different from the team that works in the JV

later. The inevitable question then is how the later managers can benefit from negotiations that are carried out in the UK or Germany.

Interestingly, the smaller SMEs carried out relatively most of their negotiations exclusively in China, whereas Size Two SMEs employed a strategy of holding negotiations both in China and at home. Perhaps the larger SMEs had more bargaining power to demand this from their Chinese counterparts.

### ***Duration of negotiations***

The fact that negotiations require substantial company resources is not so much of a problem when negotiations can be completed within weeks. It becomes a great problem, however, when they last for months or years, as is often the case in China. Daniels et al. (1985) discovered negotiation periods of between seven months and four years and Davidson's (1987) US MNEs negotiated two years on average. The average duration for the negotiation of their JVs was less than two years in the case of the New Zealand SMEs of Au and Enderwick (1994). The 25 German SMEs in Kaiser's (1997c) study spent, on average, four years and four months from the first collection of information until the granting of the business licence.

Negotiations can easily become a major problem of an SME's entire JV preparation process. A certain amount of funds, time, etc., is allocated to the preparation of a project. When the actual preparation exceeds the set time-scale, not only more management time, but also additional funds are necessary. In the worst case, this can endanger the whole undertaking. For instance, American tractor manufacturer John Deere was reported (Yatsko, 1997) having plans to establish four farm equipment factories in China. Only later it learned that negotiating JVs and getting them approved was not the six-month procedure that had been expected. Eventually, the company dropped two of the projects because it did not have the resources to support them.

Thus, it is not surprising that the majority of SMEs perceived their negotiations having taken longer than expected. The amount of resources the firms allocated was based on what was financially bearable, but not what would have been reasonable for the case of China. The analysis with respect to firm size does not reveal any differences between the smaller and larger SMEs.

### ***Language of negotiations and use of interpreters***

With exceptions, English is not spoken in China. Shenkar (1994) suggests this with regard to the work of western researchers in China. This fact is, however, of equal interest to the UK and German SMEs in this study. Thus, Frankenstein (1986) and Eiteman (1990) argued that there should be a Mandarin speaker in the foreign

negotiation team. Chinese interpreters are often very keen to act more as 'interpreter' than as translator: contents, alternatives, etc. disappear and affect negotiations as well as the entire JV – disadvantageously often. Having somebody in the team who speaks Mandarin, improves the quality of discussions since the interpreter tries harder to stick to the core meaning of the conversations, without applying much own interpretation.

When employing the services of interpreters, it is important that the interpreter not only is fluent in both languages, but also has an understanding of the topic that is being discussed. For instance, the research of the UK-8 case has shown that it is inevitable to have negotiations (discussions) translated by somebody who is familiar with the topic. When the English speaking marketing manager of UK-8-JV was temporarily not available, a hotel employee was asked to assist as interpreter for the conversation between the researcher and the Chinese general manager of UK-8-JV. Though this person spoke English, the conversation had to be postponed since the interpreter had no understanding of the issues discussed.

In most cases it is a distinct problem for SMEs to appoint a Mandarin speaking manager. As has been shown in chapter two (section 2.3.3) of this thesis, SMEs frequently lack not only managerial time and capacity, but also managerial quality. However, the ability to speak several foreign languages, including Chinese, certainly is a managerial quality. In contrast, Simon's (1992, 1996) 'hidden champions' employ managers that can speak several foreign languages. However, these world class SMEs are the exception rather than the rule.

Thus, negotiating a JV with Chinese counterparts who do not speak German, and frequently not English, was a challenge for the SMEs from the UK and Germany. Not surprisingly, thus, all eight UK SMEs that answered the question, had used one or more interpreters. Interpreters were also provided in the negotiations of the China JVs of the 25 German SMEs (Kaiser, 1997c). In detail, the Chinese side provided the interpreter in eleven cases, in six cases was an independent interpreter employed and the German side provided the interpreter in five cases. Both sides provided interpreters in five cases and no interpreter was used in only three cases.

The smaller SMEs had more often carried out JV negotiations in English, compared with the larger SMEs which have, in turn, relatively more often negotiated their JVs in both English and Chinese or exclusively in Chinese. With regard to use of interpreters there is no considerable difference between Size One and Size Two enterprises to be read in the data.

### ***Negotiation difficulties***

China and the UK as well as China and Germany are characterised by a considerable psychic distance, and it was found that SMEs are more affected by psychic distance



than large firms (Carlson, 1975; Buckley and Mathew, 1979; Schmidt et al., 1995). In environments, such as the Chinese, SMEs are at a disadvantage when negotiating contracts since they often lack the competitive advantage of large firms and have only a poor understanding of Chinese negotiation styles (Leung and Yeung, 1995).

The cultural differences between the European and Chinese negotiators which manifest themselves in language problems, problems with the negotiation styles, the slow pace of the negotiations and other cultural issues were both for the UK and the German SMEs the most frequently cited problem areas of negotiating a JV in China. For instance, for UK-6 problems did not arise with regard to engineering, but with business and cultural issues. The problems appear similarly to Size One firms and Size Two firms alike.

### ***Factors for successful negotiations***

As known from chapter three, Hamill and Hunt (1993) discovered, as the factors for successful negotiations to create bargaining power through controlling the technological know-how, the ability to cultivate good relationships with the authorities and the venture partners with matching the requirements of the country for foreign currency, modernisation, technology transfer and exports.

Indicating that patience and sincerity of the SME team and a good relationship with the Chinese negotiation partners are important factors for successful negotiations, both the UK and German SMEs reflect what has been found with regard to partner selection. In many cases where the SMEs had no expatriate on-site who could oversee the business and report to the headquarters if and when things were going wrong, the UK and German firms had to trust their partners. Accordingly, the managing director of UK-8 said that "there is no use establishing a JV without trusting the partner."

As important factors for successful negotiations considered were further the use of a good interpreter (for the reasons outlined above), the SME's technical expertise and knowledge of the Chinese business practices, whereas of less importance to the success of negotiations were the uniqueness of the SMEs' product, its willingness to offer good financing, and familiarity with social customs, knowledge of China's political and social situation and the SME's past reputation in selling to China.

As a trend, the above observations contradict earlier findings by Stewart and Keown (1989) who studied the factors for successful negotiations with Chinese partners. Whereas the empirical results in this thesis would suggest personal qualities, such as patience, sincerity and relationship-building as the most important factors for successfully negotiating with the Chinese, Stewart and Keown (1989) found that the factors for successful negotiations with China tend to be rather product and finance-

related, and less personal and culture-related. Thus, the findings in this study are more in line with earlier findings by Tung (1982) and Leung and Wong (1993) who discovered personal factors more important for successful negotiations than finance and product issues. The results of this thesis clearly suggest, however, that product and financing issues rank fifth and sixth at best (chapter seven, section 7.2.3).

In a more recent study, Leung and Yeung (1995) undertook an identical investigation to the earlier research by Stewart and Keown (1989) and extracted support in their data for the works of Tung (1982) as well as Leung and Wong (1993) and rejection of Stewart and Keown's (1989) results. However, Stewart and Keown's (1989) findings are confirmed by the results in the study of 25 German SMEs with JVs in China (Kaiser, 1997c). As factors influencing negotiations, technology transfer and investment volume were ahead in importance of, for instance, *guanxi*.

Eiteman's (1990) findings neither support nor reject the empirical results in this thesis or Stewart and Keown's (1989) conclusions, respectively. Although Eiteman (1990) found important the possession of an unique technology, he classified this factor as 'inherent strength', whereas patience of the US team and mutual understanding for each other's objectives and desires, for instance, were classified as 'developed strengths.' Eiteman's (1990) study lacks, however, a ranking that would incorporate 'inherent' as well as 'developed' strengths.

Apart from what UK-2's managing director suggested, namely "to be polite, to be sure of the facts and to protect yourself," a further important factor for successful negotiations is the SME's ability to make concessions to the Chinese, to be able to compromise where it does not affect the SME's business disadvantageously. GER-0's negotiation with its Chinese partner with respect to the JV duration serves as example for this: whereas GER-0 wanted 15 years, its Chinese partner, ABC, wanted 50 years. GER-0 that was very determined of what it wanted from the proposed JV and that was prepared to withdraw from its proposal, agreed. By compromising, GER-0 showed its willingness to co-operate. On the other hand, its concession was not at a cost for the German enterprise. Compared with duration findings in the literature of, on average, 16 years and with over 60 per cent between eleven and 20 years (Dong et al., 1993) this appears exceptionally long.

Further, UK-3 that insisted on a majority stake in its JV accepted a 50-50 equity distribution which was wanted by the Chinese side. The UK SME was prepared to give in since it knew that its Chinese partner would not be familiar with the industry the JV would be operating in. Thus, UK-3 would be the dominant partner anyway.

A negative example is the proposed JV between ABC and UK-9: after three years of discussions the parties withdrew from their proposals, because the valuation of contributions could not be solved.

Both the UK and German SMEs displayed significant similarities in their perceptions of the importance of negotiation success factors. Also with regard to firm size, the perceptions of the SMEs are significantly similar, though the similarity is greater when analysed according to nationality. In other words, SMEs of different sizes display greater dissimilarity in their perceptions of factors for successful negotiations. However, there is no meaningful interpretation of these differences.

### **9.2.5 Partner contributions**

#### ***SME contributions***

It has been argued that JVs are formed to combine advantages of the partners (Blodgett, 1991) and that firms forming JVs need partners for a variety of potential contributions (Beamish, 1987).

Accordingly, capital, technology, management expertise and technical training were the most frequently observed contributions of the UK and German SMEs. This reflects exactly what the Chinese side desires when entering a JV with a foreign company and what the literature (Woodward and Liu, 1993; Commerzbank, 1995) suggests. Apart from the scarce resource capital (all SMEs used their working capital to finance the JV), the UK and German SMEs contributed their technology to the joint undertaking. In many cases this is special technology which the SMEs attempt to exploit in the Chinese market rather than licensing it to a Chinese company. Since most of these technologies are 'high-context' technologies the SMEs also have to provide the necessary training, initially at least. This was the case with UK-3 and UK-4 where the SMEs sent an engineer to the JV to train local staff in manufacturing the products.

On the other hand, machinery, access to world markets and patents were the least frequently contributed assets and attributes by the SMEs in this study. This does not surprise too much. Machines to manufacture certain products can easily be purchased in China and it is rather the soft technology, human resource, that is most important for producing high quality. This was outlined in the case of GER-0. Further, the vast majority of UK and German SMEs came to China to exploit the potential Chinese market, but not to open their traditional export markets to the output of the JVs.

Interestingly, whereas the SMEs show significant similarities with respect to nationality, the SMEs display no significantly similar responses when analysed according to firm size. For instance, although cash was the most frequently cited contribution of the

smaller and larger SMEs, technology was perceived more important a contribution by the smaller SMEs than by the larger. On the other hand, management expertise was relatively more often contributed by the larger firms than by the smaller ones. This supports the argument that managerial capacity is limited in smaller firms. The smaller SMEs could not involve too much managerial capacity in the JV business.

### ***Chinese partner's contributions***

It has been argued (Contractor, 1984; Hamill and Hunt, 1993; Woodward and Liu, 1993; Commerzbank, 1995) that the local partner contributes expertise, capital, location-specific knowledge on politics, economic and customs environments, contacts with government officials, faster entry into the domestic market, marketing personnel, plants, facilities and land, materials, local labour, infrastructure and trade union relationships as well as access to financial institutions.

Accordingly, local labour, contacts to customers, access to markets and government contacts were amongst the Chinese partner contributions that were most important to both the UK and German SMEs. This suggests that Chinese partner attributes rather than assets were most appreciated by the UK and German SMEs. It was just the importance of these cultural attributes that was also reflected in the motivations of the UK and German SMEs for entering a Sino-foreign JV. Getting contacts to customers and to the government and access to the Chinese market were perceived valuable since the SMEs could not provide these attributes by themselves.

Of less importance to the SMEs were Chinese partner contributions, such as plant or cash - in other words, assets. To expect cash from the Chinese partner would not have been very realistic since it is exactly this contribution that is sought by the Chinese side. This was suggested by both Mr. Davies of the British Consulate General in Shanghai (interview on 21.11.96) and the production and quality assurance manager of GER-0-JV. In contrast, UK-4's Chinese partner poured into the JV double the cash contribution of the UK SME and UK-7's Chinese partners contributed the same amount of cash as the UK SME did.

In summary, the UK and German SMEs display significant similarities in their perception of the importance of the Chinese partner's contributions. However, when analysed according to firm size, the SMEs show considerable differences in their perceptions. For instance, the Chinese contribution of land was ranked first within the larger firms, whereas it ranks last within the group of smaller SMEs. Apart from this huge discrepancy, the results within both groups do not suggest too great differences in the firms' perceived perceptions of the importance of certain Chinese contributions.

### ***Contribution valuation problem***

The exact valuation of the partners' contributions is a problem. This has been shown above (section 9.2.4). Chinese companies do not trust their foreign partners and vice

versa. Perhaps this is one of the reasons for the UK and German SMEs' strong, though implicit, desire to be sincere and trust each other. Reports on the fraud of both Chinese and foreign companies are plenty: as the *Handelsblatt* (5./6.7.96, p.18) reports of Chinese who overvalue their asset contributions sometimes two and three-fold, and quote fantasy figures for second-hand machines, so the *Economist* (6.8.94, p.65) knows of a foreign firm that contributed equipment to a Sino-foreign printing JV that was supposedly worth more than US\$2.6m (£1.7m), though its true value was only US\$0.5m (£0.3m). Further, a Hong Kong investor allegedly provided 15 pieces of equipment to a JV, of which two were made in Japan in the 1930s and two in China in 1973 and 1983 and which were allegedly worth US\$2.12m (£1.36m), whereas local inspectors found the true value to be US\$20,000 (£12,821) (*FT*, 5./6.11.94, p.2). Whether this was the real 'true' value is debatable again.

In section 9.2.4 of this chapter it has been established that the valuation of contributions was on top of the list of negotiation conflicts. Of the 25 German SMEs in Kaiser's (1997c) study only 14 had no problems with the valuation of contributions.

Of the SMEs studied further, UK-3, UK-6, UK-7, and GER-0 experienced conflict in the valuation of the SME technology or know-how. The case of UK-3 is exceptional, compared with the others: the valuation of the SME's contributions created substantial dispute between the two parties. Since UK-3 had put into the planned JV too much time and money already, it could not afford at that stage to jeopardise the undertaking or to withdraw even. On the other hand, GER-0 was prepared to withdraw from its project in case it could not have negotiated a deal with which it was entirely satisfied.

On the other hand, the assets and attributes of UK-4 and UK-8 had been valued without major conflict. UK-4's know-how had not been valued and accepted as a contribution to the JV at all. This was because the deal between the UK SME and the Chinese company was a 'camouflaged' contract manufacturing agreement where the UK company wanted to produce at a low cost and the Chinese company to obtain 'production fees', but was not interested in the UK SME's technology. This becomes obvious further in the fact that the Chinese company's line of business is completely different. In the case of UK-8-JV, the Chinese established the relevant figures (with respect to the value of UK-8's contribution) and UK-8 accepted.

## 9.3 Sino-foreign joint venture operation

### 9.3.1 Joint venture background information

#### *Establishment, total investment, number of employees*

The analysis reveals that the German SMEs approached China as a location for JV activity later than the UK SMEs. For German firms growth markets in Eastern Europe

have been considerably more important than markets in distant China. Whereas with respect to nationality of the SMEs a meaningful statement concerning the investment volume cannot be made, it becomes obvious that smaller SME JVs had the smallest total investments.

The UK JVs employ, on average, nearly double as many staff than do the German SME JVs. Firm size analysis shows that the smaller SMEs have fewer personnel than the larger SMEs.

### ***Joint venture location***

China's developed areas of the East, Northeast, Southeast and South have attracted the majority of the UK and German SME investment. This high concentration of UK and German SME JVs in the coastal areas, in special economic zones (SEZs) and major municipalities with attractive investment zones, corresponds with earlier observations by Beamish and Wang (1989), Glaister and Wang (1993), Schüller (1994), Grimm (1994), Delegation of German Industry and Commerce Hong Kong (1995) and Commerzbank (1995). These sources report a range of 76 to 85 per cent of international, UK and German direct investment, respectively being located in coastal areas. Shenkar (1990) stresses the environmental distinctiveness of these areas from the rest of China.

For some years, now, various sources have been reporting the gradual shift of new direct investment inflows from China's east coastal areas to its remote West (China aktuell, September 1993, January 1995; FT, 7.11.94, p.iv; Fan, 1996). However, the empirical results of this study do not support this, though the vast majority of the JVs are fairly recent. This clearly suggests that the UK and German SMEs considered it as important to have, on the one hand, supportive infrastructures and, on the other, proximity to their markets and customers. Especially for exporting JVs it is important, if not essential, to choose a location that has access to a harbour. The same applies to SMEs that rely on the importation of certain goods. Equally, being close to an airport, for example, eases the transport of not only urgently needed parts and materials, but also of expert staff that come to China for fixing production problems, etc.

Overall, the UK and German SMEs in this study contradict what has recently been demanded by the general manager of another German SME JV, based in Chongqing. He said that (German) SMEs should locate in China's remote areas because of lower costs for land use rights, labour, electricity, etc. This corresponds with what Commerzbank (1995) suggests as attractions of investing in China's hinterland - as opposed to the coastal areas where investors get above-the-average economic

growth, high demand, and a better infrastructure. Moreover, GER-0 which had located its JV in China's East coastal area, argues that in CITY [East China] it saw emerging the world's biggest region and "you have to move into areas that are civilised, otherwise you'll find nobody to send there" ]...[ with hindsight to the later expatriation of one of its engineers. For SMEs that do not intend to expatriate staff to their China venture, as was the case with the majority of SMEs in this study, this argument loses of impact.

Whereas with respect to the smaller firms a clear preference of location cannot be identified, the larger SMEs are located in North and East China rather than in the South. Interestingly, the two SMEs that 'dared' to locate in China's remote area are larger SMEs, suggesting that for smaller SMEs a location too remote is not suitable.

### ***Choice of location***

The availability of trained labour was the most important criterion for the choice of location for the SMEs in this study. The importance of the availability of trained labour for foreign investors was recognised by Chinese municipalities that wanted to attract FDI. For instance, in its investment promotion brochure, the government of CITY [East China] emphasises its super kids as its special asset, known for their "superb mental arithmetic skills based on using the abacus" (The People's Government of CITY, 1996, p.18). However, trained labour that meets the requirements of foreign investors and particularly of many SMEs that produce with special technologies, is a relatively scarce resource in China. Whereas in China's coastal areas trained labour is available, there is still a big lack in the remote areas of China. This makes production difficult.

The availability of cheap labour is inevitably linked with that of trained labour as a factor influencing the choice of location. The majority of SMEs that came to China intended to service the Chinese domestic market. This meant competition would be fierce from domestic as well as other foreign companies, making cost-competitive production necessary. At least this was cited by the UK and German SMEs as second most important motivation for engaging in an FDI project. The state of the infrastructure was of further importance for the SMEs. The SMEs prefer to locate in such locations in China that are privileged by a functioning infrastructure in terms of transportation, telecommunication and the provision of supporting services for carrying out their business.

Apparently, this was one of the reasons why the SMEs located in China's coastal areas. It reflects the opinion expressed in the literature on both large UK and German

firms (Glaister and Wang, 1993; Delegation of German Industry and Commerce Hong Kong, 1995) as well as German SMEs (Kaiser, 1997c).

The opinion about the importance of the partner's location is more important to the UK SMEs than it is to the German SMEs. It is difficult to state why this discrepancy arises. In one case (UK-7) the choice of location was pre-determined. There, the potential Chinese partner was in charge of selecting the location of the JV and, naturally, opted for a location nearby its own. Similarly, UK-2's choice of location was influenced in that its Taiwanese partner had an operation in China already. Also this finding corresponds with the literature: both Glaister and Wang (1993) and Delegation of German Industry and Commerce Hong Kong (1995) detected this motivation as considerably important for their UK and German firms' partner selection.

The SMEs did not select a location because it was close to their target markets or sources of raw materials. This heavily contradicts earlier findings by the Delegation of German Industry and Commerce Hong Kong (1995). There, the choice of location was determined by the proximity to customers in 93 out of 120 cases. Further, the UK and German SMEs would not have chosen a location because of the provision of investment incentives, such as preferential tax treatment or exemption from certain duties, etc. The minor importance of proximity to target markets clearly contradicts what Glaister and Wang (1993), Delegation of German Industry and Commerce Hong Kong (1995) and Kaiser (1997c) found with respect to UK and German firms. For the firms in these studies, proximity to target markets was the most or second most important or frequently cited criterion, respectively. Overall, however, the German SMEs in this study are more likely to show similarities with the firms in the studies by Glaister and Wang (1993), Delegation of German Industry and Commerce Hong Kong (1995) and Kaiser (1997c).

With regard to investment incentives and raw material sources, the findings in this study correspond with the findings of Glaister and Wang (1993) and Delegation of German Industry and Commerce Hong Kong (1995). In contrast, the German SMEs in the Kaiser (1997c) study expressed great interest in investment incentives, including tax concessions.

For instance, both GER-0-JV and UK-4-JV enjoy tax concessions. Kaiser and Grimm et al. (1997) extensively discussed the different areas and requirements to be met in order to be eligible for tax reduction or exemption. According to this source, the kind of tax treatment which GER-0 and UK-4 received, is very common in China. It is not really a discriminatory factor for location choice. UK-6 explicitly states that tax



concessions, for instance, did not affect the SMEs' choice of location since they were considered to be largely the same in all provinces.

Overall, the perceived importance of criteria for the choice of location is not significantly similar between the UK and German SMEs and it is even less similar when the perceptions of the SMEs are analysed according to firm size. For instance, the location of the Chinese partner is more important for the larger, whereas the provision of incentives is more important to the smaller SMEs. While proximity to target markets is important to the smaller SMEs, it is nearly least important to the larger SMEs.

### ***Production site***

The majority of UK and German SMEs had taken over existing production facilities, whereas three UK and German SMEs each erected new buildings on green-field sites (two German SMEs rented office space). Without longer periods of building a production site, these SME JVs could start with production at an early stage in their existence. This reflects the observations in Kaiser's (1997c) study where only eight JVs established a green-field operation.

Taking over or renting already existing production and office buildings is not always as satisfactory and uncomplicated as in the cases of UK-2 and UK-4. This shows the case of UK-3. There, substantial renovation works had to be carried out. Although with the erection of a green-field operation, these kinds of problems can be avoided, the construction of purpose-built premises does not allow an immediate production start. For instance, UK-7 spent no less than 18 months to build its factory). Further, buildings are expensive and need to be paid, in many cases, with the cash contribution of the foreign partner. However, this money would be better used for the importation of high quality machinery, raw materials, etc. Sometimes, however, the establishment of new buildings cannot be bypassed since existing premises cannot be used at all or cannot be refurbished at a reasonable cost or do not exist, as was the case with UK-7.

The larger SMEs more often preferred a take-over operation than the smaller SMEs.

### ***Product range***

As a trend, the UK and German SMEs manufacture only a limited product range, compared with their production at home. The SMEs started with a small fraction of their product programme that was, as the case of UK-3 shows, initially only assembled by the JV and later completely manufactured locally. Also as a trend, the product programme was gradually extended in the SME JVs. The SME tested production and the market with a small fraction of products before they introduced more products to

their JVs. This also meant committing further funds in the form of sending expert staff to the JV or a new set of machines, etc.

Also with regard to firm size analysis, it becomes obvious that both groups of SMEs manufacture only a limited range of products, though the difference in responses is greater within the group of the larger SMEs. The reason for this is possibly that the whole product range of the larger SMEs is larger than that of the smaller SMEs.

### ***Target market***

With their direct investment projects, the majority of UK and German SMEs target the domestic Chinese market, rather than export markets. One SME JV within every group of SMEs exports its entire production. Within the group of UK SMEs this is UK-4. Other SMEs were required to also export a certain fraction of their production, although they came to China in order to service the domestic market. Being prepared to export a certain share of their production was the price the SMEs had to pay for being approved by the Chinese authorities. For instance, UK-7 agreed to export as much as 30 per cent of its annual output and UK-3 50 per cent even. Also GER-0 had to agree to sell, within five years, up to 30 per cent of its production into overseas markets. UK-8, on the other hand, could bypass this requirement by including an 'as-much-as-we-can' phrase into the JV contract.

This is rather wise since committing itself to a certain export contribution often creates problems. In many cases is the quality of products manufactured in China not sufficient to satisfy the demand of the world markets. In most cases also, do exports from the JVs into the SMEs' traditional export markets create so-called 'cannibalism' effects that are highly unwanted by the UK and German parents. Engelhardt and Seibert (1981) suggest the danger of cannibalism can be reduced in that country-specific product differentiations allow the marketing of JV products in countries only with similar or equal structures of need as the market that hosts the JV. On the other hand, country-specific product adjustments can damage the reputation of the investor (ibid).

An SME JV that is the only subsidiary and whose parent company is not able or not willing to absorb parts of the JV's output, could easily drift into serious problems. In the case of GER-0-JV, the Mexican subsidiary (and subsidiaries in Australia and South Africa) helped the JV to meet its export target. Without an order from the Mexican customer, GER-0-JV's export situation would have faced serious problems since the German SME, following its global strategy, co-ordinates the market activities of its various subsidiaries. A single venture's own export ambition often does not go hand in hand with such a strategy. This was previously suggested, for instance, by Gomes-Casseres (1989) and Hill et al. (1990). Also firm size analysis suggests that both groups of SMEs target the domestic Chinese market first and foremost.

### ***Market share in China***

Both Stratos (1990) and Simon (1992) discovered that many SME entrepreneurs did not know the size of their shares in individual markets. For instance, Simon (1992)

argues that some of the 'hidden champions' operate in extremely fragmented markets for which clear market definitions and reliable statistics do not exist; what the 'hidden champions' do know, however, so argues Simon (1992, 1996), is when they are the market leader. Five UK and two German SMEs specify or estimate their 1995 shares of the Chinese market ranging from 4 per cent to 35 per cent. Also GER-0 could specify its market share in China, accounting for some 3 to 5 per cent.

### 9.3.2 Joint venture ownership

On average, the SMEs have taken on minority equity positions in their China JVs. Although corresponding with the average German SME investment share observed by Kaiser (1997c), the average minority shares of the SMEs are higher than the average foreign equity holdings of 43 per cent and 42 per cent, respectively, that were detected by and Dong et al. (1993) in their research of Sino-European, Sino-US and Sino-Japanese JVs, and Pan (1997), who examined Sino-Japanese and Sino-US JVs.<sup>3</sup> The higher foreign equity of the SMEs compared with the firms in Dong et al.'s (1993) study may have resulted from a relaxed Chinese government attitude towards foreign ownership during the past years. It would not explain, however, the discrepancy with Pan's (1997) recent findings. To explain the discrepancy with company size of the investing company would prove useful at first glance, though there is no indication in the literature that would support this.

The detailed analysis of the equity shares reveals that there is no trend within the group of the UK SMEs. Three UK SMEs hold majority stakes, three have minority stakes and three equal equity stakes. There is more of a trend to be read within the sample of German SMEs: six have accepted the minority position in their JVs, four JVs are equally owned by the German and the Chinese partners and only one German SME holds a majority equity stake. The German SMEs' minority equity position in six out of eleven JVs clearly contradicts findings by the Delegation of German Industry and Commerce Hong Kong (1995) and Commerzbank (1995). These suggest that German companies prefer a distinct capital majority in more than two thirds and more than 50 per cent, respectively, of Sino-German JVs.

The empirical findings of this study on ownership distribution strongly contradict earlier observations by Davidson (1987) of Sino-US JVs and Woodward and Liu (1993) of foreign investors in general. Explicitly, Woodward and Liu (1993) revealed that in two thirds of cases the foreign and Chinese partners shared the ownership of the venture. The equity structure of the SMEs in this study corresponds much more with the ownership structure detected in Beamish and Wang's (1989) examination of the data

of 805 Sino-foreign JVs. The Beamish and Wang (1989) study shows that foreign investors had a minority equity position in 60 per cent of the cases, whereas they shared the equity in 31 per cent and were majority owners of their JVs in 9 per cent of all cases only. Later, Beamish (1993) stressed that most foreign firms in China have a minority equity position, though equal ownership is quite common.

This must be treated with caution and eventually this will have to be amended. Beamish and Wang's (1989) sample contained a substantial number of firms from Hong Kong and it is known that direct investors from Hong Kong are much more willing to take a minority position than investors from Japan, the US and Europe (Beamish and Wang, 1989). Pan (1997) found even that Japanese investors would more frequently opt for a 50 per cent or majority position in a Sino-foreign JV than US firms. In 1993, Beamish predicted that, with the increasing relaxation of the investment conditions in China and the encouragement of WFOEs, more foreign firms take a larger equity position. Pan's (1997) data largely confirm this prediction. They show a shift of Japanese and US equity stakes from 50-50 to a majority position between 1991 and 1993, compared with the period 1988 to 1990. However, no large volume data exists that provides useful insight into the equity holding development of UK and German investors in China that allows comparison.

Interestingly, the larger SMEs own, on average, 51 per cent of the equity, whereas the smaller SMEs own nearly 10 per cent less equity. Further, the smaller SMEs had more often a minority equity position than the larger firms.

### **9.3.3 Joint venture control**

It has been established in chapter six (section 6.2.2) that ownership is perceived as a control mechanism. However, it has been found also (chapters three and six, sections 3.2.2 and 6.2.2) that the level of ownership does not necessarily correspond with the level of control. Explicitly for LDCs, such as China, Beamish (1993) discovered that foreign firms are typically able to exercise somewhat greater control over their JVs than their equity levels would suggest. This was the case with UK-3 that controls the JV despite having only a 50 per cent equity stake. However, UK-3's Chinese partner is not familiar with the industry the JV would operate in and it would have to rely, thus, on the UK SME.

Contrary to that is the case of GER-0. Although the German SME could have gone for a share bigger than absolutely necessary for a majority stake, it refused to take a bigger stake since it did not want to have a passive partner. The avoidance of a silent partner is also known from Hamill and Hunt's (1993) research of the company APV that could have opted for 100 per cent ownership in its JV in Hungary. However, the company preferred a 60 per cent equity stake, instead. Both companies, GER-0 and

APV, believed that the long-term success of the JV required the active involvement of local partners in decision-making.

In chapter five (section 5.3.3) the need for, and functions of, the BoD have been established. The SME JVs in this study had at least three directors on their boards. Regarding the number of board directors, the JV law provides a minimum of three and a maximum of fifteen members, depending on the size of the venture. As a trend, the Chinese had an equal or larger number of directors on the JVs' BoDs than the foreign side. Overall, the distribution of seats in the BoD in this study reflects that in the majority of cases, the Chinese side held majority equity stakes. This corresponds with earlier findings by Campbell (1989) where of the 17 equity JVs for which information was available, more than half had a Chinese majority on the BoD and a third of the boards had an equal number of Chinese and foreign members.

UK-2 that has a Chinese and a Taiwanese partner and three out of eight seats on the BoD, believes that "the Ethnic Chinese are running the show." Thus, in order to protect its interest in the JV, the stipulations of the contract provided for a 70 per cent agreement for decisions to be made. A similar constellation was found by Brown (1985) in the case of the Schindler Elevator JV. Although the Chinese partner held six out of eight positions in this JV's BoD, including the chairmanship, any change in the articles of association required assent by one of the western directors. Also UK-4's managing director has to agree to major decisions to be made regarding investment or management appointment, though the UK SME held one third of the equity and had two seats of five on the BoD only.

Despite the relatively unequal distribution of equity and BoD seats, in the vast majority of the SME JVs in this study was decision-making shared between the partners. This coincides with earlier findings by Beamish (1993) where 17 of 22 JVs exercised split control (and thus joint decision-making). However, as Lane and Beamish (1990) emphasise, when decisions are shared within a JV, they are in fact not being jointly made, but rather divided or split between the partners on knowledge, skill, experience and understanding of the particular issue.

This was the case with the UK and German SMEs that had split decision-making authority of most of the different functions in their JVs. Only two SMEs indicated that they had not split responsibilities of individual functions.

To divide up control along functional lines has been found effective (Shenkar, 1990; Teagarden, 1990; Beamish, 1993). It has been suggested also that to have one partner making nearly all the decisions increases the probability of poor performance in

a Sino-foreign JV. Teagarden and von Glinow (1990) observed that Sino-foreign JVs with split control of management functions became profitable faster than passive alliance forms, though there are also other, contrary voices. Ding (1993) and Osland and Cavusgil (1996) detected that the JVs that were managed entirely by the US side performed much better than JVs that were managed by the Chinese side. However, Ding (1993) could not observe any significant performance difference between US-dominant and shared management JVs.

The vast majority of SMEs retained research and development responsibility and could so avoid to disclose their firm-specific advantages. This was previously demanded by Reynolds (1984) and Daniels et al. (1985). The SMEs made it clear during negotiations that they did not want to give too much of their firm-specific knowledge away to their Chinese partners. For instance, UK-8 insisted to supply the special, chemical, component to its JV, whose secret formulation the SME was not prepared to disclose. The supply of this special component had become a major source of income for the SME and to disclose its formulation would have meant to threaten this.

The SMEs also, as a trend, retained the production function and, in the majority of cases, also the finance function. This is in line with findings by Commerzbank (1995) where two thirds of the 45 German JV entrepreneurs in China were in charge of production. Osland and Cavusgil (1996) observed that the two shared-control JVs in their study where governmental bodies controlled production as part of five year plans, were the most dissatisfactory of all.

It is known that the Chinese are traditionally bad in financial reporting procedures. On the other hand, western companies are experienced in forecasting and planning, for instance. Thus, it was important for the SMEs also to retain control over the finance function. The problems that UK-2 had when giving away the finance function to its Taiwanese partner are documented in chapter seven of this thesis. Also, UK-8's general management is in Chinese hands. Due to dissatisfactory performance of the finance function that rests with the general management, UK-8 planned to send an expatriate to help solve the problem.

Overall, the UK and German SMEs kept control over all the functions that were part of their expertise: research and development, production and finance. The SMEs, in the vast majority of cases, entered China to exploit their firm-specific advantages, their technologies in producing what the Chinese market needed. Thus, the firms considered it essential to control these functions. Further, since the SMEs intended to manufacture high quality products (for export markets and for the Chinese market), it

was also important for them to keep the production function in the JVs. Contrarily, in the case of UK-4-JV, the production function was given to the Chinese partner. However, UK-4 gave its approval to the JV that it could manufacture UK-4-standard ELECTRONIC DEVICES only after an engineer of UK-4 had trained staff on-site and examined the quality of the output.

The distribution of responsibility with regard to the personnel function, is considerably unbalanced. A clear trend for both groups of SMEs cannot be recognised from the existing data. Whereas the UK SMEs are in charge of the human resources function in the majority of cases, in the Sino-German JVs responsibility relatively more frequently rests with the Chinese party. Compared with the findings in Osland and Cavusgil's (1996) study where the Chinese side perceived human resource management as very important and the parties thus agreed that control rests with the Chinese side, only the German SME JVs reveal a similar trend. Also Ireland (1991) and Woodward and Liu (1993) consider the Chinese side taking on responsibility of the human resources function as beneficial to the operation. On the other hand, authors, such as Hendryx (1986) and Tai (1988) stress to retain control of personnel management, thus supporting the attitudes of the UK SMEs in this study.

The UK and German SMEs agree in the majority of cases that the marketing function should rest with the Chinese side, with the notable exception of UK-4. This SME markets the entire production of its JV in Europe. These results contradict previous findings by Daniels et al. (1985) and Osland and Cavusgil (1996). Also of the 45 German firms with a JV in China in Commerzbank (1995) nearly two-thirds controlled marketing and sales.

However, it became also evident from further research into the SMEs that in several cases, including UK-3, UK-8 and GER-0, the western managers had gradually taken on a share of the responsibility of the marketing and sales function. In the case of GER-0 the Chinese marketing staff was lacking the pro-active approach that was needed and relied too much on people they knew from somewhere. UK-3-JV's British general manager hits the point when he suggests that "the Chinese (customers) want to see the European manager." Conflict about the marketing in JVs was previously detected by Dong et al. (1993) in a study of Sino-Japanese, -US and -European JVs.

As a trend, the bulk of UK and German SMEs had not experienced major problems in decision-making. Apparently, the SMEs in this study paid considerable attention to a decision-making that would not rest on one party's majority stake.

The JV law provides for board meetings to take place at least once a year (see Campbell, 1989). Contents of the board meetings are various issues regarding further investments, the future course of the JV, etc. It is thus essential for the SMEs to participate in these meetings. This means, however, travelling to China on a frequent basis and spending funds and management time. Osland and Cavusgil (1996) showed that board meetings are not always a matter of a day or so. In one of their, admittedly extreme, cases of Sino-foreign JVs a board meeting had lasted for 33 hours without a decision made.

Kaiser and Grimm et al. (1997) in their China direct investment guide for SMEs stressed that SMEs could appoint a so-called alternate director (a solicitor, representative of a chamber of commerce, etc.) who would participate in board meetings in China and look after the interests of the foreign SME. However, since the joint venturing in China in the vast majority of cases is 'chief's business', the SME would not delegate this so important right to an outsider.

In cases, BoD meetings take place both in China and in the home country. However, an SME director still has to travel to China and in the majority of cases this has to be more than once a year (see cases UK-3, UK-8, GER-0).

The larger SME JVs have, on average, more directors on their BoDs than the smaller firms. With regard to the nomination of the chairman of the JV, there is no clear trend to be read from the data provided. As was the case with the analysis according to nationality, also when analysed according to firm size, it suggests that both groups of SMEs preferred to be in charge of research and development as well as of production. Further, both the smaller and the larger SMEs were keen to be in charge of the finance function. With regard to the marketing and personnel functions, the Chinese side was slightly more frequently in charge within the group of the smaller firms, whereas the control constellation was reversed within the group of the larger SMEs.

Of the larger SMEs the majority had not experienced problems with decision-making, whereas within the group of the smaller SMEs a clear trend cannot be worked out.

#### **9.3.4 Joint venture management**

An important instrument of controlling the overall management of a JV is the appointment of the general manager. The JV law suggests that the general manager can be appointed by the Chinese or the foreign partner (chapter five, section 5.3.3). The UK and German SMEs in this study could appoint the general manager in five and four cases, respectively. As a trend, this suggests that general manager appointment



does not reflect equity and control (BoD) distribution in the SME JVs. Some JVs that were minority-owned by the UK and German SMEs had a general manager appointed by the foreign party.

For instance, GER-0 that had the majority share in its JV insisted that a Chinese national would be in charge of the general management (see section 9.2.5). Certainly, its majority stake of 51 per cent gave GER-0 confidence in appointing a Chinese general manager and if there are arguments between the partners, "we can play out easily our 51 per cent." In the case of UK-4-JV where the UK SME held only one third of the equity, the appointment of the general manager was not an issue. The Chinese side was very keen to have its own general manager and the UK SME expressed no interest in expatriating staff because this had meant an extraordinary financial burden.

This was different in the cases of UK-3 and UK-6. Although UK-3 had only 50 per cent of the equity in the JV, it insisted to appoint the general manager and would have withdrawn from its proposal even if the Chinese partner had agreed to it. UK-3's Chinese partner was not familiar with the industry and the business the JV would be operating in. Thus, UK-3 regarded it as essential to have a UK-3 manager on-site for the management of the JV. Without lengthy negotiations about this, the Chinese side accepted UK-3's demanding position since it knew that the UK SME's management input would be essential to the successful operation of the JV.

Also, UK-6 that only had 48 per cent of the equity in its JV, was granted the right to appoint the general manager, though this was difficult. However, for the SME this was only possible since it did not have to expatriate UK staff to the JV, but could ask its Singaporean distributor to take on the post of general manager. This strategy, at first glance, should have proven beneficial since the UK SME had a Chinese element in its JV that would look after the UK SME's interests, but for much lower a cost than UK personnel would do. Indeed, the use of Overseas Chinese in the management of Sino-foreign JVs is a strategy that saves resources of the SMEs.

Whereas in the cases of the smaller SMEs the Chinese side appointed the general manager twice as often as the foreign side (six vs. three), for the larger SMEs the reverse applies (four vs. six). This contradicts the results in Campbell's (1989) study, where the general manager was frequently foreign and in some cases the majority of subordinate managers were foreigners also.

To represent more effectively their interests, foreign investors expatriate employees to their JVs in China. Wu (1993) stressed the importance to afford an expatriate in a JV. As a trend, the UK and German SMEs expatriated only a relatively small number of

employees to their JVs. The maximum number of employees the UK SMEs could or would afford was two. Also five German SMEs had expatriated staff to their JVs in China and the maximum number was also two. This is in line with previous findings by Kaiser (1997c) where of the 25 German SMEs with a JV in China only eleven, and thus less than half, had expatriates on-site.

This suggests that relatively more UK SMEs considered it essential to have an expatriate on-site who would look after their business interests, implement SME technology, etc. The expatriate jobs were considerably different. Whereas UK-3's expatriate was the JV's general manager, UK-8's expatriate supervised the installation of ROAD INFRASTRUCTURE PRODUCTS and had to report to the Chinese general manager. Also the German expatriate in GER-0-JV was only a 'level two' manager who had no decision-making authority with regard to the overall business of the JV.

The range of expatriate jobs was also wide in the case of the German SMEs studied by Kaiser (1997c). There, the managers were in positions, including general manager in seven cases, deputy general manager in three cases, deputy chairman (3), finance director (2), technical director (2) and general sales manager (1). Overall, however, the empirical findings of this study as well as the findings of Kaiser (1997c) show that the SMEs sent expatriates to look after the functions the SMEs had a firm-specific advantage in, technical matters, finance and also general management. From the cases of UK-3 and UK-8 the importance of having an expatriate manager on-site became evident. UK-2 that had, at the time of interviewing, no expatriate in China, considered it essential to have its own staff there.

However, expatriating UK or German personnel to China means a considerable financial burden for an SME that ranged, in the case of the SMEs in this study, between US\$62,400 (£40,000) and US\$300,000 (£192,308) per year. Not only have the salaries of the expatriates to be increased and funds for travel, housing, relocation, children's education, etc. be provided. The SME needs also to replace the employee in its operation at home. In most cases, the expatriates are experienced and skilled employees for whom replacement is difficult to recruit.

Although UK-7 felt that it was necessary to have its own staff on-site, it could not afford to send a UK engineer to the JV. On the other hand, the JV in that UK-7 held (eventually) 40 per cent of the equity, was not prepared to cover the cost of an expatriate. In this particular case, the ethnic Chinese opposition in the JV BoD (Chinese and Taiwanese) was too strong.

The actual financial burden which the SME has to bear on its own depends, amongst others, on how much the JV management is prepared to cover. Frequently, the foreign company covers the expatriate's salary and the premium on top of that. The costs that occur on-site (accommodation and subsistence, etc.) are paid by the JV. However, since the expatriate issue is a critical one at board meetings and provided the fact that the UK and German SMEs do not have, in the majority of cases, the majority in their JV's boards, it is difficult for the SMEs to negotiate with their Chinese partners to cover the costs of foreign expatriates. UK-2-JV and UK-7-JV serve as examples for that.

Equally, the limited resources of SMEs are reflected in expatriate preparation for an overseas assignment in China. Although authors, including Tung (1982, 1986), Zamet and Bovarnick (1986) and Commerzbank (1995) demanded adequate expatriate preparation, as a trend the expatriates that were sent to China by the UK and German SMEs in this study, did not receive China-specific preparation in, for instance, cultural issues, language, etc. UK-3's expatriate had to insist on a several week-long language training, because the UK SME did not offer the training in the first place. This corresponds with the findings of Kaiser (1997c) were only one German SME offered its expatriate preparation. Four SMEs, however, indicated that their expatriate staff had worked in Asia before and two that their managers had studied in Asia for some time.

Not surprisingly (with regard to the literature in chapter two), the larger SMEs had more than twice as often expatriated a manager or even more personnel to their JVs to China. On the other hand, the smaller firms sent personnel in three cases, and seven larger SMEs expatriated staff to China.

#### **9.4. Joint venture problems**

During the various phases of the JV process as discussed in this study (JV formation: planning, partner selection, negotiation, JV operation, ownership, control, management), the UK and German SMEs experienced a variety of problems. These problems were located, as can be seen from the subsequent sections, both internal and external, though Killing (1983) argues that JV problems are located internally rather than externally.

The Chinese partner's concept of quality was the most striking aspect of the JV activity for the SMEs. In many cases, so was feared by SMEs, such as UK-2 and UK-8, would insufficient product quality not only hamper the SMEs' efforts to service the domestic and, especially export, markets. It could also harm the SME's reputation. UK-7-JV, for instance, that was required to export as much as 30 per cent of its output, at the time

of the investigation, experienced problems with product quality. It could, thus, not meet its set export target.

Apart from the quality problem, the SMEs also experienced problems with the repatriating of their profits. The Chinese JV law provides for the unrestricted repatriation of profits abroad. However, neither the UK nor the German case SMEs could provide meaningful comments on this problem that would have further advanced its understanding.

The SMEs show discrepancy with regard to problems linked with the transfer of technology. Whereas the German SMEs considered the transfer of technology as relatively problematic, for the UK SMEs it was not. UK-6 made an interesting comment, stating that, although the Chinese engineers' standards are sufficiently high to understand the technology transferred, they would have problems in transforming theory to practice. The reverse constellation has been observed with the recruiting of personnel. Whereas this was highly important for the UK SMEs, it was only of less importance as a JV problem for the German SMEs.

Rather important for both groups of SMEs appeared to be the problem of lacking motivation of Chinese personnel and the problem of communication with Chinese staff, the potential loss of control and a mismatch in management styles. Though these problems were felt to be of equal importance to both groups of SMEs, they were, absolutely, not too important to the SMEs.

However, communication between the Chinese and the foreign sides was a major, and an important, problem in the case of UK-3. In this case the problem stemmed not only from the potential mutual misunderstanding between two different cultures, but also from inherent and developed distrust of the UK general manager towards his Chinese vice-general manager. Already earlier in the JV process, UK-3 had experienced considerable problems with its Chinese partner, including the valuation of contributions.

The problem of a lack of control over the JV and firm-specific technology diluting into Chinese terrain was feared explicitly by SMEs, including GER-0, UK-2 and UK-7. The latter had trusted its Chinese partner, but "the Chinese company decided not to play fair any longer."

The remaining problems on the list of JV problems were either relatively unimportant to the SMEs or showed major discrepancies in the perceptions of the two groups of SMEs. Local sourcing and insufficient training of Chinese managers, for instance, were perceived relatively important problems for the UK SMEs, whereas they were relatively unimportant for the German SMEs.

The economic importance and problems of local sourcing were discussed in studies, including Campbell (1989), Trommsdorff et al. (1994) and Schuchardt (1994) and so was the strong desire of the Chinese government to develop local suppliers. Various SMEs (UK-2, UK-6, GER-0) feared that, due to problems with the quality and availability of supplies, also in the future certain supplies would have to be sourced overseas. This increases the cost of manufacture in China and thus competitiveness.

Similar applies to the problem with low productivity of the local labour: whereas the UK SMEs considered this problem as relatively important, it was highly unimportant for the German SMEs. The cases of UK-6 (chapter seven) and GER-0 (chapter eight) provide some insight into this particular problem for the China investors. However, UK-3 praised the productivity of its JV's Chinese workforce, after training the staff and providing state-of-the-art welding equipment to them. UK-3 has criticised, however, the efficiency of the venture's administration staff.

Problems, such as unfair competition, corruption and the potential of the JV damaging the SMEs' reputation were perceived as important by the German SMEs, whereas they were perceived as only relatively unimportant by the UK SMEs.

The above results somehow contradict earlier findings by Gledhill (1994). He found more than 60 per cent of the UK firms having experienced problems in establishing effective distribution networks or in recruiting suitably qualified and experienced managers, in understanding the Chinese business culture and in communicating western concepts and concerns. Almost half of the respondents in Gledhill's (1994) study had problems with recruiting skilled workers. Less than a third of the firms had language problems. Conversely, Eiteman, Frankenstein and Ireland categorised the lack of language skills as a major obstacle to a smooth JV operation.

Overall, the UK and German SMEs perceived the importance of JV problems significantly similarly and so did the smaller and larger SMEs in this study. Considerable differences exist between the smaller and larger SMEs with regard to the recruiting of personnel that ranked very highly within the group of larger SMEs, but only considerably low within the group of smaller SMEs. Further, loss of control is more feared by the smaller SMEs. Infrastructure and restrictions on sales and imports are considered more important a problem by the smaller firms than by the larger ones. Overall, the size criterion distinguishes more between each two groups of SMEs than the criterion 'nationality'.

## **9.5 Joint venture evaluation**

### **9.5.1 Joint venture performance**

SME joint venturing in China: does it make sense economically? Is it a viable strategy for UK and German SMEs entering the Chinese market? These are the imperative questions which need to be answered by this research.

Overall, the UK SMEs were satisfied with their JV performances in China and the German SMEs expressed medium satisfaction with the overall performance of their China enterprises. In this respect, the companies in this research confirm earlier reporting by authors, such as Davidson (1987), Campbell (1989) and Dong et al. (1993) on satisfactorily performing JVs in China. However, as shown in chapter six, there is also negative evidence with respect to JV performance.

A closer look at the individual factors that constitute the SMEs' responses reveals that the SMEs were not satisfied with their JVs' royalty fee generation and export performance (only UK SMEs). With respect to the remaining individual performance criteria, including supply and management fees, return on investment (RoI), in comparison with competitors, local market share and growth, the SMEs showed medium satisfaction (although the UK SMEs expressed satisfaction with their JVs' overall performance).

What has caused the SMEs' dissatisfaction with their JVs' export performance? Only a few UK and German SMEs entered the Chinese market to manufacture for export markets exclusively (UK-4: electronics, GER-6: textiles) or in addition to the Chinese domestic market (UK-3: mechanical engineering, GER-4: mechanical engineering, GER-8: electronics, GER-9: mechanical engineering). Although this contradicts findings by Stofán and Stultz (1992) as well as Delegation of Germany Industry and Commerce Hong Kong (1995) that German firms would produce for export markets, the empirical results in this study support findings of two recent studies by Wäscher and Schmitt (1994) and Commerzbank (1995). In the latter study, none of the 48 German companies engaged in the investment project for export reasons.

Interestingly, the above SMEs that came to China with the intention to export, considered the export performance of their JVs satisfactory (UK-3, GER-6) or moderately satisfactory (UK-4, GER-4, GER-9). The other SMEs (exclusively UK) perceived the export performance of their JVs as unsatisfactory or not at all satisfactory even. The German non-exporting SMEs did not indicate their degree of satisfaction with export performance.

In these latter cases the SMEs came to China without the intention of exporting, but had to agree to exporting quasi as the price that had to be paid to get JV approval. Daniels et al. (1985) from their study of eleven US manufacturing and service direct investors in China, found that none of the former exporters to China was required to export a fixed ratio of their output from China. The authors argue that the higher the technology of a company the more likely it might gain an initial opportunity to export to China and when forced to shift to local production, these firms are less likely to have to

export from China. Daniels et al.'s (1985) observation corresponds with the legal text: the Chinese JV law encourages Sino-foreign JVs to market their products outside China, unless they are needed in the country.

In fact, JVs have been reported to be required to fix a minimum export ratio in the JV contract (Tai, 1988). It has been reported (Delegation of German Industry and Commerce Hong Kong, 1995) that if a JV exports at least 70 per cent of its output and thus earns a foreign exchange surplus in every year, it is granted a special status when being approved and, thus, additional privileges. In the meantime, though, this over-emphasis on export requirement has been softened. JVs are considered now, more than previously, as a means of import substitution (Kraus, 1989).

Again, these latter enterprises were not committed to exporting and they ran into difficulties with fulfilling their determined export ratios. Exporting substantial volumes of their ventures' production to their own traditional export markets conflicted with the SMEs' market target strategies. GER-0 stressed this point: "We are not here to export." Further, even if agreed to export a fixed ratio of output, this has been difficult for many JVs (Kraus, 1989). Frequently the quality of the goods manufactured in Sino-foreign JVs is not sufficient for export markets and foreign investors refuse to export the goods since this could damage the firms' reputation for high quality products.

Although there is a trend amongst the SMEs that suggests overall satisfaction with JV performance, various SMEs indicated that it would be "too early" to make any meaningful and detailed comments on satisfaction. Some of the JVs were established only in 1995 or 1996. In many cases production was delayed by ongoing building works, especially with those JVs that started in a green-field site. Tang et al. (1992) detected considerably higher satisfaction ratings for equity JVs established before 1983, compared with those established after that time. Dong et al. (1993) confirm this.

Where managers could not evaluate the JV's financial performance, because the JV had not been in operation for long enough a period, other criteria were applied. In the case of UK-3-JV, for instance, that had been in operation only since May 1996, the general manager stressed that the JV had not done its homework with regard to establishing relationships. However, this is considered very important. And while he praised the quality standard the JV had achieved, he criticised its achievements in terms of productivity and administration efficiency, though, overall, "what we have achieved in the first months looks quite good." Both the general manager of the JV and the managing director of UK-3 allowed for time giving the new JV a chance to learn from its mistakes. Having the necessary patience, however, correlates with financial staying power. This, however, can cause trouble for many SMEs which lack the

necessary funds. Also UK-2-JV, UK-6-JV, UK-7-JV and UK-8-JV were behind their scheduled results for the year 1995. GER-0-JV, on the other hand, met its financial goals for the year.

UK-8 managers also measured their satisfaction with the JV in China at the generation of business for headquarters. Since it had contractually agreed that all but one component can be sourced in China and that UK-8 would supply this special component, the UK SME generates a substantial income from that. Whereas, when UK-8-JV started its operation, these deliveries accounted for only approximately 5 per cent to the UK SME's total earnings, in 1998 UK-8 intended to supply approximately 100 tonnes of the component to the JV - a similar amount as the SME uses in the UK. Also UK-7 fixed in the JV contract that it would sell a set amount of components to its JV. The managing director of UK-7 considered the JV as "one of our biggest customers." However, he was satisfied moderately with the JV's overall performance.

Despite the modest success of the JVs, none of the 21 UK and German SMEs indicated that they would not again join forces with a Chinese company to operate a business in China. Two UK SMEs suggested that it was too early to answer this question and one UK and one German SME each were not sure. Five UK and seven German SMEs, however, were positive about it. One UK and four German SMEs did not answer this question, suggesting, implicitly, that it was too early for them to make a clear statement and that they rather need some more time before they can make an assessment. These SMEs seemed to be aware that investing in China requires patience - patience with the Chinese and with oneself when waiting for financial returns. Appropriately, Lane and Beamish (1990) emphasised that expectations of early or easy returns are early indicators of future problems. The SMEs in this study were prepared to let their JVs grow up first, before they started evaluating them.

This empirical result corresponds with the findings in the study of German SME JVs in China (Kaiser, 1997c) where 23 out of 25 firms indicated that they would again engage in a JV in China.

Overall, the UK and German SMEs did not display significant similarities with regard to their degrees of satisfaction with JV performance. With regard to firm size differences, the dissimilarities are more distinct. For instance, whereas the larger SMEs are most satisfied with their JVs' export performance, the smaller SMEs are nearly least satisfied with export performance and the situation is reversed with regard to local market share. Overall, the smaller firms are more satisfied with the performance of their JVs than are the larger SMEs.

### **9.5.2 Factors for joint venture success**

What determines the SMEs' JVs' overall satisfactory performance? In an interview carried out in November 1996, Mr. Yang of the China-Britain Trade Group in Shanghai



summarised his views: "Conduct research, come to China, find a suitable partner and make the agreement work."

For the SMEs in this study all of the pre-determined answers, including patience, sincerity, good business connections, good product, Chinese market adaptation, relationships with Chinese officials and familiarity with Chinese business practices, were considered as 'very important' or 'important' for JV performance. Unambiguously, the UK and German SMEs perceived patience and sincerity as 'very important'.

Basically, the SMEs indicated the importance of two broad categories of factors for JV success. SME-inherent strengths in attributes and assets (patience, sincerity, good product, Chinese market adaptation, familiarity with Chinese business practices) and strengths that evolved from joining forces with a Chinese partner (good business connections, relationships with Chinese officials). SME-inherent strengths play a role more important than strengths which evolved through joint venturing.

The importance of success factors such as patience and sincerity was also perceived by the New Zealand SMEs in Au and Enderwick's (1994) study. Also with regard to the other success factors that were important for the UK and German SMEs, Au and Enderwick's (1994) study shows distinct similarities (see chapter six, section 6.2.3). These findings also correspond with observations by Davidson (1987) who emphasised qualitative variables such as individual personalities as success factors of joint venturing US MNEs in China. For UK-2 that manufactures test equipment, the fact that the SME has moved on-site with service capabilities meant considerable orders for the firm. However, the managing director of UK-2 also suggested the need to be patient and "to give them support, service support and information."

Overall, the UK and German SMEs did not show significant similarities with respect to attributes of JV success. However, inter-group correlation is stronger when the criterion firm size is applied. Whereas both the smaller and larger SMEs regard patience and sincerity as the most important attributes for JV success, their perceptions differ considerably with regard to the factor 'good business connections' and 'familiarity with Chinese business practices'. Whereas the former is more important to smaller SMEs, the latter is more to larger. Overall, the criterion 'nationality' distinguishes more strongly between each two groups of SMEs than firm size does.

### **9.5.3 Joint venture as resource commitment relief**

The strengths that evolved through joining forces with a Chinese entity evolved exclusively from the Chinese partner's attributes, rather than its assets. For the SMEs

the Chinese partner's contribution of resources was only a medium relaxation or not a relaxation of the SMEs' critical internationalisation resources situation. Whereas the UK SMEs considered their Chinese partners' contributions towards their own managerial, finance and information needs as medium relaxing, the German SMEs regarded only the Chinese companies' information contribution as relaxing and management and financial contributions as not relaxing. In other words, the German SMEs were relatively more dissatisfied with their Chinese partners' contribution. As was established earlier in this chapter (section 9.2.2), the German SMEs expected more financial and managerial assistance from their potential Chinese partners than the UK SMEs did. Thus, the German SMEs were eventually more disappointed.

As a trend, the smaller SMEs regard the JV strategy more as a strategy that eases the resource scarcities of SMEs than the larger ones. The smaller firms suggest that in terms of management and financial resource ease, the benefits from joint venturing are moderately, whereas the larger firms cannot see such an ease. Although with regard to information needs, the smaller firms appreciate the JV strategy more than the larger firms do. However, also they regard the provision of essential information by the JV strategy as moderately easing the scarce resource situation of SMEs.

In conclusion, five of the nine UK SMEs would again engage in a JV, two suggested that it was too early to answer this question and one respondent was not sure. Of the German SMEs seven would again engage in a JV in China, one indicated that it did not know and four SMEs did not provide an answer to this question. There is no dissimilarity between the responses of the smaller and the larger SMEs.

## 9.6 Conclusion

The results of this study suggest that market seeker as well as resource seeker motivations are amongst the most important motivations of UK and German SMEs with a JV in China. However, the market seeker in the firm dominates the set of driving forces. It shows also that transaction related motivations such as transport costs, import duties, etc. are only of minor importance to the SMEs. Further, the main driving forces of the UK and German SMEs in this study are not different from the motivations that drive large MNEs to an FDI or JV activity, respectively.

With regard to partner search, it has been found that SMEs employ strategies that are considerably resource saving. However, these 'shortcut' strategies are particularly dangerous since in many cases the evaluation of alternative partners falls short and also the evaluation of the easily found potential partners. When selecting a Chinese partner the SMEs paid attention to the Chinese enterprise's resource contributions.

This was expected and necessary, but being able to trust the later partner in a venture, its links to officials, product range etc. were perceived more important even by the SMEs. This confirms findings by Young et al. (1989) that considered the local partner's assets only marginally important, especially in LDCs, whereas the partner's knowledge of the local economy, of politics and culture are appreciated highly.

The study found further that the negotiation contents and conflicting areas are not too different from what previous authors have suggested. The SMEs in this study had to make sure that their technology contribution was valued in a way that reflects the true value of their technology, since, in many cases technology is the main contribution of 'cash-less' SMEs. On the other hand, the value of technology that is to be contributed to a JV must not exceed 50 per cent of the foreign partner's contribution or 20 per cent of the JV's total registered capital (Kay and Mann, 1995). For the reasons that were most important to the SMEs when choosing the location, availability of trained labour, infrastructure and proximity to target markets, the SMEs had to choose, in their majority, a location in the more developed areas of China, rather than in remote China. However, the SMEs' desire to also have access to cheap, apart from qualified labour, would suggest a remote area, rather than a coastal. Since the main motivation of the UK and German SMEs was, however, the development of the Chinese market and not solely cheap production in the country, the SMEs had to prefer the more developed coastal areas where they would be closer to their markets.

Product and finance issues were amongst the most frequently negotiated issues of the UK and German SMEs in this study. However, the fact that issues were most frequently discussed does not necessarily mean that the discussion of these issues leads to successful negotiations. This study has shown this.

By and large, the control distribution in the SME JVs corresponds with the findings by Dong et al. (1993). There, the foreign partners have much more control over areas such as product planning and quality control and a bit more over marketing, while the local partners have more control over labour policy. The findings are also in line with earlier observations by Kim (1996) who reveal that the internal variables are mostly controlled by the Chinese partner, except for production/operation and that labour management usually rests with the Chinese side.

As factors of success the SMEs in this study confirm the findings of earlier studies on (New Zealand) SMEs as well as on large MNEs. The factors for JV success in China are similar for small and large MNEs: they revolve around company-inherent strengths. The provision of relevant information through the potential Chinese partner saved scarce managerial and financial resources. Apparently, this was welcomed by the SMEs that did not see the need to carry out, in addition, their own market research or commissioning studies to market research institutes.

## Notes

<sup>1</sup> ECIP is the European Union's flagship investment financing programme. It has four facilities that offer organisations (facility one) and companies (primarily SMEs) (facilities two to four) financial assistance towards preparing and executing a direct investment project in an LDC.

<sup>2</sup> One partner sold its share to the other partners.

<sup>3</sup> The foreign equity stakes in Pan's (1997) research ranged from 10 to 99%. However, since the Chinese JV law of 1979 demands a foreign minimum equity share of 25%, this seems rather unlikely.

## Chapter Ten

# Conclusions and Recommendations

### 10.1 Introduction

The final chapter of this thesis summarises the key findings of the study and attempts to derive conclusions from those. The chapter presents implications for the underlying theory and for policy-making. It further offers a brief outlook into the future of FDI in China. Finally, the limitations of the study as well as the areas for further research are outlined.

### 10.2 Summary of the results

For small and medium-sized enterprises (SMEs) and large multinational enterprises (MNEs) alike, China is a difficult terrain which is not for novices in international business (Teagarden and von Glinow, 1990). However, successful market entry is possible for SMEs, as the results of this study have shown. Although the SME interviewees were not able to present outstandingly positive financial results, none of them would not engage again in a joint venture (JV). After difficulties with getting their JVs off the ground, most of the managers of the UK and German SMEs predicted a promising future for their JVs in China. Accordingly, Kayser and Hauser (1993) argued that there is no single explanation of the correlation between profitability and firm size.

Not only would the UK and German SMEs in this study again engage in a foreign direct investment (FDI) project in China. They would also again commit themselves to a JV with a Chinese partner. Although the SMEs experienced difficulties in their JV activity, in many cases a commitment without a local partner would not have been possible. In many cases, the attributes of the Chinese partner, not its assets, were essential for the successful establishment and operation of a direct investment project in the country. In this respect, the experiences of the SMEs are not too different from that of large MNEs that joint ventured in China. Also, the factors for being successful with an FDI project in China are similar for SMEs and large MNEs: they revolve around company-inherent strengths, rather than investment incentives, provided by the home or host governments.

The problems the UK and German SMEs faced when joint venturing in China include cultural misunderstandings, distrust, reporting problems, marketing difficulties, etc. Though essential, the assets and attributes of the Chinese partners were not always as resourceful as the SMEs had hoped prior to entering a JV. Although some sources praise the JV strategy for entering and developing the Chinese market (Delegation of

German Industry and Commerce Hong Kong, 1995), others report that the Chinese partner's access to potential customers and its provision of marketing and distribution channels does often not exist to the extent the foreign partner had hoped it would (Vanhonacker, 1997). Further, Chinese partners were found unreliable and their contribution of local managerial talent was rather low. Having found that government networks are fine for taking orders but generally abysmal at actively selling products or meeting strict logistics standards, many foreign investors are building their own sales force and distribution networks (Shaw and Meier, 1993).

That expectations of foreign investors are not met applies equally to large firms and SMEs as the literature shows (Shaw and Meier, 1993; Vanhonacker, 1997). Increasingly, thus, scholars articulate arguments that oppose the application of the JV as a market entry strategy, but favour the establishment of a wholly foreign-owned enterprise (WFOE) instead. Whereas some authors critically shed light on the JV strategy (eg Kraus, 1989; Ding, 1993; Shaw and Meier, 1993; Weir, 1997), scholars also rigorously condemn the use of JVs (Glatter, 1996; Peerenboom, 1996; Economist, 29.3.97, p.73; Nölting, 1997; Diem, 1997; Vanhonacker, 1997). The German periodical *Manager Magazin* (Nölting, 1997) regarded the decision to joint venture as a strategic failure even.

According to the *Manager Magazin*, most of the new projects particularly from the 'Mittelstand', are in the form of a WFOE. Also, the above-mentioned Fiducia study of 98 European companies in China (chapter six, section 6.2.3) discovered that more than two thirds were choosing to invest in a WFOE rather than a JV, if they had the chance again (FT, 16.2.98, p.2). Also, more than half of the German companies in the earlier Commerzbank study (1995) which had minority equity positions, would opt for a WFOE or at least a majority JV if they had the choice again to invest in China. Apparently, the enthusiasm for Sino-foreign JVs has cooled down.

Statements as the one by Beamish (1993, p.41) that "the overall use of equity JVs in China has been very high, particularly in relation to WFOEs," might soon be part of China's FDI history. Also Gledhill's (1994) finding from a study of 250 UK direct investors, that investments through WFOEs are less common, will soon be dated. In fact, the past decade has seen an evolution in the thinking of the Chinese government from requiring JVs to permitting WFOEs, to encouraging such entities. At the end of 1996, 76.1 per cent of all FDI projects were JVs, less compared with the figure at the end of 1994 (Kaiser and Grimm et al., 1997). For 1997, the Economist (29.3.97, p.73) suggests that "30 per cent of foreign-funded enterprises in China are wholly foreign-

owned” and Vanhonacker (1997, p.131) anticipates that “half of all foreign investments in China will be WFOEs by the year 2000.”

The motivations of the UK and German SMEs to engage in production in China are similar to those of large MNEs and of other SMEs in previous studies. The SMEs are, first and foremost, market seekers and, secondly, resource (cheap labour) seekers. Transaction-related motivations such as transportation costs, import duties, etc. are only of minor importance to these SMEs.

The similarity of these findings with findings on large MNE investors in China and also other SME investors in previous studies confirms Grimm’s (1997c) argument from his analysis of 35 German SMEs with a JV or a WFOE in China, respectively. He insists that SMEs and large MNEs are **not** different in their FDI activity in China. This is correct only partly, however. The data he had access to, was not comprehensive enough as to look deeper into the areas where SMEs could experience size-related problems and disadvantages. For instance, the planning process of an SME project is characterised by a lack of market research and a formalised planning procedure, a ‘gut’-approach and a high reliability on information provided by the Chinese partner. All these strategies save financial resources and managerial capacity and are thus employed by SMEs. Only GER-0 which is larger than the other enterprises in this study had carried out an extensive and professional planning process of its JV in China. There, the size-related difference between smaller and larger firms was clearly detected - in correspondence with the literature in chapter two of this thesis.

The disadvantageous resource fitting of smaller firms manifests itself during the entire JV formation stage and becomes transparent also in the JV operation phase.

**Partner selection:** when selecting a Chinese partner, many SMEs in this study did not evaluate other potential partners, but decided to joint venture with just the partner who they had made contact with in the first place. Moreover, several of the SMEs in this study have been approached by a Chinese company and would not have pro-actively explored the opportunities of investing in the country. This passive attitude of the SMEs with respect to finding a local partner helped the SMEs save resources. Thus, the initiatives of the Chinese companies were welcomed by the foreign firms. However, such shortcut strategies are particularly dangerous since in many cases not only the evaluation of alternative partners falls short, but also the assessment of the easily found potential partners. Buckley et al. (1988) highlight the danger of following the proposal of a foreign company or a customer, without being driven from inside the company and determined independently to engage in an investment project.

**Negotiation:** when negotiating their JVs, the SMEs revealed that they were in a disadvantageous position compared with larger enterprises. Often, the SMEs' bargaining power necessary to demand a certain equity share in a JV or to insist on a certain value of assets or attributes contributed, was not strong enough. For instance, various SMEs in this study originally wanted a majority share in the JV, but could not realise this since the Chinese partner's opposition was too strong. Presumably, thus, the JV process of SMEs is more often characterised by compromises than in the case of large MNEs. On the other hand, the ability and willingness to compromise can become an important attribute in the subsequent JV operation. Large MNEs which can too easily play out their financial weight and, therefore, the equity share in a JV, might more often urge the Chinese partner to build up a hostile attitude against the foreign company. Too often, the equity majority is emphasised, rather than an attempt undertaken to jointly find a solution to arising conflicts. SMEs, on the other hand, have to learn how to co-exist next to their Chinese JV partners at an early stage already.

**Contributions:** the SMEs regarded it as necessary that their Chinese partners bring in asset-resources. However, being able to trust the partner, its links to officials, the compatibility of its product range, etc. were perceived considerably more important by the UK and German SMEs than physical assets, such as cash and machinery. This confirms findings by Young et al. (1989) considering the local partner's assets only marginally important, especially in LDCs, whereas the partner's knowledge of the local economy, of politics and culture are appreciated highly by foreign companies.

With respect to the evaluation of the foreign partner's contributions, especially SMEs have to rely too often on the 'goodwill' of the Chinese party. For SMEs, the contributed cash or machinery is relatively more valuable than for large MNEs. In many cases technology is the main contribution of 'cash-poor' SMEs. Thus, to get a good evaluation deal out of the negotiations, is more important for SMEs than for large MNEs. The SMEs in this study had to make sure their technology contribution was valued in a way that reflects the true value of their technology.

**Choice of location:** the study also found that for the reasons that were most important for the SMEs when choosing the location (ie availability of trained labour, infrastructure and proximity to target markets), the majority of UK and German firms had to choose a location in the more developed areas of China, rather than in remote China. However, the SMEs' desire to have access to cheap, apart from qualified labour, suggests a location in China's hinterland, rather than East coastal areas. Since the main



motivation of the UK and German SMEs was the development of the Chinese market, the choice had to be China's coastal areas.

**Ownership:** size-related peculiarities of the UK and German SMEs' JVs in China became also evident in the operation phase. For instance, the majority of the SMEs in this study had only minority equity shareholdings. The empirical results clearly suggested that, with increasing firm size, the likelihood of having a majority stake increases, too. Had the UK and German companies been larger, they would have had a greater chance of getting a majority equity stake in their JVs, *ceteris paribus*.

**Control:** nevertheless, the majority of the SMEs control the company functions that are controlled also by large MNEs in JVs in China. Independent of firm size, the SMEs insisted on the control of research and development, or production in many cases, and finance. On the other hand, they let the Chinese side control the marketing and human resources functions. The SMEs expected that there the Chinese partner would bring in its expertise. However, the results of this study show that, especially the marketing function is increasingly carried out by the foreign firm. This is because the Chinese partners performed not satisfactorily.

**Management:** with regard to the management of the JV, the size-related disadvantage of SMEs with respect to managerial capacity becomes very clear. Too often, the SMEs did not have sufficient financial and managerial resources to, for instance, expatriate a manager to the JV. Too often, the SMEs had to rely on the management input of their Chinese partners, which was, as in the areas of marketing and finance, not as satisfactory as the SMEs hoped.

Overall, whereas differences with respect to nationality could not be explained in many cases, differences with respect to firm size were in most cases more obvious: the smaller SMEs had not sufficiently large finance and management resources necessary for the straightforward execution of an FDI project in China.

### 10.3 Implications of the research

The results of this study have implications for both, the theory and for practical policy-making. For this, this study confirms the applicability of Dunning's eclectic theory of international production in the context of SME FDI in China. This is a novum in international market entry research which has, so far, predominantly dealt with Buckley's SME theories, rather than a holistic approach, such as Dunning's. The SMEs that go to China to form a JV have ownership-specific advantages (O) in the form of niche market production technology. China, on the other hand, offers the necessary

location-specific advantages (L) to attract foreign investors, including a vast potential market and low wages, a relatively stable political climate, proximity to raw materials and preferential treatment of foreign investment (Chen, 1983). Not without a reason, Wu (1993) reported China's above-the-average rate of inward investment. Still today, China receives about 50 per cent of all the FDI that flows to the developing world.

The UK and German SMEs were, in the main, not attracted by the availability of raw materials or the prospect of preferential treatment or other investment incentives, such as tax and import duty reductions, or exemptions. Instead, the potential of the Chinese market and the availability of cheap labour were the outstanding motivations for FDI activity of the SMEs. The cheap labour and production cost argument also explains why UK and German firms sometimes shift their entire production lines to China. Companies locate overseas where they can manufacture more cost competitively than at their traditional locations. Germany's identity crisis as a manufacturing location is known: wages and social costs are high and administrative barriers with respect to investment are restrictive.

Without China's vast potential market, many of the companies would possibly have located in neighbouring countries of East and Southeast Asia that permit a more cost competitive production than China. Already in the late 1980s, Kraus (1989) suggested that China had lost its comparative cost advantage.

Finally, the (O) advantages of the SMEs are in many cases best exploited by the firms themselves, rather than by using the imperfect mechanism of the market (I). The case of GER-0 clearly shows this: after an initial licensing agreement with a Chinese customer for approximately ten years, the German SME decided to set up a manufacturing site, rather than further licensing its technology to a Chinese enterprise which would then produce MECHANICAL COMPONENTS and perhaps service GER-0's customer, KMP. In this particular case, transaction costs would have been too high for the German firm. UK-3 and UK-8 could have licensed their technologies to a Chinese company, too, without establishing a presence in the foreign market. However, again for reasons of high transaction costs (of making the deal through the market mechanism) the UK SMEs decided not to do this. UK-4 is an exception: its JV is more of a hidden contract manufacturing deal, rather than a genuine JV.

The valuation problem of foreign and Chinese contributions has been highlighted in this study. Thus, to agree a price that meets the expectations of both the Chinese and the UK or German sides, respectively, in the case of a technology licensing agreement, could become a difficult matter. In the case of niche product technologies

which often do not have a market price, this would have become even more complicated. Also, Chinese companies could copy the technology of the SMEs. The fear of the UK and German firms that their Chinese partners could do exactly this, has been revealed in this study. This fear is not misplaced since to date, there is no capable legal system in China that would prevent Chinese companies from copying foreign intellectual property (see Kaiser and Grimm et al., 1997, chapter 14).

With regard to the implications for practical policy-making, UNCTAD (1993) has suggested that SMEs will play an important role in the development and industrial upgrading of the (Chinese) economy. Certain manufacturing industries in developed countries are dominated by SMEs and it is, therefore, obvious that, if less developed countries (LDCs) are to obtain the needed resources to develop these industries, the only sources (at least at the firm-level) are SMEs.<sup>1</sup> UNCTAD (1993) suggests that affiliates of SMEs seem to contribute to host economies by producing more value added per unit of input than affiliates of large firms and indigenous firms. They also make efforts to adapt their technologies to local conditions. At the national level, SMEs employ more labour per unit of capital than larger firms, undertake formal technical training (other than on-the-job training) more frequently than affiliates of large MNEs, and are more likely to export than those of large MNEs. Thus, SMEs are more likely to see China as export bases for their products than large firms. However, the empirical results in this study have emphasised the heavy domestic market orientation of the UK and German SMEs. Finally, host countries, such as China consider SMEs unlikely to become too powerful.

Many specialist SMEs will independently service market niches whereas others will help develop a component industry that provides large MNE manufacturers with high quality and reliable supplies. This study has reviewed both types of SMEs. Whereas the majority of SMEs in this study entered the Chinese market independently, GER-0 was pulled to China by existing opportunities, such as the move of one of its traditional customers to China. Following this strategy reduces the business risk since there would be a secure customer which would demand a certain share of GER-0-JV's output. Volkswagen of Germany and (ex-) Chrysler of the US have actively encouraged their traditional suppliers to form JVs with local Chinese companies and so supply the car manufacturers with reliable components for their vehicle production (Posth, 1987; Aiello, 1991). However, whereas some authors (eg Wu, 1993) believe in the rise of foreign (SME) investments in China with successful experiences, others (eg Mr. Yang of CBTG) predict that there will be no remarkable rise of (British) SME FDI in

China, due to insufficient internal resources to support their China business in the long and medium-term (see also Anyansi-Archibong, 1989 and Duffy, 1995).

As was outlined above, entering foreign markets is a difficult task for SMEs since they lack financial, managerial and information resources. On a general level, ambivalent opinions exist. Whereas Edmunds and Khoury (1986), Walker (1994), Dowson (1995)<sup>2</sup> and DTI (1995) argue that government initiatives need to target SMEs more effectively, Berger and Uhlmann (1984) as well as Lloyd (1994) suggest that the existing government support mechanisms are sufficient to utilise the business potential for SME FDI. However, Berger and Uhlmann (1984) also content that governmental FDI support is perceived more important by SMEs than by large firms. Berger and Uhlmann's (1984) study is based on the perceptions and experiences of managers interviewed in 1983. Since then, however, market conditions have changed, competitive pressures have increased and cost positions in Germany have weakened the competitive advantage of these firms. Thus, the attitudes of German investors might have changed since then.<sup>3</sup>

Some authors (Buckley, 1979; Dowson, 1995) point out that SMEs frequently display a disturbed relationship with government support mechanisms. In the simplest case, they are not aware of the efforts the government is undertaking (Dowson, 1995). More seriously, SMEs are suspicious of getting involved with governments. Buckley (1979) suggests that this has often prevented SMEs from taking advantage of subsidies provided by governments. In detail, Buckley (1979) suggests that over a third of all UK outward investors did not even investigate the incentives provided. Also UNCTAD (1993) suggests that transnational SMEs seem to derive few advantages from government assistance. The findings of Kaiser and Kirby's (1996) study of SMEs in Northeast England confirm this.

The UK and German SMEs in this study have, in the large, not used assistance provided by their respective governments. They have not exploited to a great extent the information sources they would have needed when planning their JVs as well as for finding and assessing their potential partners. The SMEs have also not used finance schemes that would have helped them finance their operations in China.

However, as the results of this study show, too, these means of assistance would have contributed positively to the joint venturing of the UK and German SMEs. Therefore, means of government assistance need to be directed to the following areas.

**Planning:** the study has shown that the SMEs have frequently taken shortcuts when planning their JV project in China. This was to save limited resources. In cases the

necessary resources are not even available in the SMEs. In the initial phase of the JV activity, quick and unrestricted access to information is essential. Often, this is a major problem for SMEs that frequently have difficulties to get the whole process of collecting and sifting information started. SMEs need access to sources that offer information free of charge, access to databases with information on individual sectors and Chinese companies. Although this type of information will be, in most cases, very general, it can be a good starting point from where to formulate more specific queries.

A good starting point are institutions in the home country, including the chambers of commerce. From those the SME can obtain free leaflets and ask for an initial discussion with a member of staff. As a result, a basic understanding of the alien market place China can be achieved. Further, financial institutions are able to provide information on China, especially when they already have a branch or a representative office on-site. Also, so-called China-clubs or the like or universities from time to time organise China days where 'China hands' report their experiences with doing business with, and in, China. SMEs need access to all these sources of (free) information.

In the UK, the department of trade and industry operates a so-called China desk from which basic information on the Chinese economy can be requested for study. An equivalent organisation in Germany is the government-funded BfAI. However, whereas DTI information is provided to interested parties free of charge, BfAI materials are for sale. An interesting and valuable address for SMEs in the UK is the China-Britain Trade Group, based in London, with an office in Glasgow and five offices in China.

Finally, various Chinese organisations with offices in the UK and Germany provide initial information or even help find a partner for a co-operation project.

In a further step, UK and German investors need to approach their embassies and consulates in China. They have, in their commercial sections, people working who can help with the provision of information or information in an interview, for instance. Further, the British Consulate General in Shanghai carries out databank searches (China-on-disk™) and is able to release the information requested within 24 hours – for a fee. Once in China, the interested SME executive can carry out this computer search himself in the offices of the consulate, free of charge. Although the personal interview with staff from the embassies or consulates is valuable, own experience has shown that the printed material available at these institutions is not too valuable. For UK SMEs a further address are the offices of the British Chamber of Commerce, whereas German SMEs contact the Delegates of German Industry and Commerce in Shanghai, Beijing and Guangzhou. Finally, the offices of the China-Britain Trade Group

in China should be contacted and even membership with this organisation can prove beneficial since many services, such as the provision of office space in China, are so available at more favourable conditions.

If more specific information is needed, the above listed institutions can be asked to carry out database searches or to commission a market research project to a local, often a Chinese, market research agency. For this specific information, the SMEs have to make funds available. Alternatively, the SME can directly ask a market research company or management consultancy either in the UK or Germany, respectively, or in China to collect and process market data or to prepare the entire market entry of the SME. Meanwhile many of the big consultancies and also smaller, less-known, consulting firms have offices in China, at least in the major cities, such as Beijing, Shanghai and Guangzhou. In many cases, the legal advice of a law firm is a worthwhile investment.

SMEs must be made aware of the financial support available to commission market research projects. The chambers of commerce can offer an overview of the financing schemes available to SMEs. After an evaluation, according to the special needs of the individual company, the SME can apply to the various schemes. In many cases, SMEs are not aware of these and if, often, they perceive them as bureaucratic or not suitable. The European ECIP support is one example. Although the scheme offers SMEs (and large firms) financial support for carrying out a market study, for instance, Europe wants to see a lot of paper work. For many SMEs it is, thus, not attractive.

**Partner selection:** also with respect to partner selection, SMEs are well advised to consult the above sources. From databases with potential Chinese companies, the above institutions can offer initial assistance to select a shortlist from a variety of potential partners for a JV, for instance. Also, if one source does not produce a sufficiently large number of firms from which a smaller number of enterprises can be shortlisted, another source should be consulted.

**Negotiation:** SMEs are advised to allow sufficient time, management resources and funds. This is to avoid to be forced to agree to a deal without proper evaluation or with which the SME is not happy. Often, the Chinese party knows when a foreign investor is under pressure (time and finance-wise). This makes it easier for the Chinese company to push through deals that are only sub-optimal for the foreign company. GER-0 was prepared to withdraw completely from its proposal to joint venture in case the Chinese party had not been prepared to agree to its terms. For many SMEs, however, the ability to 'ignore' sunk costs is a luxury which they cannot afford.

Further, the SMEs that face a size-related disadvantage with respect to bargaining power are advised to build up a sufficiently large amount of knowledge about the Chinese market, its economy and legal system prior to entering into negotiations. This helps avoid that the SME is being manoeuvred into a position where it is difficult to negotiate beneficial deals with respect to equity shares, JV durations, JV asset evaluations, etc.

Host governments have to understand the importance of SME investment in their economies. Special tax treatments or special conditions when setting up an SME FDI project could ease the efforts of SMEs in engaging in FDI. So far, the Chinese government has not reacted to what researchers at MOFTEC have demanded recently, namely to offer SMEs such special treatment. Further, host governments, such as China, could help SMEs to a greater extent in finding a potential partner, though this strategy is dangerous (see chapter nine).

#### **10.4 An outlook into the future of FDI in China**

For a long period, academics and business people alike have debated on the future of FDI in China (Wu, 1982; Daniels et al., 1985; Simon, 1990; Aiello, 1991; Zander and Richter, 1992). It is not only what Grub and Lin (1991) pointed out, namely that investing in an LDC assumes a greater degree of country risk than investing in a developed country. It is also that China has its own tradition of not being a stable destination of FDI (Daniels et al., 1985). Political uncertainty has been a major concern of foreign investors in China. This has been shown by Davidson and McFetridge (1985), Frankenstein (1986), Tai (1988), Thiess (1994), Gledhill (1994) and Geissbauer (1994).

Arguments can be found for both go-aheads of China's FDI policy. There are arguments which consider China's opening up as a strategy to obtain western technology. When this is achieved, China would retrieve to its ideological autarky with a 'socialist transformation' following, similar to what happened to Soviet investment projects in the 1950s (Klenner, 1986; Kraus, 1989).

On the other hand, there is increasing evidence from the literature that China's transition from a planned to a 'market' economy also reflects prospects for a continuation of its new policies towards a China open to foreign trade and investment and for the stability of the country's leadership (Phillips, 1985). 90 per cent of the UK respondents in the study of Woodward and Liu (1993) believed in political stability or at least thought there is no instability. 90 per cent of the German investors in the study of

the Delegation of German Industry and Commerce Hong Kong (1995) regarded the investment climate in China as favourable or very favourable, even.

Since the death of Deng Xiaoping early in 1997, most of the doubts have been removed from the minds of foreign investors and with Zhu Rongji becoming China's new prime minister, the country's position as a stable destination for FDI has been reinforced. Equally, president Jiang Zemin, the strong man of China's government, has repeatedly expressed his determination to a continuation of his reform course (Wäscher, 1992; Shaw and Meier, 1993; SBFD, October 1995, p.69). This becomes evident in China's determination of joining WTO which requires the country to make concessions to foreign trade and FDI as part of the entry requirements. On the other hand, China's WTO entry also means an equal treatment of foreign and domestic companies and changes in tax and tariff incentive will represent a big handicap to foreign investors (FT, 27.6.96, p.4). Copyright and patent infringement remains an issue of major concern of foreign investors in China and although China has declared its commitment to combat such (after the immanent trade war between China and the US in 1995), it remains open to what extent this was Chinese lip service.<sup>4</sup>

## **10.5 Limitations of the study - areas for further research**

Though the study has documented the joint venturing of UK and German SMEs in China, it has limitations that need to be addressed in future research. Due to the lack of a comprehensive database containing Sino-foreign investment projects undertaken by foreign SMEs, a systematic, cross-industry sample building was not impossible. Instead, the sample in this research was rather a convenience sample. The number of research objectives was too small as to be choosy of which companies to include in the sample. The results presented in this study are not representative of the population of UK and German SMEs with an FDI project in China. Subsequent research needs to attempt to develop industry and also regional patterns of SME FDI in China.

Further, various JVs in this study were rather recent. This made an evaluation along the classical criteria difficult or impossible at all. Also, including JVs of considerably different ages in a sample makes comparison difficult. In future research projects, JVs of about the same age should be examined, thus. Especially in China, so is suggested, JV projects need a certain amount of time before they start generating financial results.

A further methodological shortcoming of the study is that, although the UK SMEs were interviewed after surveying them, the German SMEs were not (apart from GER-0). This was due to financial constraints the researcher was confronted with. This suggests that of the German SMEs which participated in this study, the amount of



information is not as rich as in the case of the UK SMEs. Future research projects should address this aspect, too.

Finally, this research project has commenced in autumn 1994. The data used in the study were collected in the course of the year 1996. At the time of submission of this study, it is autumn 1998. This suggests that most of the data is dated already, especially since the pace of change in China is very fast. New regulations towards FDI have been put in place in the meantime and others will follow, induced by China's proposed entry to WTO, that demands an equal treatment of domestic and foreign companies. Thus, today's conclusions might be faced with challenge tomorrow. For this reason, this study can only pave the way for further research.

Future research needs, in particular, address the questions of how attractive JVs remain over the next years and whether the WFOE as a market entry strategy is viable also for SMEs, as the recent literature speculates.

Research also needs to be carried out into ways how home governments can assist their SMEs in establishing a market presence in China and to successfully defending it against increasing competition in the Chinese market place. There are initial efforts undertaken by UK and German bodies. However, they need to be concerted resulting in more focussed support.

Important is also to address the issue of SME JV dissolution. Though this research has not addressed this issue, too, it can provide insight into the actual problems of SME joint venturing. It can also contribute to the avoidance of such problems in future projects to be undertaken by UK and German SMEs.

Finally, and this is criticism directed towards the community of researchers and practitioners alike: sometimes, both species collaborate, in, perhaps, government-funded projects, and can so learn from each other. In many other cases, however, the direct interface between researchers and entrepreneurs is only little. Researchers do not understand the problems of SMEs and, on the other hand, SME entrepreneurs do not have access to the knowledge base of researchers which could contribute to the success of an investment project in China. Researchers must no longer keep their writings to themselves. They must leave their ivory tower, at least for a while, and make their findings available to entrepreneurs. On the other hand, entrepreneurs must become more open towards the role which researchers can play in their own market entry process. The perception, at current, is rather opposite. This is the experience of the author of this study. In many cases, when a company agreed to participate in a research project, it was felt by the SME that it was doing the researcher a favour. An experience which the author of this study made was, thus, rather motivating: one of the SME entrepreneurs with whom the researcher had carried out various interviews, asked for a meeting and presented his ideas of forming a consultancy that would help SMEs successfully enter the Chinese market.

## Notes

<sup>1</sup> In the general context, scholars have suggested various occasions where SMEs can benefit from their smallness, including the establishment of overseas market niches (Buckley 1979, 1997; Porter, 1980; Berger and Uhlmann, 1984; Clifford and Cavanagh, 1985; Modiano and Ni-Chionna, 1986; Kerr, 1989; Simon, 1992, 1996; Schmidt et al., 1995; Eden et al., 1997; Gomes-Casseres, 1997; Kohn, 1997).

<sup>2</sup> Dowes (1995), in an appendix of his MBA dissertation, provides a precious enumeration of support tools for trading abroad which is available to UK companies.

<sup>3</sup> A recent Lloyds Bank study (1996), carried out in November and December 1995, attempted to examine the role that the German government, banks and support agencies play in the development and growth of SMEs in order to see what can be best learnt and then applied in the UK. However, since the study was particularly concerned with start-ups on a national basis, rather than support mechanisms on an international scale, its empirical value for the current investigation is limited. Although there are over 800 support schemes available in Germany that are channelled through the KfW (Lloyds Bank, 1996) there are only few available to SMEs (see Kaiser and Grimm et al., 1997).

<sup>4</sup> As a demonstration of good faith, China had closed seven pirate factories including the two most notorious plants - the Shenfei Laser and Optical System Co and Zhuhai Audio-video publishing house. China was also given credit for destroying some two million pirate items since early 1995 as part of its attempt to demonstrate a commitment to the enforcement of its own regulations against copyright violations (FT, 27.2.95, p.5).

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## Appendix I

# Defining SMEs

The exercise of developing a concept of SMEs has proven anything but easy (Barrow, 1993; DTI, 1995; Ali and Swiercz, 1991). Kimberley (1976) found that, as criteria, authors employ either the scale of operations or the scope of organisation and responsibilities. Also, both quantitative and qualitative definitions are employed, making comparison difficult (Brooksbank, 1991).<sup>1</sup> Even if, uniformly, quantitative criteria are used, some (eg Bhatti, 1981) applied two criteria, ie sales turnover and number of employees, whereas others (Piercy, 1983; Modiano and Ni-Chionna, 1986; Stanworth and Gray, 1991) employed only one criterion. Also, the application of a single quantitative criterion does not necessarily permit the comparison of different businesses since, frequently, margins between small, medium and large are drawn differently.<sup>2</sup> Further, the criterion 'sales turnover' is subject to adjustment on a regular basis due to its exposure to inflation.<sup>3</sup> And what about the criterion 'number of employees' in an age of growing technologicalisation at work where a business with few employees can turn over as much as a large business in a different industry or some years ago? Also the qualitative concept is subject to change because the independent decision-making is modified, for instance, by the expansion of franchising as a new type of being self-employed (Kayser and Hauser, 1993).

A graver problem is that the literature frequently uses the terms 'small business' and 'SME' interchangeably (eg Stratos, 1990; Stanworth and Gray, 1991; Lloyd, 1994) and Kaynak et al. (1987) insist even that it is possible to use one for a proxy of the other since *small and medium firms are very similar in their export behaviour*. Again others (Stanworth and Gray, 1991; Storey, 1994; Buckley, 1993) do not consider a clear terminology as important. Instead, they suggest that definitions are "not right or wrong, just more or less useful." This coincides with Brooksbank's (1991) observation that figures are chosen on the basis of convenience, personal judgement or conventional wisdom.<sup>4</sup> Gibb (1996) even used a rather philosophical approach in addressing the question of what is "a small business?" He proposed that "small business is a way of life" and "for those who run small businesses it is an extension of themselves and of the family" ]...[ "it is a key determinant of social life to a degree that being an employee or manager of a large company rarely demands" ]...[ "it is a style of life, a form of enjoyment, and occasionally of masochism."

Whereas the majority of authors draw their line of demarcation at 500 employees, Samuels et al. (1992) introduced a 200 employee - margin, but did not provide further specifications on that. Kumar and Neyer's (1992) definition of SME embraces 1,000 employees even. Kohn (1997) in a recent study exploring the strategies of US SMEs with FDI defines companies with ten to 499 employees as small and those with 500 to 1,999 employees as medium-sized.

Also, the institutional opinion about SME definitions is divided, including Bolton's (HMSO, 1971), Wilson's (HMSO, 1979), Macmillan's (HMSO, 1931) and that of the UK Company Act (Thomas, 1988).<sup>5</sup>

The German equivalent of the Anglo-American/Romantic area term 'SME' is 'Mittelstand' company. Berger and Uhlmann (1984), the German Small Business Research Institute (Kayser and Hauser, 1993), Parnell (1993) and Smith (1997) specified companies with up to 499 employees<sup>6</sup> and 500 employees,<sup>7</sup> respectively as SMEs. 'Mittelstand' actually refers to the concept of medium-sized, rather than small-sized. However, Simon (1996) insists that 'Mittelstand' encompasses all SMEs.

Braun (1982, p.117) in his study of SME FDI in LDCs moves the upper margin of medium-sized companies to 1,000 employees and refers to enterprises with 1,000 to 5,000 employees as medium-large and to those with more than 5,000 employees as large companies. Equally, Simon (1992, 1996) employed a rather extraordinary definition of 'Mittelstand': he identified a representative German midsize company having a turnover of approximately DM525m and employing 2,900 staff. Simon's margins, however, far exceed the customary criteria for defining SMEs employed by the governments of, for instance, the UK and Germany.

As is the case in the UK, the different institutional SME definitions in Germany vary, in places, considerably, with turnover margins ranging from DM100m and DM1bn (KfW programme) to DM30m and DM300m ('Establishments and technology transfer by SMEs to LDCs' programme) to DM200m (R&D support programme).<sup>8</sup> As is known from the UK SME sector, the German definition of SME knows quantitative as well as qualitative criteria (Kayser and Hauser, 1993; German Federation of Small Business, no date given), making thus the definition flexible. Many of the German Mittelstand companies are in fact very large firms (Mulhern, 1994).

Mulhern (1994)<sup>9</sup> highlighted the difficulty of deriving a commonly accepted, appropriate definition across borders.<sup>10</sup> Although the Commission of the European Communities (CEC) stated that "a general definition of SME is **not** possible, because the term SME varies from sector to sector and country to country", the departments of the



commission generally use the definition of the financing instruments, ie every company with a workforce not exceeding 500 employees and fixed assets up to Ecu75m and whose capital is owned by a larger company up to a maximum of one third is an SME (CEC, 26.8.86, p.15).

EUROSTAT, the statistics department of the CEC, limits its approach to the workforce criterion and defines companies with 10 to 500 employees as SMEs,<sup>11</sup> from its orientation on the definitions of the majority of member states. The major advantage of the CEC definition is that it uses the employment criterion and does not vary its definition according to the sector of the enterprise<sup>12</sup> (Storey, 1994) - unlike Bolton (HMSO, 1971) and the German Small Business Research Institute. However, Storey (1994) also admits that one of the key problems remains, namely that, for a number of countries, the CEC definition is too 'all-embracing'.

## Notes

- <sup>1</sup> Brooksbank's survey covered a European cross section of ten empirical studies.
- <sup>2</sup> Whereas the margins for the 'number of employees' revolve around the 500 mark (Stanworth and Gray, 1991<sup>2</sup>; Stratos, 1990<sup>2</sup>) the turnover margins differ considerably, from £ 10 m (Buckley et al., 1988) to between US\$25m and US\$1bn for American midsize high performing companies (Clifford and Cavanagh, 1985).
- <sup>3</sup> For instance, analysis of the Bolton report (HMSO, 1971) as discussed by various authors (Buckley, 1993; Laughton, 1995) shows that the turnover figures provided differ due to inflationary tendencies. Equally, the turnover figures provided in the UK Company Act versions (Thomas, 1988) differ considerably. For instance, from 1981 to 1985, the turnover margin was increased, in average, by 41% for small-sized and medium-sized enterprises and the balance sheet total was increased, on average, by 40% over a period of four years.
- <sup>4</sup> The case of the Small Business Administration (SBA) of the US should serve as an example: in 1966, SBA classified American Motors as small in order to enable it to bid on certain government contracts and justified this by applying a not frequently used criterion of smallness, namely that a business qualifies as small if it does not dominate its industry (Barrow, 1993).
- <sup>5</sup> The Bolton definition did not offer a commonly accepted definition of SME at all, since it considered different industrial sectors differently with regard to lower and upper limits of turnover and number of employees. Criticism of the Bolton report (HMSO, 1971) is widespread with Storey (1994) being one of the most prominent critics. Further, the literature shows some inconsistency with regard to the Bolton and Wilson reports (HMSO, 1971; HMSO, 1979), based on, as frequently observed, inaccurate researching. Finally, the UK Company Act (Thomas, 1988) is frequently ignored when researchers discuss firm size in the UK. Buckley et al (1988), however, are an exception. For instance, Buckley (1993) refers to the Wilson report as Cmnd 7503, whereas Barrow (1993) suggests Cmnd 7937. Whereas, according to Buckley (1993), the Wilson report dates 1978, Barrow (1993) suggests 1979. Laughton (1995) argues that the definition exposed in the Wilson report varied by industrial sector, since the committee recognised that, for example, the characteristics of a small firm in the retailing sector would be different from those in construction. This reveals some logic inconsistency: either, the Wilson report replicated the arguments earlier made by the Bolton Committee, or Laughton (1995) is simply wrong, having mixed up the Bolton report of 1971 and the Wilson report of 1979.
- <sup>6</sup> The German Small Business Association employs as second criterion an upper turnover limit of DM100m for medium-sized enterprises.
- <sup>7</sup> The upper limit for small firms was 250 employees.
- <sup>8</sup> For a comprehensive and detailed summary of this see the study of SME statistics by Kayser and Hauser (1993).
- <sup>9</sup> This author provides a range of European (Danish, French, German, Italian) definitional approaches.
- <sup>10</sup> A range of other definitions of the SME, such as in the US and the Netherlands, are presented in Buckley (1993, p.91). For further discussion of the French and Danish definition of the SME, see Barrow (1993, pp.5-6). For the case of Japan, Kayser and Hauser (1993, p.12) suggest that small trade- and industrial companies have less than 5 employees and those in other sectors of the economy have less than 20 employees. Certain SME support in Japan is also available for companies exceeding these limits. In the porcelain and ceramic industries, SMEs can employ up to 900 staff and up to 600 staff when they are manufacturing coloured textile garments.
- <sup>11</sup> Companies with 1 to 9 employees are referred to as micro enterprises.
- <sup>12</sup> Worthwhile to investigate would be whether Storey was involved in the creation of a European definition of the SME sector since he has no words of doubt about this approach.

## Appendix II

# Internationalisation strategies

### The range of market entry strategies

#### Arm's-length market entry modes

The various forms of **exporting** are considered as arm's-length market servicing strategies. Exporting is the least risky method of internationalisation (Lopez-Gonzalez et al., 1995) and as such it normally presents the "toe in the water" (Young et al., 1989, p.11). With exporting the value-adding part of the manufacturing process is carried out in the home country without the need to establish an overseas production facility. Spare capacity within domestic operations has been identified as the reason for the initial export decision (Johanson and Vahlne, 1977; Edmunds and Khoury, 1986).

In practice, exporting appears as either indirect or direct exporting, according to how the exporting firm carries out the transaction flow between itself and the importer or foreign buyer (Lopez-Gonzalez et al., 1995).<sup>1</sup> An enterprise is an indirect exporter when it sells its products into a foreign market without undertaking any special activities within the company. In other words, a firm is an indirect exporter when the export operations, including all documentation, the physical movement of goods and channels of distribution for sale, are carried out by others, and indeed may take place without the knowledge of the manufacturer himself. Indirect exporting may occur through an export house which buys directly from the firm on behalf of a foreign principal and then arranges for the export of the goods. Other forms of indirect exporting are the use of a trading company or piggy-backing, where the company sells its goods abroad through the overseas distribution facilities of another producer normally manufacturing complementary, non-competitive products. A more indirect form of exporting occurs when foreign buyers approach a firm to buy a product which they regard as suitable and desirable for their home markets abroad; or a buying house operating on behalf of clients undertakes the same activity (Young et al., 1989).

In contrast, the direct exporter undertakes the export task himself and, therefore, has to build up contacts, carry out market research, handle documentation procedures and transportation, establish pricing policies, etc. The product is then sold by agents or distributors,<sup>2</sup> through company technical specialist export salesmen, or through a sales subsidiary established by the exporting firm. Direct exporting facilitates greater control, information feedback from the foreign market and the development of 'exportise',<sup>3</sup> but is also more expensive alternative. Generally, the move to direct exporting, the setting up of a sales subsidiary, shows a genuine commitment to exporting, since it requires

direct investment in marketing institutions in the target country. In general, this genuine commitment is absent when the indirect export route is used (Young et al., 1989).

Traditionally, exporting has been highly attractive to small firms due to its requirement of only limited foreign capital investment and its perception of being less risky than FDI (Walker, 1994). However, once exporting activities are fully established, a re-evaluation of international strategic options may favour the adoption of an alternative strategy for servicing foreign markets (Walker, 1994; Bilkey, 1978), especially since exporting faces more entry barriers than other strategies such as JVs, foreign licensing, or FDI (Naumann and Lincoln, 1991). Piercy (1981) and Bilkey (1978) point out that SMEs usually take up the position of the re-active exporter, at least in the early stages, and consider exporting as an option to increase turnover when the scope for domestic market expansion is constrained.

### **Contractual modes of market servicing**

International **licensing** is often used as a generic term to cover a wide variety of contractual arrangements between companies located in different countries for effecting transfers of rights and resources (Young et al., 1989). For instance, Rugman et al. (1985) subsume management contracts, franchising and contract manufacturing under the term licensing, whereas Contractor (1984) and Young et al. (1989) licensing is a contract in which a foreign licensor provides a local licensee with access to one or a set of technologies or know-how or other firm-specific advantages. Typically, with a licensing agreement the exclusive rights are transferred to produce and market a product within an agreed area for an agreed period of time in exchange for financial compensation.

A licensing arrangement may be agreed, as suggested by Young et al. (1989), over contents such as patents,<sup>4</sup> copyrights,<sup>5</sup> trademarks,<sup>6</sup> trade secrets and know-how.<sup>7</sup> Know-how is different from patents and trademarks in the sense that the latter enjoy additional legal protection. In licensing arrangements, control over operations and strategies is granted to the licensee in exchange for a lump-sum payment, a per-unit royalty fee, and a commitment to abide by any terms set out in the licensing contract (Hill et al., 1990). Generally, terms of payment in licensing arrangements vary according to individual external and internal factors, such as political risk, market prospects, competition in the market for licensing arrangements, and the individual negotiating strength of the parties involved. License fees represent, according to Rugman et al. (1985), another means of repatriating profits JVs and WFOEs in the event of capital controls. The different external and internal influences are important

elements not only in setting direct payment terms, but also in determining equally significant contract components such as markets to be supplied, tie-clauses, etc.

The duration of the licence varies, but typically might run for three to five years. However, a successful licensing arrangement might be fairly automatically renewable in fact (Young et al., 1989).

Compared with exporting, production under licence takes place in the foreign market. This means that both manufacturing and marketing lie in the responsibility of the licensee. The licensor avoids the capital investment required to establish production and distribution facilities, and licensing permits entry to markets which may be closed to exports or other forms of market servicing (Young et al., 1989). Licensing is a market entry option that allows a company to spread the cost of its research and development and a company to harvest technology feedback (Robock and Simmonds, 1989). This is, according to Rugman et al. (1985), the access to potential fall-outs of new technology that the licensee creates on the basis of the licensed knowledge. However, this has to be ensured contractually.

Licensing is available to both large firms and SMEs as an appropriate market servicing strategy (Robock and Simmonds, 1989). It is not simply a matter of transferring a patent right or providing start-up training, but involves extended links between the two firms and on-going interactions on technical or administrative issues (Contractor and Lorange, 1988). Licensing is the preferred mode if transaction costs are low. This is the case with mature technologies, globally fragmented or multi-domestic industries, technologically sophisticated licensees, technologies which are peripheral or involve only parts of the overall process (thereby advancing the competitive position of licensees only slightly) and extremely strong patent positions that can effectively protect the licensed asset from unauthorised dissemination (Contractor, 1990). Licensing is especially attractive since it involves no investment risk and the volatility of cash flows is lowest under this contractual mode (Contractor, 1990).

Carstairs and Welch (1982) in their study of the circumstances under which licensing was employed in the international operations of 43 Australian SMEs and the role it would play in the internationalisation process of SMEs, suggest that international licensing is adopted as a secondary or residual strategy. However, the risk of know-how dissemination born with licensing, must not be overlooked (Brockmeyer, 1987).

MNEs do not frequently welcome licensing as a mode of servicing foreign markets, since they fear to lose their competitive advantage when transferring technical and technological know-how to a foreign licensee. Exporting, in several LDCs, faces major

restrictions in the form of tariff and non-tariff barriers. FDI, on the other hand, by internalising various aspects of a firm's market servicing operation may put a company in the advantageous position both to avoid transaction costs of using the market and to increase its marketing effectiveness through a greater control of key distribution and marketing functions (Buckley et al., 1991). Thus, FDI is increasingly preferred as a strategy of servicing foreign markets.

However, from the perspective of the SME which often is faced with financial constraints, this might not be valid. When considering to service foreign markets, SMEs frequently have to neglect choices which are the best from the strategic point of view. They have, however, often to apply second best choices, since they are better meeting their limited financial opportunities. Thus, licensing, is still favoured by SMEs.

**Franchising** is a special form of licensing in which the franchiser grants the franchisee the right to do business in a prescribed manner. This right can take the form of selling the franchiser's products, using his name, production and marketing techniques, or general business approach. However, franchising is often thought of as a strategy to be used for foreign market entry only by large firms. Yet franchising may be a viable alternative for SMEs, if limited to undeveloped market where the firm can establish its reputation relatively unopposed.

Licensing is not without disadvantages. To a large degree, it may leave the international marketing function to the licensee. As a result, the licensor may not gain sufficient international marketing expertise to ready itself for subsequent world market penetration. "The initial toehold in the foreign market may not be a foot in the door" (Czinkota and Ronkainen, 1993). Moreover, in exchange for a fee or the royalty, the licensor may create its own competitor not only in the markets for which the agreement was made, but also in third markets.

Franchising is an evolving organisational form with broad implications for the way decisions are made and implemented within a company (Dandridge and Falbe, 1994). It provides an inexpensive way to acquire capital and to introduce new products and services to other countries (Young et al., 1989; Falbe and Dandridge, 1992). It is a special form of company co-operation without capital investment (Braun, 1996), a particular type of licensing or technical assistance agreement (Young et al., 1989) and a marketing-oriented method of selling a business service (Lopez-Gonzalez et al., 1995). Normally, the franchisee operates under the name of the franchiser with the former providing the franchisee with a package including trademarks and know-how, local exclusivity and management, financial assistance and joint advertising.

Fundamentally, the franchisee runs a controlled business using the reputation and techniques of the franchiser. The business that is operated by the franchisee is viewed by the public as part of a country-wide chain rather than a single business enterprise. The success of this market entry mode is based on the fact that the individual franchisee gets, on a contractual basis, a comprehensive package of management know-how, both for establishing and operating the business (Braun, 1996). Payment will comprise an initial fee, royalties, and compliance with certain company regulations.

Different franchising constellations include manufacturer-retailer systems, manufacturer-wholesaler, wholesaler-retailer, trade mark licensor-retailer and retailer-retailer systems. Thus franchising can be used to segment the market spatially, with a full market coverage being achieved without internal competition. On the other hand, host-country benefits from franchising are high because training and development of management skills are incorporated within the franchising deal. However, since the licensee uses the MNE's brand name and international promotion, the licensor's reputation is particularly in acute risk with this type of contractual arrangement.

A **management contract** is "an arrangement under which operational control of an enterprise (or one phase of an enterprise) is vested by contract in a separate enterprise which performs the necessary management functions in return for a fee" (Brooke, 1985). The management firm's duties are essentially the same as the administrative and technical functions of an MNE in running a subsidiary (Young et al., 1989). Services may include general management, financial and personnel administration, production management and marketing. The services are generally limited to ongoing operations and do not give the authority to the management contractor to make new capital investments, assume long-term debt or initiate basic management or policy changes.

Management contracts are commonly found in conjunction with other forms of international market servicing - for example supplementing licensing, JVs or turnkey projects, and facilitating management control which may be absent in the latter arrangements per se (Young et al., 1989). Management contracts facilitate an MNE to better control the amount of knowledge that is divulged and through the MNE's influence on the foreign firm's management, the enterprise may obtain other benefits, such as becoming the supplier of factor inputs. Further, management contracts help ensure quality control and provide international experience for the firm's executives.

Various formulae are used for the calculation of management fees. Most contracts include a basic fee along with an incentive fee, with special services including

marketing, pre-operations assistance, training and recruitment of personnel, etc. being remunerated separately. In many cases, the length of contract term is limited to the time necessary to complete a specific undertaking.

A disadvantage of management contracts is that it does not allow a firm to build up a permanent market position, and difficulties have been experienced between management contractors and developing countries in recent years. The reasons are largely different objectives but also poorly specified contract terms, which have led on occasion to termination or re-negotiation (Young et al., 1989). Management contracts are especially attractive to expanding firms, since they involve no investment risk and have only little volatility of cash flows (Contractor, 1990). However, as discovered by Young et al. (1989), management contracts are concentrated in particular industries, with hotels and transportation being especially important, but also including industries, such as agriculture, public utilities, mining and minerals.

**Contract manufacturing**, also known as international subcontracting or offshore processing or assembly, is the reverse situation of a franchise, since the MNE pays the licence fee (Rugman et al., 1985). It involves a principal company in one country placing an order, with specifications as to the conditions of sale and the products required, with a firm in another country (Young et al., 1989). Typically the contract would be limited to production; marketing would be handled by the principal because sales often take place in the principal's home market. In order to ensure product standards, the provision of design and product specifications and technical know-how and even the provision of physical equipment for the subcontractor may be part of the arrangement, the latter being formalised in separate licensing or technical assistance agreements between the two parties. Young et al. (1989) found considerable differences in the nature of orders placed under contract, as between long-term, short-term and single batch orders with no guarantee of renewal.

**Turnkey projects**<sup>8</sup> are package deals in which the MNE constructs a production facility and provides training for the personnel necessary to operate it (Rugman et al., 1985). Young et al. (1989) suggest that, while differing from project to project, the contractor's responsibilities generally include the basic design and engineering of a plant, the provision of technology and know-how, the supply of a complete plant and equipment, the design and construction of civil engineering works, the complete construction of a plant and installation of equipment, the commissioning of the total plant facilities up to the stage of the start-up, and the operation and maintenance by the contractor. The latter was added only in recent years to eliminate problems that



have arisen in this area (Young et al., 1989). Individual contractors are often engineering firms which have had the ability to mobilise personnel, equipment, technology, etc. and to co-ordinate the activities of subcontractors. Turnkey projects can be an alternative to exporting or to FDI when a host government has imposed restrictions on these. An MNE can benefit from turnkey projects in that it can become the supplier of factor inputs needed for future operations. In addition, the MNE can expect to license additional managerial or technological expertise to the nation that hosts the turnkey project (Rugman et al., 1985). There is no single term of payment in conjunction with turnkey projects. Payment may be in a variety of forms, including counter trading, where the supplier takes payment wholly or partly in the form of physical output from the completed plant (Young et al., 1989).

### **Foreign direct investment**

The discussion of the organisational level of FDI is somehow hybrid in its character. Both subgroups of FDI, co-operative (equity JV, contractual JV) and hierarchical modes (WFOE) of market servicing are forms of FDI. FDI is considered the subsequent form of being internationally active (Rugman et al., 1985; Walker, 1994). FDI can be a means of making most efficient use of indigenous production resources within an overseas market, given the right balance of skill, flexibility and cheapness in the labour force, or the availability of cheap raw materials without the disadvantages of high transport costs. With FDI, an MNE can circumvent tariff quota or exchange control restrictions by governments which might be a barrier to exporting (Laughton, 1995).<sup>9</sup> Edmunds and Khoury (1986) found that getting behind the tariff walls has historically accounted for a large proportion of FDI. FDI allows the fastest and most sensitive response to local demand (Laughton, 1995).

## Market servicing enumerations

Author	Dimension	Market servicing enumeration
Pavitt, 1969	Risk, resource commitment, financial return	Licensing, exporting, FDI
Root, 1987	Risk, control	Direct exporting, licensing, exporting via agent, branch, JV, WFOE
Rugman et al., 1985	Resource commitment	Licensing, indirect exporting, direct exporting, local packaging, assembly, FDI
Brockmeyer, 1987	No specification	Direct exporting, licensing, JV, liaison office, branch, WFOE
Young et al., 1989	Risk, control	Export, contractual modes, FDI
Shenkar, 1990	Managerial commitment	Import, export, counter trade, licensing, compensation trade, processing and assembling, contractual JV, equity JV
Erramilli and Rao, 1990	Market involvement	Franchising, licensing, indirect exporting, direct exporting, export subsidiary, minority JV, 50-50 JV, majority JV, acquired WFOE, green-field WFOE
Lopez-Gonzalez et al., 1995	Risk	Export, licensing, franchising, FDI, JV, strategic alliance
Laughton, 1995	Experience, commitment	Export, contractual modes, FDI
Robock and Simmonds, 1989	Resource commitment	Licensing, exporting, local warehousing with direct sales staff, local packaging, assembling, full-scale production and marketing operations
Kaufmann et al., 1990	Capital and management commitment in the host country and capital and management commitment in the home country	
Schmidt et al., 1995	Capital and management commitment	Indirect exports, direct exports, subcontracting, co-production, licensing, management contract, franchising, turnkey projects, representative office, equity JV, partnership, WFOE

## Limited internationalisation resources

Authors	Mgmt	Finance	Info	Know-how	Ambition	Competence	Risk
Donckels & Lambrecht		• <sup>+</sup>					• <sup>++</sup>
Walker	•	•					
Cavusgil	•						
Edmunds & Khoury			•				
Buckley	•	•	•				
Buckley et al.	•	•	•				
SBFD		•	•	•	•	•	
Stanworth & Gray			•				
Penrose	•						
Schmidt et al.		•	•	• <sup>**</sup>			
UNCTAD <sup>****</sup>	•	•		• <sup>*****</sup>			
Peridis <sup>*****</sup>	•	•					
Oman	•	•					
Braun <sup>*****</sup>				•			•
Eden et al.	•	•					

Note: + cited by JV entrepreneurs; ++ cited by the non-JV entrepreneurs as obstacles to establishing JVs; \* insufficient know-how is regarded as a management weakness; \*\* internationalisation know-how; \*\*\* The small business research institute in Bonn study showed that planning was a barrier to internationalisation for 51.5% of the companies in the sample; \*\*\*\* Also a preference for short-term goals, limited transfer capabilities (which are, compared with the other problems, not as severe – UNCTAD, 1993); \*\*\*\*\* international experience; \*\*\*\*\* plus lack of knowledge protection; \*\*\*\*\* plus problems with mobility of staff and problems when planning and establishing a project.

## Notes

<sup>1</sup> For a classification of the various forms of (indirect and direct) exporting see Lopez-Gonzalez et al. (1995, pp.216-8) and Kerr (1989, pp.22-3). Wagner (1995) suggests a somewhat different distinction between direct and indirect exports. He defines exports as all sales in foreign countries directly exported by a firm, including sales via export agents. Indirect exports, on the other hand, are sales of intermediate goods that become part of finished goods that are exported.

<sup>2</sup> A major difference between agent and distributor is that the distributor actually takes title to the goods and represents the manufacturer in the sale and service of the product which he carries.

<sup>3</sup> The term has been used in seminars run by the Bank of Scotland (in Young et al., 1989).

<sup>4</sup> Inventions are protected by patents and might be used until the period of expiration.

<sup>5</sup> They usually protect expressions as in book publishing, films and television, computer programs and other information transfer systems.

<sup>6</sup> They are words or symbols used to distinguish particular goods and services and to indicate their origin; as with patents, the duration is likely to vary between countries, although it is fairly easy to renew a trademark registration once it has expired.

<sup>7</sup> These are not generally available information which may be disclosed either by itself or as part of a patent or trademark license; the information may include product and process specifications, quality control procedures, factory layout drawings, instruction manuals, etc.

<sup>8</sup> Young et al. (1989) propose a variety of modified or turnkey-plus contracts: product-in-hand contracts, for instance, are turnkey operations in which the contractor's responsibilities end only when the installation is completely operational with local personnel. Another form of modified turnkey contract is the market-in-hand agreement requiring the project contractor to give assistance in, or take responsibility for, the sale of at least part of the project's output.

<sup>9</sup> This needs some clarification: Laughton (1995) does not consider, as is shown below, JVs as being one form of FDI. Instead, he uses FDI and WFOE interchangeably. However, then it has to be added that also JVs can be seen as defensive modes of entering a foreign market in order to make sure that an MNE can maintain its market share in a specific host country!

## Appendix III

# Sources of Data Gathering

### UK sources

Source approached	Outcome	Description
North East Chamber of Commerce <sup>1</sup>	Negative	Prime area of interest is Europe
Government Office for the North East (GONE) <sup>2</sup>	Database with Northeast of England SMEs active in the Asia-Pacific region	No indication of the countries the enterprises were doing business with and of the types of market servicing strategies used. Database was used for carrying out a study on the attitudes of Northeast England SMEs towards Asia-Pacific. Findings were presented at the '96 Changzhou SME Convention' in October 1996 (see Kaiser and Kirby, 1996)
Institute of Export (IoE) <sup>3</sup>	Negative	The IoE expressed its interest in the research collaboration; the database promised never arrived
Department of Trade and Industry (DTI) <sup>4</sup>	Negative	'DTI Export Promoter China' responded, that "there are <b>many</b> UK companies investing in China [...] ICI, Unilever, and Pilkington"
China-Britain Trade Group (CBTG) <sup>5</sup> and British Chamber of Commerce Shanghai (BCC) <sup>6</sup>	CBTG Shanghai and BCC provided five contacts	Three companies were located in Greater Shanghai and two in Wuxi, Jiangsu Province. One of these JVs was known from previous research. The remaining four companies were approached and one company participated in the research. One was a UK WFOE and two did not respond to the researcher's request. The other CBTG offices in China were contacted, including the Guangzhou office. Four addresses were suggested which were followed up: One address was inaccurate, one company was a UK WFOE, one was a JV between a Chinese and a Hong Kong-based firm. The fourth UK investor was very large. The CBTG offices in Beijing, Wuhan and Chengdu did not respond
British Embassy Beijing <sup>7</sup>	'JV list' (UK companies with a JV in China) and 'British Chamber of Commerce Shanghai membership list'	No indication of firm size of the UK enterprise
British Consulate General Shanghai <sup>8</sup>	Two contacts were provided	Both JVs were contacted
Northern Development Company (NDC)	Negative	Although taking a trade mission to China in 1996, NDC expressed it would look more inward. This information seemed rather contradictory, since an MBA dissertation (Butler, 1993) established that the NDC's export promotion department holds data on regional firms by industry type and markets traded with. Further, the database was a major mechanism of recruiting for NDC trade missions
TEC <sup>9</sup>	Negative	

## German sources

Source approached	Outcome	Description
Delegation of German Industry and Commerce Shanghai	Database with addresses of German WFOEs, JVs and representative offices	No specification of size of German companies
German Embassy Beijing <sup>10</sup>	Negative	Database of German companies present in China should be obtained from BfAI. Eventually, a copy of this directory was received from CICASME. The latest directory published in 1996 listed 314 entries. 255 of them were labelled as Sino-German JVs, 58 as WFOEs and one as a representative office. As the directory serves as the basis of the further developed directory of the Delegation of German Industry and Commerce Shanghai, the value-added of the embassy directory was not great
German Consulate General Shanghai	Negative	Does not have its own directory of German companies present in China
German Centre for Industry and Trade Shanghai <sup>11</sup>	Negative	Reference to Delegation of German Industry and Commerce Shanghai
Chambers of Commerce (CoCs) in Germany <sup>12</sup>	CoC in Nuremberg provided a list of 13 (alleged) SMEs located in Central Franconia	Not all companies were SMEs and no specification of the type of business strategy employed by the companies
German Asia-Pacific Business Association (OAV) <sup>13</sup>	Directory of German firms with a WFOE, a JV or a representative office	Information valid at the end of January 1994, suggested a total of 380 German establishments in China. 115 of them were supposed to be JVs. However, neither the exact numbers of German WFOEs, nor German representative offices could be identified since the directory does not distinguish between them, not to mention that the directory has a section 'German representative offices in China and German-Chinese JVs' and another section 'German-Chinese JVs' which suggests an overlap and it cannot be specific whether the remaining 265 (380 - 115) entries were either WFOEs and representative offices or WFOEs, representative offices and JVs
German Economics Research Institute (HWWA) <sup>14</sup>	Eight contacts provided	The HWWA research proposal did not provide a reliable figure of German SMEs with investments in China, but suggested only ten German SMEs that were involved in a JV. For instance, one of the 'JV companies' that were visited was a JV between a German and a Taiwanese company and therefore not regarded as a JV in the Chinese understanding (see Kaiser and Grimm et al., 1997). An additional list was provided by HWWA, containing 17 companies where the HWWA did not know whether these companies had direct investments or representative offices only. This suggests that even prestigious research institutes did not have sufficient information on German SMEs with China FDI

## Chinese sources

Source approached	Outcome	Descriptions
Ministry of Foreign Trade and Economic Cooperation (MOFTEC) <sup>15</sup>	Negative	MOFTEC data was considered as being comprehensive since all foreign companies establishing a presence in China have to register with the ministry or its provincial or local authorities. A response to an enquiry never arrived
Chinese International Association of Small and Medium Enterprises (CICASME) <sup>16</sup>	Negative; copy of German Embassy directory sent	CICASME was thought to be a reliable source of information to learn about German and UK SME FDI projects in China
Other Chinese sources (Guangzhou Investment Centre) <sup>17</sup>	Negative	Request for Guangzhou/Guangdong investment brochure. The Chinese representative responded that it would not be possible to forward a copy and that it should be picked up in Guangzhou, instead

## Notes

<sup>1</sup> In a letter of 10.6.1996 to Mr. Robin Mackay, the chamber of commerce was asked for the provision of addresses of Northeast England SMEs involved in business with the Asia-Pacific region in general and with China in particular. Further, collaboration in a planned study of the attitudes of Northeast England SMEs toward the Asia-Pacific region was offered. However, the chamber was not prepared to collaborate in the proposed study, nor to release any of its databases to support the research.

<sup>2</sup> Letter of 29.5.1996 to Mr. Mike Cairns.

<sup>3</sup> The IoE was asked in a letter of 30.5.1996 to Mr. Ian Campbell to collaborate in the proposed study and to provide a database with relevant SME contacts.

<sup>4</sup> In a letter of 4.2.1996 to Mr. A.G. Atkinson the DTI was asked for specific information on UK SME FDI in China.

<sup>5</sup> The CBTG provides services to all UK companies. Its core membership at the time of interviewing was approximately 250 companies. It has, apart from its head office in London and its Scotland office in Glasgow, five offices in China, including one each in Shanghai, Beijing, Guangzhou, Wuhan and Chengdu. CBTG offers a library in its London office and five days free use of office space for its member companies. For every day longer of use, member companies pay some £150 per day. Non-member companies have to pay from the very first day, a rate of £180 per day for office use. The membership fee is some £1,100 per year (minimum charge). If companies want to rent a desk and a telephone terminal, they have to pay another £5,000 per year. In Shanghai, six companies had rent seven desks (at the time of interviewing). CBTG carries out smaller market investigations and provides lists of potential partners or customers in China. Another part of its activities is the organisation of trade missions for mainly (80%) SMEs from the UK to China (these participating companies look basically for selling opportunities. However, frequently, these businesses' intentions change very rapidly, meaning that, often, companies come to China in search of a customer and then go home having found a partner for a joint project) (R. Yang interview, 21.10.1996).

<sup>6</sup> The chamber of commerce is organised like a club with approximately 150 corporate and individual members from all different areas of business. The chamber provides a forum for getting together on various aspects, also with guest speakers. Predominantly, the chamber of commerce provides services for companies that are already in China. It "puts everybody together." For this service, corporate members pay RMB1,500 (£125) per year (Lisa De Abreu interview, 21.10.1996).

<sup>7</sup> The British Embassy was approached in writing on 28.5.1996 to Mrs. Diane Ward with the request for information about UK SMEs with an FDI project in China.

<sup>8</sup> The Consulate in Shanghai promotes British exports, works with companies and ministries, finds out what projects are on offer, persuades Chinese companies to form JVs, consults on equity, participation and sales strategies, and offers databases and directories (China on-line) to provide UK companies with information on, for instance, sources of supply (Paul Davies interview, 11.11.1996).

<sup>9</sup> Training and Enterprise Councils in County Durham. Telephone conversation with Mr. Clive Smithers on 21.6.1996.

<sup>10</sup> The embassy was approached in a letter to Mr. Jens-Peter Voss, head of the trade promotion department of the Embassy. The database is organised along dimensions such as name of company in China, indication of whether the investment project is a JV, WFOE or a representative office, address, contact person, industry, and, in many cases, address and telephone number of the German parent company.

<sup>11</sup> The German Centre for Industry and Trade Shanghai is a limited liability company sponsored by the Bavarian ministry of economics, transport and technology and the Bavarian Regional Bank. Its aims are to provide German SMEs with information about the Chinese market, and thus ease their market entry and efforts to establish a presence in China. Its managing director Mr Michael Gotschlich was approached for information during a field visit to Shanghai in the winter of 1995/1996. He was contacted again with the request for data on German SME FDI in China in a letter of 3. June 1996. In his response of 4. June 1996 he suggested that the German Centre would not have any of the requested data.



<sup>12</sup> During a research placement with the Delegation of German Industry and Commerce Shanghai in 1995, various chambers of commerce in Germany that were active with regard to the Chinese market and with whom the candidate had interacted, were identified: these included the chambers in Nuremberg and Regensburg. Both chambers were asked for relevant information in letters to Dr. Alfred Brunnbauer, head of the Chamber of Commerce Regensburg, and to Mr. Armin Siegert of the Chamber of Commerce in Nuremberg, respectively. The chamber in Regensburg did not respond. The chamber in Nuremberg provided a list of 13 companies that were involved in business with China. An examination of the list revealed that only one company qualified for participation in the survey (ie being an SME and having a JV in China).

<sup>13</sup> The directory is organised along dimensions, such as name of the company in China, address, telephone and fax numbers.

<sup>14</sup> In the spring of 1995, the HWWA forwarded a research proposal on German SME FDI in Asia to the Delegation of German Industry and Commerce Shanghai, asking for logistic support when carrying out research in China.

<sup>15</sup> In a letter of 3. December 1996 to Professor Wang Zhile the ministry was asked for databases containing UK and German FDI projects in China, perhaps specified with regard to the size of the foreign parent company. The fact that contact had been made with a German businessman in Shanghai who had established links to Professor Wang Zhile at MOFTEC's Research Institute for International Economic Cooperation in Beijing, encouraged the candidate to approach MOFTEC.

<sup>16</sup> Invitation by Lin Wenying of 17.4.1996 to Professor David Kirby to attend (supervisor of the researcher). Ms. Lin suggests that Taicang, a county nearby has set up eight JVs with German SMEs with the last three years. Follow-up fax of invitation of 3. May 1996 asking for contacts with the JVs.

<sup>17</sup> Telephoned in the first week in November 1996.

## Appendix IV

### Durham University Business School *UK SME joint ventures in China*

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#### Questionnaire

This questionnaire survey is part of a PhD research project looking into the joint venturing of UK small and medium-sized enterprises (SMEs) in China. Please answer the following questions and return the completed questionnaire to me in the enclosed pre-paid, self-addressed envelope by date in hand, if possible. Many thanks for your time and effort.

Stefan Kaiser

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#### I. Basics about your UK business

Q1: Please specify the following basic characteristics of your business.

Type of ownership (eg Ltd, subsidiary)	
Year of establishment	
Industry/activity	
Turnover in the last financial year (in £)	
Number of employees in the UK	
Number of countries active in	
Total number of foreign operations	
... of these wholly owned enterprises	
... of these joint ventures	

#### II. About your joint venture in China

Q2: Prior to your joint venture, did you do business with China and for how long?  
(Please specify)

No	<input type="checkbox"/>	
Yes	<input type="checkbox"/>	please specify

Q3: How important were the following reasons for engaging in an investment project in China? (Please tick)

	very important	important	medium important	not really important	not at all important
Potential market for our product					
Faster entry into the market					
It is necessary to be there					
To overcome import duties					
Cheap labour					
Access to raw materials					
Strategic position in Asia-Pacific region					
We were approached in the first place					
Following customers/clients					
Other					

Q4: How important were the following reasons for establishing a joint venture instead of, for instance, a wholly owned operation? (Please tick)

	very important	important	medium important	not really important	not at all important
Local participation required by China					
Overcoming nationalistic prejudice					
Political insurance					
Favourable government treatment					
Less financial input					
Less management input					
Limitation of risk					
Partner's China business knowledge					
Partner's knowledge of customers					
Smoothing way through bureaucracy					
Sharing of distribution channels					
Access to other firm's technology					
Access to other firm's skills					
Access to raw material					
Strat. action to pre-empt competition					
Trade union relationship					
Other					

Q5: Compared with your operations in the UK, how well have you planned the joint venture in China? (Please tick)

Much better	
Better	
The same way	
Nearly as good as usual	
Not at all as good as usual	

Q6: Please specify the following characteristics of your joint venture operation.

Year of establishment	
Total investment (in £ or US\$)	
Turnover (in 1995 and expected 1996 turnover)	
Number of employees	
Location	
Product range (compared with range in the UK)	same – limited - different
Greenfield or take-over plant	
Market target	domestic market - export markets
Market share in China (%)	
Number of partner(s)	
Industry of partner(s)	
Turnover of partner(s) compared with your firm	much larger – larger – similar – smaller - much smaller
Employees of partner(s) compared with your firm	much more – more – similar – less - much less
Partner's type of company	state-owned – township - private
Range of products/main product	
Location of partner(s)	

Q7: Could you choose the location of your joint venture? (Please tick)

Yes  Please go to Q8.  
 No  Please go to Q9.

Q8: How important were the following criteria for choosing the location of your joint venture? (Please tick)

	very important	important	medium important	not really important	not at all important
Location of partner					
Proximity of target market					
Availability of trained labour					
Availability of cheap labour					
Sources of raw material					
Infrastructure					
Investment incentives					
We were advised to go there					
Other					

Q9: How did you find your Chinese partner? (Please tick)

Partner was our agent	<input type="checkbox"/>
Partner met at a trade fair in China	<input type="checkbox"/>
Partner met at a trade fair in the UK	<input type="checkbox"/>
Chinese company approached us	<input type="checkbox"/>
Chinese organisation helped to find partner	<input type="checkbox"/>
UK organisation helped to find partner	<input type="checkbox"/>
Other	<input type="checkbox"/>

Q10: Were there alternative partners for choice? (Please tick)

Yes  Please go to Q11.  
 No  Please go to Q12.

Q11: How important were the following criteria for choosing your partner? (Please tick)

	very important	important	medium important	not important	not at all important
Size of partner					
Products of partner					
Location of partner					
Complementary resources					
Links to officials					
Financial fitting with local currency					
Trust between top management					
Reputation					
Access to technology					
Other					

Q12: What were the contents of negotiations and did they create conflict? (Please tick)

	Contents	Conflict
Equity shares		
Distribution of responsibilities		
Financing		
Royalties		
Training sessions of JV staff in UK		
Technology selection/transfer		
Intellectual property rights		
Composition of the board of directors		
General manager appointment		
Staffing issues (number, salaries)		
Expatriate issues (number, salaries)		
Valuation of assets		
Market priorities		
Other		

Q13: Please tell me more about the negotiation process.

Location(s) of negotiations	
Duration of negotiations	longer than expected - shorter than expected - as expected
Language of negotiation	English - Chinese
Your negotiation team	Number of negotiators - Positions of negotiators
Use of interpreters	Yes - No
Difficulties	

Q14: How important do you consider the following factors for successful negotiations? (Please tick)

	very important	important	medium important	not really important	not at all important
Good personal relationship					
Knowledge of PRC business practices					
Partner's need for your product					
Uniqueness of your product					
Willingness to offer good financing					
Preparation of your team					
Patience of your team					
Your technical expertise					
Familiarity with social customs					
Past reputation in selling to China					
Knowing PRC polit. & social situation					
Your team's sincerity					
Good interpreter on your side					
Other					

Q15: What is your contribution to the JV and what is its relative value? (Please tick)

	Value (%)
Cash	
Machinery	
Technology	
Patents	
Management expertise	
Technical training	
Access to world markets	
Other	

Q16: What is the Chinese partner's contribution to the joint venture and how important is it to you? (Please tick)

	very important	important	medium important	not important	not at all important
Access to markets					
Contacts with customers					
Contacts with host government					
Cash					
Land					
Plant					
Machinery and facilities					
Local labour					
Materials					
Other					

Q17: What is your equity share in the joint venture? (Please specify where appropriate)

	specify %	tick
Majority stake		
Minority stake		
Equal stakes		

Q18: Please tell me about the management of the joint venture (Please specify).

Number of members of the board of directors (BoD)	
Number of UK members in the BoD	
Number of Chinese members in the BoD	
Any other nationals in the BoD	
Which parent nominated the chairman of BoD	UK - China
Parent nominating the general manager	UK - China
Parent in charge of production	UK - China
Parent in charge of marketing	UK - China
Parent in charge of finance	UK - China
Parent in charge of personnel	UK - China
Parent in charge of R&D	UK - China
Does decision-making exist in the JV	Yes - No
Is joint decision making a problem in the JV	Yes - No

Q19: About expatriates in the joint venture (Please specify)

Number of expatriates sent to China	
How much does an expatriate <u>cost</u> you	£
... remuneration	£
... allowances	£
... accommodation	£
Who covers the cost of the expatriate	SME - JV

Q20: What would you consider as problem areas of operating a joint venture in China and how important are they for you? (Please tick)

	very important	important	medium important	not really important	not at all important
Recruiting personnel					
Technology transfer					
Loss of control					
Creating a new competitor					
Damaging reputation					
Low labour productivity					
Local sourcing					
Bureaucracy					
Mismatch in management styles					
Insufficient training of Chinese managers					
Infrastructure					
Concept of quality					
Personnel motivation					
Chinese commercial practices					
Communication with local staff					
Absence of detailed investment laws					
Repatriation of profits					
Transfer pricing					
Dividend policy					
Political risk					
Restriction on sales and import					
Corruption					
Foreign exchange restrictions					
Unfair competition					
Other					

Q21: Overall, how satisfied are you with the performance of your JV? (Please tick)

Very satisfied	
Satisfied	
Medium satisfied	
Not satisfied	
Not at all satisfied	

Q22: How satisfied are you with the following criteria of success? (Please tick)

	Very satisfied	Satisfied	Medium satisfied	Not satisfied	Not at all satisfied
Return on investment					
Growth					
Compared with competitors					
Local market share					
Export performance					
Royalty fees					
Supply fees					
Management fees					
Other					

Q23: How important are the following attributes for success in China? (Please tick)

	Very important	Important	Medium important	Not really important	Not at all important
Good product					
Adapting to the Chinese market					
Sincerity					
Patience					
Familiarity with PRC business practices					
Good business connections					
Relationship with Chinese officials					
Other					

Q24: How did you finance your joint venture?

With working capital	
With loan from UK bank	
With loan from Chinese bank	
With Grant from UK or European institution	
Other	

Q25: Does entering the Chinese market with a joint venture relieve your resources commitment in the following areas? (Please tick)

	Very big relief	Big relief	Medium relief	Not a relief	Not at all a relief
Management resources					
Financial resources					
Information needs					
Other					

Q26: If you had the choice, would you again engage in a joint venture? (Please tick)

Yes	
No	



## Appendix V

# Defining FDI and JV

### Foreign direct investment

"FDI is the transfer of capital and managerial and technical assets of a firm from one country to another by the same firm" (Grosse, 1981, p.1). The transfer can be direct, by payment of finance for assets in the host country, ie through acquisition of an existing firm or the creation of a new firm through transfer of physical and financial capital to the host country (Grosse, 1981). FDI means ownership of property abroad, usually in a company, for a return (Daniels and Radebaugh, 1992). It is a means of making most efficient use of indigenous production resources within an overseas market, given the right balance of skill, flexibility and cheapness in the labour force, or the availability of cheap raw materials without the disadvantages of high transport costs (Laughon, 1995). Control and managerial participation have been considered essential components of the definition (Kindleberger, 1979; Grosse, 1981; Robock and Simmonds, 1989; Daniels and Radebaugh, 1992; Office for National Statistics, 1996; UNCTAD, 1997), distinguishing it from portfolio investment that is undertaken with a rather short horizon for the purpose of obtaining investment income or capital gains rather than entrepreneurial income.

However, authors have different opinions on the amount of equity a foreign investor has to hold in a project, ranging from 10% (US Department of Commerce) to 20% (Office for National Statistics, 1996), 25% (Hood and Young, 1979), or even variable stakes (Rugman et al., 1985). This makes it difficult to determine the dividing line between direct and portfolio investment (Robock and Simmonds, 1989).

### Joint ventures

There is no precise (universal) definition of JV (Engelhardt and Seibert, 1981; Herzfeld, 1983; Lichtenberger and Naulleau, 1993). In their pioneering study on JVs, Friedman and Kalmanoff (1961, p.6) adopted a very broad definition of JV as "any type of association which implies collaboration for more than a transitory period." Tomlinson (1970) added that the partners collaborating in that association are legally separate and collaborate for their mutual benefit. He also stressed the establishment of a new entity, as opposed to Friedman and Kalmanoff's (1961) earlier definition. Harrigan (1984, p.7, 1985, pp.2-3) considers the JV as a "partnership in which two or more firms create an entity to carry out a productive economic activity and take an active role in decision-making, if not also in operations." Harrigan (1984, 1985), Kogut (1988) and Hennart (1988), highlight the importance of management participation. Harrigan's

(1984, 1985) JV definition has enjoyed much popularity in the literature. A JV implies the sharing of assets, risks and profits (Oman, 1984; Hennart, 1988).

Other works have specified Tomlinson's (1970) 'mutual benefit' criterion, suggesting "mutual improvement of their market growth potential" (Walmsley, 1982) and "agreed-upon goals" (Lopez-Gonzalez et al., 1995, p.218), whereas elsewhere (Beamish, 1987; Beamish and Banks, 1987; Gomes-Casseres, 1987), it is outlined that each party must hold at least 5% of the equity in a JV. Earlier, Drucker (1973, p.720) provided an assessment of the JV as "the most demanding and difficult of all tools of diversification - and the least understood." Hennart (1988) considers JVs as situations where a firm acquires partial ownership of another firm.

Basically, there are two different forms of JV, the domestic and the international. Whereas in a domestic JV the participating companies are from the same country in which the JV is established, its international version brings together, according to Lichtenberger and Naulleau (1993), individuals who differ in national origin, cultural values, and social norms. There are also geographical, political, economic and legal system differences which are found not only in the beliefs and behaviour of individual employees, but also in the policies of organisations (Albrecht et al., 1996). Authors, including Engelhardt and Seibert (1981), Shenkar and Zeira (1987) specify that at least one partner has its headquarters located outside the country of the JV's operation. Other sources have stressed the location where the economic activities of the JV are carried out: Geringer and Hebert (1989, 1991) regard a JV as international if it has a significant level of operation in more than one country, though the authors do not specify that level. International JVs in LDCs are, according to Oman (1984), those in which the LDC partner holds at least 50% of the equity.

Various authors (Killing, 1983; Harrigan, 1984; Oman, 1984; Beamish and Banks, 1987; Contractor and Lorange, 1988; Kogut, 1988; Hennart, 1988; Gomes-Casseres, 1989; Young et al., 1989; Lichtenberger and Naulleau, 1993; Laughton, 1995) consider the creation of a separate legal entity as essential for the definitional existence of a JV, though this is not essential for the existence of a JV.

## **Appendix VI**

# **Featuring EJV and CJV**

### **The EJV**

#### **General information**

Earliest (1979) form of FDI in China.

#### **Legal form**

Limited liability company formed in accordance with China's law on Chinese-foreign EJVs. It is a joint-stock company that is not described in detail in the law. It requires stock holders to be liable only up to the amount of the registered capital (Duscha, 1987; Wäscher, 1992). Despite the clear wording of the law, there had been tendencies since the early 1990s for the establishment of an EJV also as 'company limited by shares'. Officially, a 'company limited by shares' is possible since 10. January 1995 (Kaiser and Grimm et al., 1997).

#### **Rights and liabilities**

Can acquire property, sue and be sued (Delegation of German Industry and Commerce Hong Kong, 1994). According to Laughton (1995), this is the essential characteristic of an EJV. Also a CJV can adopt a separate legal identity.

#### **Partners**

At least one Chinese and one foreign.

#### **Contribution**

Minimum foreign equity contribution to registered capital 25%, maximum 99%. The minimum foreign share is to ensure the bi-nationality of the venture (Brown, 1985) and the foreign partner's effective management contribution (Duscha, 1987). Foreign equity can be contributed as cash, intellectual property, machinery and equipment, other tangible assets. The contribution of know-how is only recognised by the approval authorities if it helps develop or manufacture new products, improve quality of existing products or save raw material (Delegation of German Industry and Commerce Hong Kong, 1994). Value of know-how can neither exceed 20% of the registered capital of the JV nor 50% of the equity of the investor (ibid). Contribution of the Chinese partner is similar. In addition, he often provides the right to use the site on which the JV is located. To expect financial resources and know-how from the Chinese is not the norm (Kaiser and Grimm et al., 1997).

## **Management**

Usually managed by a BoD with at least three and a maximum of 13 members, appointed by the investors in proportion to their respective share of equity. According to Anglo-American practice, the BoD not only has management, but also supervisory functions. Its legal representative is the chairman. Only after the revision of the EJV law in 1990 was the BoD allowed to be chaired by the foreign partner. BoD meets once a year, more usually, two to four times (Campbell, 1989), either in China or abroad. At least two thirds of the BoD members have to be present, though representation by an 'alternate director' is possible.

Principally, decisions are made according to the principle of simple majority or two-thirds majority rule. However, it can be agreed that at least one director of each party has to vote with majority (Duscha, 1987). Unanimous BoD decisions are necessary for modifications of the articles of association, transfer of equity, merger, termination and elimination of the JV (ibid). For the latter three, the approval of the authorities is necessary (Kaiser and Grimm et al., 1997). For the day-to-day matters, the JV has to establish an administration office which is headed by a general manager. Usually, the foreign partner appoints the general manager, whereas the Chinese side appoints the deputy (Kraus, 1989).

## **Profits, risks and losses**

Distribution in proportion of the partners' contribution. Deviations from this are possible only in proven cases. In principle, the net profit for the foreign partner can, after deduction of various reserves of up to 20% (10% into statutory reserves and 5% to 10% into the legally laid down social welfare), be transferred through the Bank of China (Kaiser and Grimm et al., 1997).

## **Duration**

Original version of the 1979 EJV law provided for contract duration of 10 to 30 years, in some cases 50 years, with the possibility of extension. For this, the unanimous decision of the BoD is necessary as well as approval by the authorities (Kaiser and Grimm et al., 1997). Article 12 of the revised EJV law of 1990 states, principally, no more limitations on the duration. In certain industries they still exist (Wäscher, 1992). The duration of a JV reflects China's perception with regard to the process of technical adaptation and the developmental importance of the project (Duscha, 1987). The transfer of foreign funds prior to the venture's elimination is not possible (Thiess, 1994).

## The CJV

### General information

Created in 1988, after continuous foreign criticism of the inflexible EJV. Specific form of co-operation developed by the Chinese, through which, originally, Overseas Chinese investment should have been promoted (Wäscher, 1992). It is an especially attractive alternative to the EJV when bureaucratic delays hamper the approval process, but has since become less important (Brown, 1985). It subsumes various arrangements whereby the partners co-operate in joint projects and business activities according to the terms and conditions stipulated in a venture agreement. CJVs, on the surface, have a clearer specification of responsibilities and perhaps a more focused task in comparison with EJVs (Laughton, 1995). A considerable difference between EJVs and CJVs is the clear regulation of the EJV through laws and implementation rules. Furthermore, for the CJV, there is no minimum amount of capital commitment provided for (Delegation of German Industry and Commerce Hong Kong, 1994). CJVs are permitted in all industries. Experience has suggested that approval is granted predominantly to those companies or associations that intend to plan and carry out construction and infrastructure projects, or the development of raw materials and energy resources, or if they operate in technology-intensive industries or in the services sector in areas such as legal and corporate consulting and insurance (Brown, 1993). Foreign companies choose CJVs to bypass the minimum equity required for EJVs. Later, they apply to change in registration to an EJV (Kaiser and Grimm et al., 1997). The more important the project the more difficult this is.

### Legal form

Can take any form of agreement - from contractual co-operation with no own legal identity to EJV (Plasschaert, 1993; Beamish and Spiess, 1993). Provides, thus, more flexibility in negotiation than the EJV. However, according to Grub and Lin (1991), the CJV is not as well protected by Chinese laws and regulations as is the EJV. If disputes arise, solutions may depend only on legal procedures and court settlement. The legal form of the CJV can be a limited liability company or a 'company limited by shares' and, as opposed to the EJV, the 'company limited by shares' has been a feasible option from the very beginning (Kaiser and Grimm et al., 1997). This contradicts the ideas of authors such as Young et al. (1989), Campbell (1989), Child (1994) and Laughton (1995) who argue that, with the CJV, the formation of a legal entity is not possible at all.

### Partners

At least one Chinese and one foreign.

### **Contribution**

With most contracts, the partners contribute capital in a variety of forms (cash, buildings, equipment and know-how, etc.) towards a project (Child, 1994). Since in its pure form, where 'pure' refers to cases where CJVs have no own legal identity, such ventures do not have fixed equities and liability capital. As such there are no assessment problems.

### **Management**

Partners manage the venture jointly (Pearson, 1991). However, there is no legally provided structure. Thus, Brown (1985) insists that CJVs normally have no shared management. Management can also be transferred to outsiders (Thiess, 1994). Wäscher (1992) specifies the alternative structures as BoD or joint administration committee with at least three members. If the chairman of this committee is appointed by the Chinese side, the foreign side appoints the deputy chairman, and vice versa. Daily management is executed by a general manager appointed by the committee.

### **Profits, risks and losses**

Regulations are formulated in a way that may lead to a high degree of freedom. The sharing of profits does not proceed according to fixed ratios, but is negotiable: the contract can provide either the splitting of profit and loss or the splitting of products (Delegation of German Industry and Commerce Hong Kong, 1994). Early transfer of the invested funds is possible, but has to be fixed in the contract and a unilateral, early termination of the contract is possible (Thiess, 1994) - as opposed to the equity JV. Repatriation of foreign funds is undertaken through preferential treatment of the foreign partner when distributing profits (foreign partner receives repayment out of gross profit, Thoburn et al., 1990) or - similar to compensation trade - through transfer of products of the contractual JV to the foreign partner (Wäscher, 1992). After expiration of the contract, the fixed assets become part of the Chinese partner (Brown, 1985) - only if the foreign partner has already repatriated his investment during the operation of the JV. If not, a liquidation process has to be gone through that distributes the CJV's property - in accordance with the contract - after deducting outstanding demands or discharging debts, respectively.

### **Duration**

The CJV may be formed for a particular project of limited duration, or for a longer-term co-operative effort (Wright, 1981). Thus, the duration of the CJV needs to be fixed in the contract. Extension is possible, but needs to be announced to officials at least six months prior to its expiration.

## Appendix VII

# Case Studies

### Case One: GER-0-JV

#### Basic facts about GER-0

Established as a limited partnership (KG), GER-0 is located in South Germany. For more than 100 years the *Mittelstand* company has been manufacturing high tech mechanical components applied in industries, including chemicals and petrochemicals, crude oil, machine building, coal refining, conventional and nuclear power generation, shipping and marine engineering, pulp and sugar production, etc. GER-0's products are suitable for uses in critical areas, where they are exposed to high pressures and high speed (GER-0 Company Catalogue, 1988).

GER-0 considers itself as the second most important manufacturer of MECHANICAL COMPONENTS worldwide having a market share of 13% (GER-0 Annual Report '94, 1994), second after its biggest competitor, UK-9, that holds 30% of the world market for MECHANICAL COMPONENTS.

#### International business activities

International markets are very important for GER-0 as they are for the majority of German machine building companies. In the financial year 1995, GER-0 generated 57% of its turnover overseas. At the time of the investigation, the company had been operating subsidiaries on all continents except Africa. In 1995, GER-0 established an operation in South America and its JV in China, in order to be able to establish a worldwide distribution system that gets the company closer to its customers (GER-0 Newsletter, August 1996). In 1996, operations were established in the Middle East, Southeast Asia and Russia.

Apart from its effort to extend its worldwide distribution network, GER-0 wants to widen its network of manufacturing locations. In other words, GER-0's long term goal is to manufacture increasingly for the local markets. Eventually, the German company's Asian production centres will be India and China (GER-0 Newsletter, August 1996). The setting up of its JV in China was GER-0's first step of establishing itself as the leading supplier of high-quality MECHANICAL COMPONENTS in China (GER-0 Annual Report '94, 1994).

#### GER-0's China experience

GER-0's first commitment in China was a know-how transfer agreement made in 1982 where the Chinese customer, a SOE based in CITY [Northeast China], for a lump sum

of DM1.5m (£0.6m) received the right to produce three different types of MECHANICAL COMPONENTS, together with training in the manufacture of the components. The agreement was due to expire in 1992. Initially, GER-0 was not very keen to continue engaging again in business in China, due to unsatisfactory living conditions in the country for German managers who had to go there for the delivery of training sessions, etc. However, especially in the early 1990s considerable improvements in this respect emerged with further improvements in sight, which eventually helped to change the company's mind.

## **Joint venture formation**

### ***Joint venture planning***

Since the know-how transfer agreement was financially successful and since China was perceived by the German company as offering a great potential market for its products, GER-0 developed a vested interest in continuing its commitment in China "in one way or the other." Thus, in 1990, the company started actively seeking for opportunities of contracting with a Chinese partner. At approximately the same time, KMP, a German leading manufacturer of ENGINEERING PRODUCTS, was involved in negotiations with ABC, a Chinese SOE located in CITY [East China] to establish a JV to manufacture ENGINEERING PRODUCTS. The Chinese SOE not only had manufactured ENGINEERING PRODUCTS, but also had a MECHANICAL COMPONENTS division that had produced the MECHANICAL COMPONENTS that were needed by its ENGINEERING PRODUCTS division. A high degree of vertical integration is common for Chinese ENGINEERING PRODUCTS manufacturers and, to some extent, also for European.

The German firm KMP which has been a long-known and very important customer of GER-0 in Germany had made clear that it was not interested in acquiring the MECHANICAL COMPONENTS division of ABC, but instead laid out the situation to its German supplier GER-0 and presented the opportunities which the teaming up with the MECHANICAL COMPONENTS division of ABC would hold for GER-0. Basically, KMP proposed to split the Chinese enterprise ABC between itself and GER-0 and both German companies would join forces with one part each of ABC which then would cease to exist as a manufacturer of both ENGINEERING PRODUCTS and MECHANICAL COMPONENTS.

Since GER-0 was searching for collaboration opportunities in China anyway, KMP's proposal of 1993 "to invest in Asia" was very welcomed by GER-0. Also, the joint project would be located in CITY [East China], where GER-0 saw emerging the world's



biggest region. GER-0's intensive research and KMP's initiative eventually led to first talks at GER-0 about committing funds to a JV in China.

GER-0's director for overseas affairs produced a so-called 'JV assessment handbook' which he employs for the planning of foreign subsidiaries and JVs. During the planning process, GER-0 examined and determined market potentials in various relevant industries in China and the size of the overall Chinese market for MECHANICAL COMPONENTS, the geographical distribution of these potentials, and the absolute and relative positions of its competitors. The manager had further undertaken a growth prognosis of the Chinese market for MECHANICAL COMPONENTS and GER-0's potential market share. SEZs and other investment regions as well as on-going co-operation projects between China and Germany were examined as were forms of co-operations and investment, know-how transfer, financial assistance for investment projects, assessment of existing investment projects and their problems, special treatment, advantages and disadvantages of investing in China and a comparison of potential partners.<sup>1</sup> GER-0 spent one month on the completion of this task and relied heavily on country-specific information provided by BfAI, a German government-funded body that provides information about market and investment opportunities abroad. All the information collected was used later for the preparation of a project feasibility study.

GER-0 could obtain finance from the German Development Bank (KfW) at 2.5% interest rates. It also looked into financing through ECIP. However, this was not considered appropriate for the company for no further reasons given.

### ***Motivations for production in China***

#### Motivations to engage in an FDI project

The reasons of GER-0 to set up a plant in China were the potential of the Chinese market for the German company and GER-0's aforementioned strategy of developing its operations on a worldwide scale. China would thus be used as a strategic position from where to develop and penetrate other markets. GER-0's goal has been to become not only the best, but also the biggest manufacturer of MECHANICAL COMPONENTS in China (GER-0 Newsletter, January 1996).

#### Motivations to form a joint venture

For GER-0 the following-the-customer motivation was one of the main driving forces behind, and the initiator for, its decision to establish a JV with a local Chinese company instead of a WFOE. GER-0 followed one of its biggest customers in Germany, KMP, to China. In fact, KMP had initiated talks between GER-0 and the Chinese SOE ABC with

which KMP was negotiating the possibility of establishing a JV to manufacture ENGINEERING PRODUCTS. In its newsletter (GER-0 Newsletter, January 1996), GER-0 emphasises the importance of following its international customers. In this case, the market potential of GER-0 would be created, initially at least, by KMP. This was a high business security factor for GER-0. Secured volumes would be sought by KMP and would help GER-0-JV to facilitate the cost-effective production of high quality components to develop further segments of the Chinese market.

### ***Partner selection***

#### Finding the partner

Although GER-0 examined other, alternative, Chinese companies, its way of finding its Chinese partner was somewhat pre-determined by KMP's strategic move to joint venture with the Chinese SOE ABC.

#### Partner selection criteria

Despite the above mentioned pre-determination of GER-0's Chinese partner company, the German firm applied thoroughly a set of criteria when comparing ABC with other, alternative, Chinese enterprises. This set of criteria had been successfully applied for the establishment of all of GER-0's operations before. Selection criteria included the partners' turnover (total and MECHANICAL COMPONENTS), market shares, number of employees, turnover per capita, industrial focus, location, range of MECHANICAL COMPONENTS, licences for ENGINEERING PRODUCTS and MECHANICAL COMPONENTS, sales and distribution networks, production, technical know-how and management. GER-0 investigated further the potential partners' five-year profitabilities and their cash flows. Eventually, GER-0 had to choose between an ENGINEERING PRODUCTS manufacturer based in a provincial capital in North-China and the SOE ABC that was said to have a good reputation in and out of CITY [East China].

### ***Partner characteristics***

GER-0 teamed up with one Chinese partner in its JV. Prior to committing itself to the JV with the German enterprises KMP and GER-0, the Chinese company ABC had a workforce in excess of 2,000 employees with 200 working in its MECHANICAL COMPONENTS division. The remaining employees worked in its ENGINEERING PRODUCTS division and supporting departments, typical for Chinese SOEs.

After GER-0 had taken over ABC's MECHANICAL COMPONENTS division and KMP ABC's ENGINEERING PRODUCTS division, ABC ceased to exist as an ENGINEERING PRODUCTS and MECHANICAL COMPONENTS manufacturer. However, in September 1996, the municipal government of CITY [East China] had

decided to revive ABC to new corporate life and in October 1996, ABC had sold its shares in both the KMP JV and GER-0-JV to CGMG Corp., a holding closely linked to the municipal government of CITY [East China]. Simultaneously, ABC terminated its partnership with GER-0 and KMP. The new co-owner of GER-0-JV is a conglomerate of three dozen firms, both Chinese and Sino-foreign (including eight ENGINEERING PRODUCTS manufacturers), employing some 60,000 staff.

The transfer of the equity has brought at least one major change to GER-0. CGMG Corp. has international links, as opposed to ABC and it was hoped that the member companies in the group will be potential partners or customers of GER-0-JV. For instance, it is hoped within GER-0 that being part of this 'union' would help meet GER-0-JV meet its set export share of total production. By the time of the investigation, GER-0 had supported GER-0-JV's exports with DM100,000 (£42,553.2) and the JV's own export topped some US\$30,000 (£12,766.0), equalling a total of RMB745,703. However, according to plan, GER-0-JV should have exported goods worth some US\$0.28m (£0.18m; RMB2.4m). This suggests a gap of approximately US\$0.19m (£0.12m; RMB1.6m).

According to an official document about the change of ownership, GER-0 agreed to the proposed acquisition since CGMG Corp. could help GER-0-JV with providing access to ENGINEERING PRODUCTS manufacturers. As a matter of fact, GER-0 had no choice, but to agree [...] and it was annoyed since it was informed about the transfer of shares only when it already was completed.

Although ABC was re-established, it had been, contractually, not allowed to manufacture or sell neither ENGINEERING PRODUCTS nor MECHANICAL COMPONENTS. Instead, it had turned into a service provider, catering for the KMP JV's and GER-0-JV's workforces and operating a huge fleet of buses which transport workers to and from the factories. In addition to its catering and transportation services, ABC created an operative division that takes on contract manufacturing orders. For instance, if manufacturing capacity at GER-0-JV becomes a temporary bottleneck, it subcontracts work to ABC. This move helped ABC find alternative employment for some of its staff not taken over by either KMP or GER-0-JV.

### ***Joint venture negotiation process***

#### **Negotiation contents and conflict**

The main content of the negotiations was the product programme that would be manufactured by the JV. GER-0 offered approximately 65% of its entire MECHANICAL COMPONENTS programme and the potential Chinese partner selected what should

be manufactured in the JV. Eventually, GER-0 did not accept the entire shopping list of its Chinese partner, since some were perceived to be too state-of-the-art, for instance. Of the accepted MECHANICAL COMPONENTS types, the entire technology was transferred to the JV.

Contents of the negotiations were further the planning of operations in subsequent years, the contents of the feasibility study, the distribution of equity shares, and particularly the valuation of both partners' contributions, such as drawings (German contribution) and machinery (Chinese contribution). Initially, this was a major problem for both parties. Eventually, however, the companies could agree upon their contributions' values. For instance, the valuation of contributed assets or attributes was a major problem of the negotiations between the Chinese SOE ABC and UK-9 that was, for three years prior to GER-0, involved in JV negotiations with ABC. In this particular case, both parties had already signed the 'letter of intent'. However, the inability of both partners to compromise, together with the fact that ABC considered GER-0 as technologically more advanced, eventually terminated the plans to establish the mutually intended JV between ABC and UK-9.

GER-0's director for overseas affairs had his clear idea of what would be acceptable and what not as the outcome of negotiations. He "was prepared to withdraw from our proposal if I had not felt comfortable with an issue." For instance, GER-0, out of principle, demands 51% equity ownership in JVs. If ABC had not accepted this, GER-0 would have withdrawn from its proposal to JV with the Chinese enterprise. Eventually, ABC offered GER-0 a 60% equity share even. Would the total investment in the project have been larger, ABC's opinion of the foreign equity share and that of the municipal government would have been different, though and it would likely not have accepted a foreign majority stake.

The duration of the JV was agreed at 50 years with an option of extension. Usually, GER-0 commits itself to project durations of ten to 15 years. However, since the Chinese party "liked such long durations very much," GER-0 agreed to it. A further aspect of JV negotiations was GER-0-JV's market target. Although GER-0 had made clear that it came to China "in order to serve the Chinese market," it had to agree to purchase a certain quantity of the JV's output for export markets: by the end of the fifth year of operation, the venture has to export 30% of its annual production.

SME negotiation team, location, duration, language of negotiations, interpreters

Things happened very quickly with the establishment of GER-0-JV. On 14. July 1994 a Chinese delegation came to Germany for talks. This was followed by a visit to China by

managers of the overseas business division of GER-0 from 25. to 29. July 1994 when the 'letter of intent' between the parties was signed. In August 1994, GER-0's director of overseas affairs went to China to sign the contract whose content was based on GER-0's business plan. The JV was approved, due to the relatively small investment in the venture, by the municipal government of CITY [East China]. Chinese law stipulates that MOFTEC must examine and approve the establishment of JVs in China, and issue a 'Certificate of Approval'. MOFTEC is authorised to delegate such examination and approval authority to its provincial and municipal counterparts (Randt, 1995).

Eventually, the operation of GER-0-JV started on 2. January 1995, after only about six months of preparations and negotiations. This was due to GER-0's determined approach towards the undertaking and its professional proceeding. Further, the Chinese side could manage to get the JV approved by the municipal government so quickly for two main reasons: first, ABC had close links with the municipal government of CITY [East China] and secondly, the Chinese partner wanted the deal. ABC certainly refrained from delaying or even jeopardising its deal with GER-0 since this could have affected its main deal with KMP to form the proposed KMP-JV to produce ENGINEERING PRODUCTS. This certainly saved GER-0 substantial funds, otherwise necessary for extended negotiations, travel to China, etc.

### ***Partner contributions***

#### SME's contribution

GER-0 contributed to its JV assets and attributes worth a total of approximately DM3.32m (£1.41m) in the form of cash, know-how and drawings. Its cash contribution accounted for some DM1.7m (£0.7m) and the remaining DM1.62m (£0.69m) were in the form of some 6,000 drawings of sizes A4 to A0.<sup>2</sup> These were the drawings and part lists which formed the basis of the JV's production in China.

#### Chinese partner's contribution

GER-0's partner, ABC, had contributed its own MECHANICAL COMPONENTS programme, machinery, land, warehouse facilities, and it was responsible also for the staffing of the JV. GER-0 had not expected a cash contribution from its Chinese partner, according to the JV's German production and quality assurance manager, though his assistant insisted that the Chinese side also contributed local currency. The production and quality assurance manager of the JV considers land to be the most important contribution of the Chinese partner since, "as a foreigner you never have the right to acquire land." Instead, China knows the system of land leasing of up to 99 years. Subsequently, the land and buildings on it fall back to the Chinese People.

A problem that relates to the Chinese partner's contribution of land is that, frequently, foreign direct investors failed to reassure themselves when establishing a JV: the Chinese partners bring into the JV land and later, a third party starts claiming money due to its right which it holds in the land. "And of course, when they know they can get money off you, they try to squeeze you," suggested the production and quality assurance manager. This problem was confirmed by Mr. Gotschlich of the German Centre for Industry and Commerce in Shanghai (interview on 5.11.96). This is not the case in GER-0-JV - at least it had not been detected at the time of the investigation.

## **Joint venture operation**

### ***Joint venture background information***

#### Joint venture establishment, total investment and workforce

GER-0-JV is an equity JV and was established as a limited liability company, according to Chinese law. The total investment in the JV accounts for DM6.5m (£2.8m). At the time of the investigation, GER-0-JV employed 95 staff.

#### Joint venture location

GER-0-JV is located in an economic and technological development zone in CITY [East China]. It is located in the neighbourhood of the Sino-German KMP JV, on the site that originally belonged to the Chinese parent company ABC. Not only can GER-0-JV find many of its clients in immediate reach in CITY [East China], but CITY [East China] had always had the reputation of being superior, suggesting that products manufactured there would be appreciated by customers all over the country - a good marketing argument. It is relevant, however, for Chinese, rather than for Sino-foreign customers. For those, the reputation of the German partner weighs more than the fact of producing in CITY [East China].

#### Choice of location

Although GER-0 had two other, alternative, locations for establishing a JV, one in North China and another one in China's remote area, the question always was very dichotomous: CITY [East China] or not. Only if CITY [East China] as location for an investment had been rejected, the other locations would have been thoroughly investigated. A GER-0 research team was sent to CITY [East China] and after the presentation of their location assessment report, CITY [East China] was chosen. Proximity to GER-0-JV's markets was a main factor determining the choice of location. Important for the director for overseas affairs of GER-0 was also that the location was in a "civilised area, otherwise you will find nobody to send there." From the very

beginning of its JV planning process, GER-0 had the intention to expatriate a German manager who would look after the interests of GER-0 on the spot.

The economic and technological development zone offers the usual tax concessions: there are no taxes to be paid in the first two years and from year three to five the JV pays only 50% income tax. After that, the JV pays the full rate of 33%.

#### Production site

From January 1995 to July 1996, GER-0-JV had operated in an old building that belonged to the Chinese parent and which was rent out to the JV. However, from the very beginning the erection of a new building was planned since the old one would be needed eventually by the KMP JV and it further was not big enough for the needs of GER-0-JV. Thus, from October 1995 to June 1996, a new, purpose-built workshop and office building was established on the land that was contributed to the JV by the Chinese parent company. The new company building on a total site of 5,000 square metres, was officially opened in June 1996. Most of GER-0's DM1.7m (£0.7m) cash contribution was used for the erection of the new production site. Being located in the immediate neighbourhood of GER-0's customer KMP saves time and money for transportation and makes thus GER-0-JV's products attractive to KMP-JV.

#### Product range

According to the contract between GER-0 and ABC, the JV has the right to manufacture MECHANICAL COMPONENTS and MECHANICAL COMPONENT SYSTEMS, predominantly for the power and chemical industries. Compared with the range of MECHANICAL COMPONENTS and other products that are manufactured at the SME's German plant, the JV's production programme is only a small fraction.

#### Target market

The JV contract provides that the vast majority of the JV's output should be sold into the Chinese market. However, from the first to the fifth year of operation (= 1999), the share of output sold into the Chinese market must be reduced gradually from 95 to 70%. To export as much as 30% of its entire output is considered a lot by GER-0. Whereas the German production and quality assurance manager believes the 30% share to be difficult to achieve - in fact, according to the director for overseas affairs at GER-0, these targets have never been met - both the assistant sales and assistant production and quality assurance managers are confident to meet this target. The latter based his confidentiality on a section in the JV contract that requires GER-0 to purchase up to 20% of the JV's output.

GER-0 had recently arranged an order for the JV from a customer in Mexico about 300,000 minor MECHANICAL COMPONENTS. Although GER-0-JV could not make any money with this deal, it primarily supported its Mexican partner company that was looking for cheap products to get a foot into the Mexican market. Further, with the overseas sales the JV could contribute to its set export volume. Apart from Mexico, the JV had also been exporting to subsidiaries of GER-0 in Australia and South Africa.

China-based customers of GER-0-JV are existing Chinese as well as other Sino-foreign JVs or WFOEs. In its newsletter (GER-0 Newsletter, January 1996) GER-0 emphasises the importance of some of its international customers having already, or are about to establish JVs. This would help GER-0 to get established in the Chinese market. GER-0-JV had been further targeting customers that were being served by its domestic and overseas competitors. Another aspect of the JV's market potential is the future development of the power generation, chemical and infrastructure construction tools industries. However, new factory building in China is difficult to predict. "The government plans a certain number of factories, but at the end of the day might build only half of them, because of financial restrictions," commented the Chinese assistant production and quality assurance manager.

GER-0-JV's domestic customers are spread all over the country. However, the area around CITY [East China] is one of the bigger concentrations of its customers. Clients are also in North China and the JV was, at the time of the investigation, attempting to develop business in South China, too.

Apart from Chinese and Sino-foreign ventures, GER-0-JV has another group of domestic customers: only recently was the JV selected as one of the main suppliers of MECHANICAL COMPONENTS to the Chinese aerospace industry. The number of suppliers was fixed by the central government and GER-0-JV had inherited this privilege from ABC.

#### Market share in China

At the end of 1995, GER-0-JV had a share of 3 to 5% of the Chinese market for MECHANICAL COMPONENTS. The reason for this small share is that the Chinese parent, ABC, prior to entering into GER-0-JV, had manufactured MECHANICAL COMPONENTS only for its own ENGINEERING PRODUCTS division, but not for other customers. This suggests that the market had been open for GER-0-JV only since early 1995 when it started to serve other companies also. The assistant sales



manager's guess for the JV's market share in its fifth year of operation (= 1999) is at approximately 10 to 15%.

### ***Joint venture ownership***

GER-0 holds a majority share of 51% in its JV. This is what the German company wanted. Although the Chinese side had offered a 60% share, GER-0 refused to accept this since it wanted a strong partner in the JV. GER-0's strategy was to combine a risk position as small as possible with a control position as big as necessary to avoid dissipation of its technology. On the other hand, GER-0 wanted an active partner in the JV, rather than one who regarded the JV as a portfolio investment.

### ***Joint venture control***

GER-0-JV's board of directors (BoD) has four members, two Germans and two Chinese. On the foreign side, these are the director for overseas affairs of GER-0 who is also the superior of the expatriate production and quality assurance manager of GER-0-JV. On the Chinese side were, originally, one director of ABC and the Chinese general manager of GER-0-JV. However, since ABC had sold its share in GER-0-JV to CGMG Corp., ABC's appointment of one director to the JV's board became invalid and a new member of the BoD had to be appointed. The director for overseas affairs of GER-0 is also chairman of the JV's BoD. The vice-chairmanship is held by CGMG Corp. That one side holds the chairmanship and the other the vice-chairmanship is common in Sino-foreign JVs with equal ownership distribution or slight diversions from that. Apart from the four directors of GER-0-JV, all other managers attend board meetings. This was agreed between the parties as it allows the sharing of information and the obtaining of input for the general manager's decision-making.

Although GER-0 holds 51% and, thus, the majority stake in GER-0-JV it insisted that the general manager of the JV should be a Chinese and not a foreigner. A foreign general manager, so considered the production and quality assurance manager, would only be a marionette. Certainly, its majority stake gave GER-0 this confidence in appointing a Chinese general manager. If there are arguments within the company, the German enterprise can easily play out its 51%. Prior to his appointment as general manager, the 50 year old Chinese was vice-managing director of ABC.

Originally, sales was given into the hands of the general manager, though gradually, the German expatriate manager has taken on responsibility of this.

Board meetings take place once every six months in China and last for one to two days. Additional meetings can be arranged if and when necessary ]...[ or "if somebody

is just on his way through CITY [East China]." In the meetings, everything is discussed openly. Contents such as the policy of the company for the next six months are debated and agreed, problems are discussed, etc. For instance, at the time of the investigation, recent major decision was the implementation of a computer network at the cost of about US\$80,000 (£51,282). In principle, every major investment has to be discussed by the BoD. Discussed by the BoD are also decisions of appointing additional foreign staff to the JV or senior Chinese personnel in strategic positions, including sales.

Day-to-day decisions in the JV are made by the individual line managers whereas major decisions are made only with the approval of the chairman of the BoD.

Although GER-0 holds a majority stake in the JV, consensus decisions are sought and usually found. "Up to now, we did not have a major crisis in decision-making," said the production and quality assurance manager.

### ***Joint venture management***

Every Monday morning, all department managers and, additionally, the managers in the general manager office discuss the most important problems the JV is confronted with. In addition to this, the individual departments meet separately to debate department-specific issues.

Since the general manager does not speak English, "though he was supposed to learn it," the contact person for the chairman of the BoD is the expatriate production and quality assurance manager, who functions as an intermediary between the director for overseas affairs of GER-0 and the general manager of the JV. In this function, he can propose to the general manager what the chairman would like to happen with the JV.

As a 'level two' manager, the then production and quality assurance manager of the JV had no decision-making power with regard to the overall business of GER-0-JV or matters in other departments. Functionally, the German expatriate is in equal terms with the sales and engineering managers, for instance. He has no authority to issue directives, can only propose to the general manager who then takes action or not. "The general manager decides nearly always the way, I want it," said the German manager.

This way of management had been considered as a problem by the German side and thus the BoD decided to create a new position for the expatriate: early in 1997 he became assistant general manager. Only then would it be possible to issue directives for other managers, "and they can accept it without losing face."

At the time of the investigation, GER-0 had expatriated only one German manager, an engineer. Whereas initially he was production and quality assurance manager, later he was promoted assistant general manager. The German expatriate costs some DM400,000 (£179,213) per year. This includes the RMB450,000 (£33,383) to RMB500,000 (£37,092) for accommodation, catering and telephone born by the JV.

### **Joint venture problems**

The problems GER-0 was facing at the time of the investigation were various.

#### Production

The quality problem with sourcing subsequently affects the ability of the JV to meet its export targets since only high quality exports can be sold into international export markets. Further, MECHANICAL COMPONENTS of only low quality produced by the JV could harm the high quality reputation of the German parent company. For retaining the quality standard of MECHANICAL COMPONENTS produced in the JV, the production and quality assurance manager highlighted the importance of the transfer of know-how. "The transfer of machines is only the last step in the process of transforming quality," he said. However, customers often think that quality depends on the use of high quality machinery, exclusively. Although the JV was working with Chinese machines, it was able to manufacture German quality, according to the production and quality assurance manager.

At the time of the investigation, GER-0-JV was working on getting its operation ISO approved. ISO 9002 had been implemented as far as 70% and completion was expected by the autumn of 1996. Certification according to ISO 9001 was expected for the end of June 1997.

#### Local sourcing

Local sourcing has been a distinct problem for GER-0-JV. Although GER-0-JV sourced, at the time of the investigation, approximately 90% of its supplies locally (at a lower cost), qualitatively sufficiently good components still had to be purchased in Germany, imposed with an import duty of between 25 to 27%. "It is impossible to get them in China," the production and quality assurance manager said. Whereas the JV can easily source, for instance, carbon ceramic, silicon carbide of good quality would be difficult to get in China. Also, special measuring tools are purchased in Germany since the quality of these types of tools in China is not sufficient. Apart from a low and sometimes not even sufficient quality of local supplies, a sourcing problem has been also the lack of reliability of Chinese suppliers. The production and quality assurance manager assumes that "what complicates the quality problem even more is the fact

that Chinese staff that have worked for years with certain materials have difficulties in understanding that these materials are all over sudden not good enough any more.” This rests on a different understanding of quality between the German expatriate and Chinese workers. “The Chinese adopt new things very quickly, but they also stick to old norms,” he pointed out.

Another barrier to local sourcing is the fact that all materials are labelled according to the American system (ASI) whereas all the drawings and blueprints used by the JV are based on the German industry norm (DIN).

#### Know-how dissemination

Further, the German expatriate worried about know-how dissemination in “the biggest copy country.” Once, various GER-0-JV blueprints appeared at the German headquarters, though they were not supposed to. As a consequence, draconic protection means had to be implemented and now all blueprints are locked in a room and even the German production and quality assurance manager has to ask for the key if he wants blueprints.

#### Productivity

Both the director for overseas affairs of GER-0 and the assistant general manager criticised the lower productivity of personnel in the JV, compared with personnel in its plants in Germany. On average, a German production worker costs GER-0 approximately DM75,000<sup>3</sup> (£31,915), whereas in China, costs are at DM11,700 (£4,979) per year. Productivity of Chinese workers would be “somewhere around 30% of ours,” said the director for overseas affairs. “In our JV, some 100 employees turnover DM2.7m (£1.1m), whereas in Germany one employee turns over DM200,000 (£85,106).”

There is a big gap between what Chinese workers earn and what they actually cost a foreign investor, though this is frequently overlooked by foreign investors. The case of GER-0-JV demonstrated this. For instance, at the time of the investigation, GER-0-JV employees were paid the following basic monthly salaries.

To derive at the actual labour **costs** in GER-0-JV, the personnel manager has to calculate with an add-on-top factor of 1.48.<sup>4</sup> This changes the basic salaries paid to the employees tremendously. For instance, taken a middle manager (level 2) at GER-0-JV: instead of RMB4,500 (£333.8) per month, he costs the company RMB6,660 (£489.6). Equally, production workers do not cost the basic salary of RMB850 (£63.1) but RMB1,258 (£93.3).

Monthly basic salaries paid to employees in GER-0-JV.

Position in the JV	Remuneration in RMB (£ equivalent)
Workshop staff	RMB 850 (£63.1)
Office staff	RMB 900 – 1,000 (£66.8 - £74.2)
Managerial staff level 3 (e.g. HR manager)	RMB 2,500 (£185.5)
Managerial staff level 2 (e.g. sales manager)	RMB 4,500 (£333.8)

Note: Salaries paid in 1996.

#### Foreign exchange

Foreign exchange had been a problem for GER-0-JV. By the end of the second year of operation (= 1996) the company should have generated a foreign exchange surplus of some US\$200,000 (£128,205). The assistant production and quality assurance manager believed that the "headquarters will take care of this, otherwise the foreign exchange issue will be a big problem for the JV." With 'taking care' he means the headquarters would help the JV to export. The JV needs foreign exchange to purchase quality components from overseas.

#### Collision of interests

A major problem area had been the collision of interests of the German parent company and GER-0-JV. For instance, the production of special MECHANICAL COMPONENTS was originally not included in the contract. However, GER-0-JV was approached by a Chinese customer to produce such a component. Subsequently, GER-0-JV had ordered the drawings from Germany and they were transmitted to the factory in China. The special component was produced and offered to the Chinese customer at only 60% of the price GER-0 charged for the same product in Germany. Thus, GER-0-JV was blamed by its German parent that had to justify its higher German price to the allegedly Chinese customer that turned out to be a German-funded venture (the German company is a client of GER-0).

Obviously, there was a lack of communication and co-ordination between the German parent company and GER-0-JV. A possible reason is that there are only two persons in the JV who can speak English and are familiar with the MECHANICAL COMPONENTS business. The rest does either not speak English or does not know the business.

In fact, the director for overseas affairs at GER-0 considered communication a major problem of the German company's JV operation - however, between the JV and the German parent, rather than within the JV. To overcome this problem, GER-0 intended to recruit a Chinese who had studied in Germany. This proves a good strategy to overcome the potential and existing lack of communication between the parent

company and its operation in China. This strategy works out beneficially and is also economically justifiable if the Chinese employee is capable of doing a job a German national does. In such cases, the Chinese national has a clear competitive advantage.

#### Sales and marketing

The Chinese managers in GER-0-JV considered the most important factor for successful sales the existence of 'guanxi'. "We ask our friends to help us making the contact. If friends can help us, it's easier," both the assistant production and quality assurance and the assistant sales managers pointed out. However, this has been perceived as a problem by the German production and quality assurance manager. "Aggressive customer acquisition as we know it in Germany is not commonplace in China and even disliked," he suggested. However, slowly this changes and sometimes the Chinese sales staff pro-actively make the effort to telephone potential clients. In the past, sales staff relied too much, as perceived by the expatriate manager, on people they knew somewhere in companies and refused to approach a potential client if they did not know people there. Thus, the transfer of sales know-how has been considered extremely necessary within the JV.

#### Price

The price of its MECHANICAL COMPONENTS is a major obstacle for GER-0-JV. The higher price, compared with that of competitors, is partly caused by higher wages that have to be paid in CITY [East China], compared with elsewhere. Further, GER-0-JV is controlled by its headquarters and cannot go too low with its prices. However, the first thought in China is price. Thus, GER-0-JV will eventually have to compensate its disadvantages from being expensive by offering the highest quality available in China, accompanied by reliability, customer service, etc.

In conclusion, the director for overseas affairs of GER-0 would anticipate many more problems without having a majority equity share. "But now, with the majority stake, I determine what is happening."

### **Joint venture evaluation**

#### ***Joint venture performance***

According to GER-0, so far the JV could realise everything that was planned. "It is a good success," according to the director for overseas affairs of GER-0. He had planned two loss-making years and profits from the third year on. The second year loss had fallen even below the planned. GER-0-JV's loss in 1995 was minus RMB1.0m

(£0.074m) and for 1996 GER-0 expected a loss of RMB600,000 (£44,510) which was actually only RMB300,000 (£22,255).

Sales volume by the end of August 1996 accounted for some RMB8.02m (£0.59m) which is an increase of 39.2% over the same period of 1995 and also 25% more than was planned for the year.

## **Case Two: UK-3-JV**

### **Basic facts about UK-3**

Established as a limited liability company, UK-3 is based in the English midlands. It is one of the world's leading manufacturers of INFRASTRUCTURE SYSTEMS with installations at airports, docks and harbours, railway marshalling yards and station platforms, sports stadiums, industrial areas, motorways, expressway interchanges, etc. (UK-3 Company Catalogue, 1995). UK-3 has an international reputation for its commitment to high engineering standards and quality production with consideration to low or maintenance-free equipment. At the time of the investigation, UK-3 employed 210 staff at its corporate headquarters and its maintenance depot in London.

### **International business activities**

UK-3 has been conducting business virtually all over the world, though this information is not specific. Business activities limit themselves to exporting and the installation of INFRASTRUCTURE SYSTEMS. The JV in China is the SME's only investment project.

### **UK-3's China experience**

Approximately 15 years ago, UK-3 had first developed business in the Far East, particularly in Hong Kong. Later, in about 1985, UK-3 started seeking export opportunities also to China, since the Chinese market was perceived as having a big potential for the SME's infrastructure products.

### **Joint venture formation**

#### ***Joint venture planning***

Rather than scientific, UK-3's approach towards establishing an FDI project in China was rather shallow and risky, ie setting up a company first and looking how the market works. The approach was a so-called 'gut-approach', lacking a sound definition and assessment of evaluation criteria.

#### ***Motivations for production in China***

##### Motivations to engage in an FDI project

China is set to spend astronomic amounts of money (RMB1,000bn) over the next ten or so years on infrastructure projects all over the country. For UK-3, this might be a

huge potential market for its products. The expatriate general manager of UK-3-JV believes that the Asian market “could bring us more than enough work to occupy our capacity” and the managing director of UK-3 estimated the demand for its products in China “ten times bigger than in the UK.” Exporting back of products to the UK could possibly not even be realised by the JV, though it was considered. On the other hand, the general manager also contended that there is “perhaps not enough money to be spent.” UK-3’s ‘potential market’ argument lacks substantiation. A precise assessment of this ‘potential’ demand for infrastructure products in the form of a market study, for instance, had never been undertaken, sound figures never been established.

Servicing the huge potential Chinese market with exports from the UK was considered difficult by UK-3. Access to the market through exporting exclusively would be limited since reaction to changes in demand would be rather sluggish. Further, UK-3 had realised that the supply of goods from England to China cost-competitively would become increasingly difficult since transportation and import duties lift prices considerably. In addition, competitors in China and Vietnam, both local and foreign, that can utilise low cost production were considered being at an advantage in servicing their own as well as neighbouring markets. In summary, apart from the potential market argument, UK-3 also hoped to utilise low production costs to become more cost competitive. Steel, the main material used for production, for instance, was regarded being cheaply available in China, and so was labour. Without the ability to purchase large volumes of steel of a certain quality and at a low price, UK-3 would not have started production in China. UK-3’s further salient reasons for its FDI commitment were the ‘necessity to be there’ and the ‘establishment of a strategic position in Asia-Pacific’.

#### Motivations to form a joint venture

Establishing a manufacturing base, UK-3 had two options, to engage in a JV or to set up a WFOE. Since UK-3 does not operate in one of China’s restricted industries, both opportunities were open to the company. Eventually, UK-3 opted for a JV since it assumed having a Chinese partner was essential for setting up the venture and for developing business. In fact, the contacts of the partner in the Chinese market, its links to officials and its knowledge of potential Chinese customers were regarded as the most important attribute of the Chinese partner. Subsequently, it had taken UK-3 another five years before it started looking for a partner in a potential JV.

#### ***Partner selection***

##### Finding the partner

After UK-3 had decided to set up a business in China and that this business would be a JV, the SME, in subsequent years, approached various potential partners in North,



South and East China. Eventually, in East China, the managing director of UK-3 met with the Chinese partner company, an independent port authority under the Chinese Ministry of Communications, that would become its later partner.

#### Partner selection criteria

With its later partner, UK-3 obtained its desired 'Chinese element', the 'guanxi', and it secured a partner that had a large share of the market. Further, when approached, the East Chinese port authority showed interest in the proposed collaboration. These were the criteria that were important for UK-3 for partner selection. Of considerable interest in this particular case was the fact also that the potential Chinese partner company "had no idea about the product." UK-3 hoped that its Chinese counterpart would be a silent partner, not participating in the management of the JV. UK-3 needed its Chinese partner exclusively for getting business in the Chinese market. "Unless you have guanxi you do not get business," the managing director of UK-3 said. Without the necessity of finding a way to acquire the 'guanxi' and since it was believed that a JV is the best way to do so, UK-3 would have possibly decided to set up a WFOE.

#### ***Partner characteristics***

UK-3 joined forces with one Chinese partner company. This was the local port authority of CITY [East China] under the Chinese Ministry of Communications with a workforce in excess of 3,000 employees. The managing director of UK-3 insists that the Chinese company is not a SOE, though there was no indication in the interviews on the spot that it was not.

#### ***Joint venture negotiation process***

##### Negotiation contents and conflict

For its operation UK-3-JV needs a lot of steel. Thus, the UK SME had to ensure that logistics and material supply were adequate throughout the course of the project. "We did not want to sign a contract to find out later that we could not get steel in China," said the managing director of UK-3. With great difficulties the company negotiated that the JV could import steel if there were quality and delivery problems with international projects. This agreement allowed for the importation of as much as 200 tonnes of steel per year at a maximum duty of 15%. However, whereas the importation of raw materials is accepted in cases where raw materials of comparable quality and price cannot be purchased in China at comparable conditions (see JV law implementation rules), the contractual agreement of a fixed import duty of 15% seems rather surprising: the determination of set import duties rests upon tax authorities.

With regard to the duration of the JV, UK-3 opted for 30 years. This, however, was initially rejected by the Chinese side that wanted 15 years, instead. Since 15 years were considered not long enough as duration of the venture, UK-3 insisted on its original proposal and eventually, the parties agreed 30 years as duration of the JV with the possibility of extension.

Another issue of dispute during negotiations of UK-3-JV was the JV's market focus. The Chinese side wanted the JV to export as much as 50%, whereas it has been the objective of UK-3 to develop a new, ie the Chinese, market. In other words, UK-3 wanted to get additional business, but not to substitute for its exports to world markets from the UK. It was the intention of UK-3 that its JV should not have too much market impact on "our product and production here [UK and Europe]." The plant in China should sell its products only to the Chinese and neighbouring Asian markets. This was the idea of UK-3's managing director. The UK SME wanted to avoid so-called market cannibalism, where subsidiary (JV) sales substitute export sales originating from the foreign parent company. Subsequently, exporting certain fractions of the output back to the UK would be considered. Eventually, however, UK-3 agreed to a 50% export share with the Chinese side. The Chinese party's bargaining position was too strong for the UK SME to withhold.

Whereas the managing director of UK-3 was rather reluctant in talking about problems that occurred during the establishment or operation phases, the expatriate general manager of UK-3-JV was rather frank. He suggested that the valuation of the machinery contributed by UK-3 was "absolutely horrendous." The assets bureau in CITY [East China] simply ignored all the invoices he had provided and eventually, the Chinese side valued the assets brought in by UK-3 at some US\$100,000 (£64,102) less "than they were worth. This was to get an extra US\$100,000 (£64,102)," he said. Although it was very annoying for the general manager, UK-3 had to give in, since without the UK SME accepting it, the joint business would not have been approved by the Chinese authorities. He remembers with reference to his small black book where he pencils down all major or minor issues of conflict that "the Chinese said: if you do not accept this you will never get the business licence."

A further issue of conflict was the distribution of the equity shares in the JV. Whereas UK-3 was very keen in holding the majority stake in the enterprise, the Chinese partner insisted on evenly shared equity. UK-3 accepted, but insisted on, and was granted, the right to appoint the general manager.

#### SME negotiation team, location, duration, language of negotiations, interpreters

Negotiations were held in China exclusively. The Chinese side prepared two sets of documents and everything was discussed "point by point". The managing director of UK-3 initiated and spent considerable amounts of time preparing and carrying out the

negotiations. Only towards the end of the process was the expertise of Price Waterhouse's local office in CITY [East China] consulted that jointly with UK-3 worked out the final documents needed for the establishment of the JV. The entire negotiation process required eight meetings (including the final signing of the documents) and had lasted for 18 months. Eventually, the JV contract was signed in September 1995 and the JV approved by the municipal government of CITY [East China].

### ***Partner contributions***

#### **SME's contribution**

UK-3 committed capital, machinery and technical know-how. UK-3 had the right (see PRC Company Law; see also Kay and Mann, 1995) to contribute a maximum of 20% of the JV's total registered capital (or 50% of its total contribution to the registered capital) in the form of technical know-how. This would have saved cash. However, UK-3 gave away this right in return for extra work paid for by the Chinese partner in the form of electrical installations that needed to be carried out in the factory. Eventually, of its contribution of slightly more than US\$1.6m (£1.0), approximately US\$0.6m (£0.4) were contributed in the form of machinery and the balance in cash. UK-3 had the obligation to pay in its total cash contribution within two years. Kaiser and Grimm et al. (1997) suggest that 90 days after the JV was approved, 15% of the nominal capital ought to be contributed, and for the remaining 85% the period stipulated varies between 12 and 33 months, according to the location of the JV. This suggests that the SME had to have the necessary resources from the beginning, instead of raising more funds over the coming five or so years.

#### **Chinese partner's contribution**

UK-3's Chinese partner contributed land and the building in which the JV operates. There was no Chinese cash contribution. Important is, however, that the Chinese partner's contribution of 'guanxi' was regarded as very important by the UK SME.

### **Joint venture operation**

#### ***Joint venture background information***

##### **Joint venture establishment, total investment and workforce**

UK-3-JV is an equity JV and was established as a limited liability company. It became operational on 18. May 1996. The total investment volume of UK-3-JV is US\$3.26m (£2.09m). At the time of the interview, the JV's workforce was 25, with ten working in administration and 15 on the shop floor. There is no definite figure planned of what the number of employees should look like in one, two or more years. An increase of the workforce depends, so suggested the general manager of UK-3-JV, entirely on the

order book of the company. If the company continues working with one shift only, then the workforce in the JV would not exceed 30. "If we had enough work for two or even three shifts then this place could really make a lot of money." This would imply an increase of the number of employees.

#### Joint venture location

UK-3-JV is located in CITY [East China], in one of the city's economic and technological development zones. The company's production site has access to the harbour of CITY [East China] and a major road link into the city.

#### Choice of location

UK-3 examined a variety of locations that were close to the RIVER and finally estimated that there were approximately 200 to 300 ports along the river that would be potential customers of the JV. Eventually, however, UK-3 considered CITY [East China] and the RIVER delta as the fastest expanding region in China and thus a good location for its production. According to the general manager of UK-3-JV, for the choice of location the following criteria were relevant:

- availability of a factory building of the size and shape ideal for the purposes of UK-3,
- availability of skilled labour,
- availability of cheap material (steel),
- access to river and sea shipping (some electrical fitting components were imported from the UK), and
- proximity and access to the potential market.

However, the general manager of UK-3-JV stressed that the latter argument was not the main criterion since UK-3 had intended, from the very beginning, to develop a sales network that would cover all of China, together with a UK infrastructure component manufacturer, that had established a sales network across China and had offered to sell the products of UK-3-JV. However, the proposed alliance between UK-3 and the infrastructure component manufacturer never substantiated. "It would not have happened quickly enough," said the manager, indicating that these were problems between the two potential partners with regard to adjusting their strategies, etc.

#### Production site

UK-3-JV is a take-over operation, manufacturing on the site of the Chinese partner company. The factory building was erected in 1990. An office complex is attached to the factory located in the second floor of part of the building. Prior to the JV

establishment, the Chinese partner used the factory building for repairing buses. A production assembly line with sawing and welding facilities was installed that takes about half of the total plant space. The rest is occupied by, predominantly, machinery for drilling or bending, and a warehouse with installation materials and INFRASTRUCTURE SYSTEMS. On the general manager's request, in April 1996 UK-3 had sent a mechanical engineer for six weeks to help with the installation of the machinery equipment that was shipped over from the UK.

When the general manager first came to CITY [East China] in September 1995 for a factory inspection, "the place was empty, dusty and disgusting," he remembered. "There was only one socket in each office in the building." Eventually, the entire factory had to be rewired over a period of three months. The information that the researcher obtained about this particular issue is controversial. Whereas the managing director of UK-3 insisted that the Chinese partner paid for the refurbishment of parts of the factory, the general manager of UK-3-JV suggested that the costs were covered by the JV. "This was not written into the contract and we used our working capital for this more than I would have liked it," he remarked. The fact is, however, that UK-3 and its Chinese partner agreed that UK-3 would not make use of its right to bring in 20% of its contribution as intellectual know-how, but as cash. The Chinese partner, in return, would then cover the cost of the refurbishment.

The problem roots deeper than can be seen at first glance: the building was never properly appraised on its state and usefulness. Naively, the UK SME relied on information from its Chinese partner without undertaking a thorough look at the building itself. Instead, "it was assumed that the building would do what it should do." This was a big mistake. The concepts of quality of Chinese and UK (or German) managers are different. Especially the concept of quality is very subjective and there is no standard measure that would facilitate comparison.

#### Product range

UK-3-JV produces the full range of standard INFRASTRUCTURE SYSTEMS that are manufactured by UK-3 in England, though compared with the full range of products manufactured by the SME in the UK, the JV's product range represents only a fraction. The analysis of UK-3's product catalogue of 1995/96 (UK-3 Company Catalogue, 1995) suggests that the two product groups that are manufactured in China cover only 35 pages of a total of 176, or approximately 20% in the catalogue.

In December 1996 UK-3 also introduced its 'flagship' product of INFRASTRUCTURE SYSTEMS to the JV's range of products. At the time of the investigation, the

components of this product were shipped to China from the UK and assembled locally by the JV. At the end of February 1997, so predicted the plans of the managing director of UK-3, a UK-3 shopfloor worker would be sent to China to train the workforce of the JV in assembling this particular product. Eventually, when the JV can afford its own press at a cost of approximately RMB5.0m (£0.37m), this type of product can be manufactured locally in China.

UK-3's product strategy had been to build up the product range of the JV gradually and progressively. By mid 1997, so hoped the managing director of UK-3, also INFRASTRUCTURE SYSTEMS components would be produced in the China venture.

#### Target market

According to the JV contract, UK-3-JV should export 50% of its output. However, this general statement in the agreement "is not particularly binding," said the general manager. "We export as much as we can. How can they control it? If we can achieve this, I do not know. We have to try it." In its exporting efforts, UK-3-JV is supported by UK-3 whose export sales manager handles the JV's exports. This is not contractually fixed, but is another effort of UK-3 to help establish the JV.

At the time of interviewing, UK-3-JV has had two big orders from abroad, one from a customer in Hong Kong and one from a client in the Middle East. At the time of the visit to the JV, UK-3-JV was processing an order from UK-3 which was followed by an order from Hong Kong. Also, at the first day of the researcher's visit to UK-3-JV, the general manager was involved in discussions with a potential client from Singapore who has known UK-3 for many years and at the time of the investigation started to examine the possibility of directly buying high quality products, which UK-3 is known for, from the JV in China at a lower price.

UK-3's original strategy provided that, initially, the domestic Chinese market would be developed through a collaboration with the UK-based INFRASTRUCTURE SYSTEMS components manufacturer, ISC. This company had established a sales network across China and proposed to sell the products of UK-3-JV. In a second phase, the JV would establish its own sales network covering all China. It was further intended that the company ISC would become a third partner in the venture that would produce electric components for infrastructure systems. However, eventually, the alliance between UK-3 and ISC did not substantiate. As a consequence, UK-3-JV had to deal with domestic market development itself.

In particular, this meant for the general manager of UK-3-JV to build up its own sales team and, more importantly, its own network of contacts. "China is not an easy place. You have to have lots of contacts. You have to have lots of agreements. You have to know whose friend you are," the general manager pointed out. He also stressed the fact that "in China you do not necessarily have to offer the best product at the best price, but, instead, having the right contacts is more important." This supports UK-3's original desire to partner with a Chinese organisation to be able to reap the benefits of having the 'guanxi' essential in the Chinese market.

UK-3-JV's market development strategy had been to contact infrastructure design institutes. Although the JV has its own sales force, "at the moment I am helping out where I can," remarked the general manager. "Chinese customers want to meet the European general manager." According to the general manager, the JV could also serve customers in the UK that want to purchase from the cheaper JV since "there is a pot big enough for all", though this seems rather unlikely and does not reflect a possible UK SME's global strategy. In fact, the managing director of UK-3 attempted to avoid so-called cannibalism effects initiated by the JV.

Exporting to the UK and to world markets means that UK-3-JV must meet certain quality standards that have been applied successfully by UK-3. Since UK-3 is very strong on quality and customer service, the general manager of UK-3-JV insisted that "I will not compromise on quality." At the time of the interview, UK-3-JV was preparing its ISO 9002 certification which was planned for July 1997. As a matter of fact, the strategy apparently worked: prior to the investigation, the JV had exported a batch of INFRASTRUCTURE SYSTEMS to Hong Kong and, shortly after that, received a call from the customer who expressed great satisfaction with product quality.

#### Market share in China

Neither the general manager of UK-3-JV, nor the managing director of UK-3 could, at the time of the investigation, specify the market share of their operation in China.

#### ***Joint venture ownership***

The JV is owned equally by UK-3 and the Chinese partner company. UK-3 originally did not want a 50-50 equity distribution. However, the Chinese side insisted on evenly shared equity. Originally, the Chinese side intended to establish a US\$10.0m (£6.4m) JV. However, the value of the Chinese contribution in the form of land and building eventually determined the actual volume of the JV. UK-3 was willing to contribute more capital. The Chinese, however, insisted on their 50% share of equity. "At the end of the

day,” said the managing director of UK-3, “it was a matter of trust and you have got to have faith ]...[ and we get on alright.”

As a matter of fact, however, UK-3’s willingness to agree to the equal equity venture was not so much a matter of trust, rather than the fact that the Chinese partner had no idea of the industry in which the JV would be operating. Eventually, there might be an opportunity for UK-3 to get its majority stake in the venture: UK-3 has the contractually fixed option to increase its investment in the form of a further machinery contribution. Doing this, the company could lift its stake in the venture beyond 50% ]...[ “unless they bring in more capital as well.” The value of the next batch of machinery of approximately US\$624,000 (£400,000) to US\$780,000 (£500,000) has already been verbally agreed and will be purchased if the JV has the orders to justify this.

### ***Joint venture control***

The BoD of UK-3-JV has six members. Chairman of the board is a Chinese who had formerly been general manager of the Chinese partner company and who had, in the meantime, been promoted a director of the CITY [East China] port authority. The UK side on the board is represented by the managing director of UK-3 and two other UK-3 directors. The managing director of UK-3 is also vice-chairman of the BoD. After three years, a UK director will become chairman of the JV and the Chinese side would be granted the vice-chairmanship. This revolving system is common in Sino-foreign JVs.

Responsibilities are not distributed according to a fixed structure, though, according to the managing director of UK-3, the Chinese side is in charge of selling to the Chinese market and the ‘Chinese relations’, whereas UK-3 would help the JV in selling and marketing in China. The UK side is additionally responsible for manufacturing, technology, sales and marketing outside China.

Board meetings are scheduled twice a year or “as and when necessary,” and take place in England or China. The meetings last for half a day and issues debated include staff issues, marketing, selling, production, financing, accounting and further capital investment. By the time of the investigation, the BoD had met only two times, in May 1996 and again in October 1996 when the ‘valuation of UK assets’-problem was discussed and settled.

The fact that UK-3’s Chinese partner is not familiar with the INFRASTRUCTURE SYSTEMS business manoeuvres the UK SME into a position where it is able to control the venture, though the equity share would not suggest so. “We have control, because without us they cannot do it,” the managing director of UK-3 said. Part of UK-3’s



control strategy was also that it negotiated and contractually fixed the right to nominate the general manager of the JV. The Chinese side agreed to that and there were no lengthy negotiations about this. "Otherwise, we would not have discussed it any longer." As a consequence, the Chinese could nominate the vice-general manager.

Although both the general manager and the vice-general manager of UK-3-JV are not members of the BoD, they attend board meetings in order to support decision-making. The managing director of UK-3 insists that everything (all major decisions) is agreed between the JV and the UK headquarters. This supports again the assumption that the UK SME uses the JV in China as a tool in its global strategic operations.

### ***Joint venture management***

The equal equity distribution in the JV would suggest that control and management are shared between the partners. The general manager seemed to be the decision-maker in 'his' JV. The Chinese side seemed passive in taking an active interest in the JV and "they are destructive in what they do," suggested the general manager. "I have offered them to take an active role in the business, to meet weekly, but they did not want it."

The JV is characterised by its lean hierarchy. It does not have departments. "In departments the managers are too busy looking after their own power." Everybody in the company reports to the general manager directly. Once a week, the general manager calls for a meeting with the entire workforce where achievements, problems and further directions of the company are discussed.

The general manager empowers his staff to make decisions. However, at the time of the visit to the JV, the business was not quite there. "We are getting there," contended the general manager. He recognised that active decision-making is in conflict with the Chinese authoritarian philosophy, though increasingly staff make decisions, such as working to their own schedules. Increasingly, but slowly, the JV's personnel also dares to disagree with the general manager in one or the other matter or to ask questions when issues are not clear and need to be discussed further.

At the time of the visit to UK-3-JV, the Sino-UK JV worked with one expatriate manager from the UK-3 headquarters. The 44 year old Briton was holding the position of general manager of the JV. Formerly manufacturing manager with UK-3 where he had been working for ten years, he was asked in 1995 to represent UK-3's interests in its newly formed JV. "I am a country boy. This was a big decision for me," he said. The 'expatriate to be' had discussed this for a long time (with his family) and finally decided that this was too good an opportunity to miss. Since February 1996, he had been living

in the outskirts of CITY [East China], together with his family. The general manager's contract was due to expire in February 1998.

Although especially the first months or so were hard for the expatriate and his family, due to missing the UK and being exposed to an alien environment, at the time of the investigation, the expatriate was keen to renew his contract and do another two years since "two years are not enough to build up a company and definitely not in China."

At the time of the visit of the JV, the expatriate was teaching himself Mandarin, every day from seven to eight in the morning. Before leaving the UK, he received a several week lasting language preparatory training at a university near by the UK-3. However, the training was not offered by UK-3, but the expatriate had to insist on it.

Originally, the British manager had to look after all aspects of the JV, but in the meantime, could pass on the manufacturing supervision to his vice-general manager. This gives him more time to concentrate on the sales side of UK-3-JV.

The expatriate general manager costs approximately US\$187,200 (£120,000) to US\$234,000 (£150,000) per year. UK-3 covers the manager's salary. The costs of living (accommodation, electricity, telephone, son's education) are covered by the JV.

## **Joint venture problems**

### ***Production***

High quality is one of the marketing features UK-3 had been applying successfully throughout the past years. Also, if quality of the INFRASTRUCTURE SYSTEMS components is not good enough, the JV cannot export parts of its output back to Europe, for instance. UK-3 had been granted the ISO 9001 certificate. It has also been the intention of UK-3 to introduce the high quality standard to the JV in China. At the time of the visit, the JV had started to qualify for ISO 9002 with the general manager producing the manual. UK-3 sent to China an ISO 9001 manual and, additionally, the JV was working with a consultant "who comes into the company twice a month to assess the progress that's being made in terms of ISO 9002." The general manager planned that the JV would be suitably certified by July 1997, "or so." "I will not compromise on quality. With our ISO 9002 certification we try to give the customer confidence in what we are doing and what he is buying."

In fact, the managing director of UK-3 was "quite surprised with the standard of quality amongst the workers which "is as good as here." The workers employed by the JV were already qualified welders. This meant that UK-3-JV did not have to train the workers in welding, but only how to weld the specific products manufactured in the JV.

For that purpose, UK-3 had sent a welding engineer to China for six weeks to train the welding staff of the young JV. UK-3 had sent to the JV also sophisticated welding equipment. Controversially, the general manager of UK-3-JV reported that he bought, at the beginning of the operations, ten tonnes of steel for training purposes. "We totally destroyed this." Would this have been necessary if the JV's welders were already qualified welders as the managing director of UK-3 suggested? Nonetheless, after several months of training and practice, the welders in UK-3-JV had reached a quality standard that "is as good as, or even better than, that in our UK operation and I am very proud of that," said the general manager.

However, some potential Chinese customers of UK-3-JV are still of the opinion that "everything from China is rubbish and that everything that comes on the ship is of higher quality." This means, UK-3 still has to export products that its JV in China could produce. UK-3-JV also imports the COMPONENTS that it fits onto its INFRASTRUCTURE SYSTEMS. The JV sources COMPONENTS from a European manufacturer with a JV in CITY [East China] and from overseas. For imported COMPONENTS the JV pays some 40% import duties. Thus, the general manager of UK-3-JV considered it as good if the JV could get the same quality of lighting for less a price locally.

On average, it takes the company about 15 minutes to manufacture an INFRASTRUCTURE SYSTEMS product in the UK. The average duration to manufacture a similar product in the JV was, at the time of the visit, almost comparable. "I am very impressed," said the general manager.

For its planned assembly and later complete production of special INFRASTRUCTURE SYSTEMS in China, UK-3-JV intended to send two engineering staff for training to the UK. The JV contract does not require UK-3 to bring Chinese for training to the UK. However, "we intend to do that since it is essential. We bring both over eventually sometime next year (= 1997)," said the managing director of UK-3. In addition, the general manager intended to send his senior engineer on an MBA course, either in Europe or in China. Apart from that, he expects a welding engineer from UK-3 to come and supervise the production process of the INFRASTRUCTURE SYSTEMS.

### ***Local sourcing***

Offering the highest quality of products suggest not only having a quality-conscious workforce, but also high quality components and materials. The local sourcing of high quality products is not always possible in China, however, though it is desirable since it allows to keep costs down and to save foreign exchange that otherwise is needed for

the purchase of high quality components abroad. At the time of the investigation, UK-3-JV was sourcing almost 100% of its material locally. The ability to produce cost-competitively in China due to cheap labour and cheap material purchases was one of the prime reasons of UK-3 to invest in China and establish a plant to manufacture INFRASTRUCTURE SYSTEMS. Material costs account for approximately 85% of the total costs of one unit of INFRASTRUCTURE SYSTEMS manufactured. Thus, savings with the sourcing of supplies could eventually contribute to substantial savings of the company. The quality of the steel from China was sufficient for the purposes of the SME. Problems with the local sourcing of materials are thus negligible in this case.

### ***Productivity***

With regard to productivity, UK-3-JV still has a long way to go, though in terms of quality achievements, both the managing director of UK-3 and the general manager of UK-3-JV are content. The two managers have recognised that, in terms of productivity, “the level needs to go up. It is good, but it is not good enough.” Interestingly, during the first interview session, the general manager of UK-3-JV insisted that his Chinese staff’s productivity level would be as good as in the UK. The JV also faces problems with the efficiency of its administration. “Although they work hard, they have to improve their organising efforts,” he criticised. An example should illustrate this: recently (at the time of the investigation) the general manager had asked one of his engineers to find a Chinese supplier of high quality and cheap steel. Eventually, this employee of the JV travelled there - taking three other staff with him. After returning from the business trip, the general manager questioned all of the ‘travellers’ about the necessity of going in a four persons large delegation only to find out that actually only one or two people were essential for the completion of the mission. “Chinese just do not understand this. This takes some time,” he reckoned. However, the general manager had already achieved, at the time of the investigation, that one person was doing one person’s job. This was different when the JV first started its operation.

Again, productivity of Chinese staff in the JV has to be viewed somewhat cautiously and comparison with productivity of workers in western factories is difficult since the salary levels are rather different. For instance, at the time of the investigation, production workers’ salary in UK-3-JV was approximately RMB1,400 (£103.9) per month. According to the JV’s general manager and based on the researcher’s own experience with foreign investors in China and particularly in CITY [East China], these are competitive salaries for locations, such as CITY. Paying competitive salaries keeps personnel loyal to the company. “Labour turnover is a waste of time and money.” UK-3

has done research on that and its consultant, Price Waterhouse, worked out labour contracts that were not violating Chinese laws. Noteworthy is that the JV operates a flexible remuneration system where workers earn between RMB1,200 (£89.0) and RMB1,700 (£126.1), depending on their skills and motivation. All office staff were at the same level with only the vice-general manager being higher than the others.

On top of the basic salaries there are various add-ons to be paid. For instance, the basic monthly salary of the general manager's secretary is RMB2,000 (£148.4). This is topped by a factor of 1.79. At the end of the month, the secretary costs the JV RMB3,580 (£265.6). This does not apply for the welders, however, who are from outside of CITY [East China] and do not get paid these social and welfare benefits. On the other hand, UK-3-JV had recruited all its welders through an employment agency which charges the JV RMB300 (£22.3) per person per month. In any case, however, the maximal cost for a welder does not exceed RMB2,000 (£148.4) per month.

### ***Foreign exchange***

Since UK-3-JV sources predominantly locally and sells its products also mainly in China, but also to overseas markets where customers pay US dollars, foreign exchange is not really a problem in the JV.

### ***Collision of interests***

The collision of interest between UK-3 and UK-3-JV is a latent problem. UK-3 does not want the JV to cannibalise its own export sales. UK-3-JV, on the other hand, attempts to serve also traditional customers of UK-3 with cheaper products, since "there is enough for all of us." In the long-term this attitude of both parties could create a major conflict in the inter-relationship between the UK SME and its *ambitious* JV.

### ***Sales and marketing***

UK-3's original turnover forecast was "ten times of the UK turnover." However, UK-3 recognised early that it has to work hard to achieve this. "We realised that we have to do a lot of work to get there, we have to build connections up, etc.," suggested the managing director of UK-3. UK-3 also faces a lot of competition, international as well as Chinese, including an American company and a UK enterprise (UK-7). The managing director of UK-3 considers the Chinese competition as threatening since "it is rather who you know than what you know," he said. In terms of quality, the general manager of UK-3-JV does not consider Chinese companies as a competitive threat.

### ***Price***

Compared with competitors - both Chinese and foreign - UK-3-JV can offer its products at the lowest price. The general manager suggested that the Chinese would not be

familiar with the concept of marginal costs and, thus, would be too expensive. Also, compared with the prices UK-3 asks for, UK-3-JV is much cheaper. In its China venture, however, UK-3 can manufacture its products at approximately two thirds of the cost for products manufactured in England and transport is not too expensive.

### ***Communication***

In UK-3-JV internal communication is a major problem that stems not only from the potential mutual misunderstanding between two different cultures (the lack of awareness of cultural diversity), but also from inherent and developed distrust. "Collaboration is absolutely dreadful," said the general manager, "and my vice-general manager is obstructive." At various occasions the Chinese manager had provided inaccurate information to influence the general manager's decision-making. The general manager's (authoritative) management style and the perception of what the JV's management should look like are different. "I offered them to take an active role in the business, to meet weekly, for instance, but they did not want it," the British manager remembered. Already earlier in the JV process, UK-3 had experienced considerable problems with its Chinese partner, including the valuation of contributions.

The general manager illustrated this with an example noted in his little black book (where he jots down every minor or major dispute between himself and the Chinese managerial staff): when he was looking for welders for the workshop, he asked the personnel manager of the Chinese partner company and his vice-general manager for a meeting to discuss ways of recruiting such staff and how to remunerate them. The Chinese participants in the meeting suggested that RMB3,000 (£222.6) per month would be commonplace as salary for welders in CITY [East China].

However, later, at a social event in CITY [East China] the general manager discussed this with a German businessman based in CITY [East China]. The German told his British friend that, for about RMB2,000 (£148.4) per months he could get a good mechanical engineering graduate. Since mechanical engineers are being paid higher salaries than welders, the general manager could not trust the figure any longer that was established earlier as salary for welders. "I thought RMB3,000 (£222.6) for a welder cannot be right."

Subsequently, the British general manager discussed this with his previous Chinese advisers who then sized the figure down to "perhaps RMB1,000 (£74.2)." Eventually, the general manager decided to pay the welders a wage high enough to keep them loyal to the company. He was prepared to pay a minimum wage of RMB1,200 (£89.0)

and a maximum of RMB1,700 (£126.1) per month (including benefits). Finally, he discovered confirmation of the above range when asking the director of a Belgian company who paid his welding staff some RMB1,200 (£89.0) per month.

Later, at the first board meeting in May 1996, the topic was raised and the general manager found that the Chinese directors of the Chinese company and the vice-general manager of UK-3-JV wanted to determine their salaries on the basis of the salaries that are being paid to welders. "We think that RMB1,200 (£89.0) is not enough." If the JV pays some RMB1,200 (£89.0) to welders then the Chinese partner company would pay its welders RMB2,000 (£148.4). "The vice-general manager was trying to talk his wages up," said the general manager.

The general manager illustrates his distrust of the Chinese vice-general manager with another example: he wanted to have a sign next to the road that displays the name of UK-3-JV in English and Chinese, telephone numbers, etc. and an arrow so that visitors would find the company easily. The sign should have been in the corporate colours of UK-3, red and white. He was told by his vice-general manager that just these colours would be illegal in China and, therefore, could not be used by the JV. Doubting this, the general manager, on a tour through CITY [East China], inspected many signs of other companies and found, amongst them, several signs in red and white. Only later, the general discovered that the vice-general manager wanted to have the colour of the Chinese parent company which is blue.

The general manager of UK-3-JV was not short of further anecdotes. One more should be illustrated here: once the vice-general manager bought steel for much too high a price and since he delivered the cheque for payment himself, the general manager suspected that he (the vice-general manager) had received money from the selling company. From that time on the vice-general manager was no longer allowed to buy or sell anything for, or of, the JV. "I gave him a last opportunity and he blew it."

Subsequently, the British general manager made the vice-general manager who speaks English "better than he admits" in charge of manufacturing, after he was originally responsible for the workshop, for buying steel, computer-aided-design drawing, production planning and repairing machines. However, this was not to promote him by adding responsibility to the Chinese manager's range of responsibilities. Rather, it was a tactically clever move by the British general manager to place his vice-general manager somewhere where he can recognise immediately "if anything is only slightly out of balance."

## **Joint venture evaluation**

### ***Joint venture performance***

The managing director of UK-3 had estimated that within five years, "if everything goes well," the UK SME would make more profit in China than in the UK. However, at the time of the investigation, none of the interviewees could specify the success of the JV, though there were orders in the pipeline.

The JV was established only in May 1996 and the interviews were carried out in November and December 1996. In other words, the JV had had less than six months to produce results which the managing director of UK-3 and the general manager of UK-3-JV could assess against their expectations with respect to JV performance.

However, both the general manager of UK-3-JV and the managing director of UK-3 had other criteria against which to assess the Sino-UK JV's performance. For instance, although relationship business is very important in China, the general manager admitted that the JV had not done its homework sufficiently. "Building relationships takes a long time. Currently, our orders from China are far from good." Although UK-3-JV is the cheapest and the quality of its products is very high, the venture still lacks of essential contacts and the expatriate manager starts realising this (ie the importance of contacts) only now.

The managing director considers the venture successful if "we can do what our product says it can do." UK-3 products have a reputation of good quality and a high reliability. The certification of the JV according to ISO 9002 that was planned for the summer of 1997 was thus one criterion of success.

Overall, the general manager of UK-3-JV suggested that "what we have achieved in the first months looks quite good, though the order book could be fuller. If I look back I am quite happy." The general manager admits that financial planning is difficult. "We are a baby and babies spill food," he said. In other words, making mistakes is rather common for a young company like UK-3-JV. "It is alright as long as you learn from this," he said. Adopting this attitude, the general manager of UK-3-JV replicates Confucius's philosophy who states that "if you make a mistake and do not correct it, this is called a mistake."

### ***Factors for joint venture success***

The general manager of UK-3-JV believes in people. He did not consider it sufficient having the best machines in the JV, but no people who do want to make the venture a success. Instead, the British manager insisted, the crucial element for a venture's success is whether its human resource wants to succeed or not. One way of creating



personnel that want to succeed is to create a corporate philosophy of success. This is the management's job. Accordingly, the general manager believed that people who are well managed are good players. However, according to the expatriate manager, "the Chinese will never understand the importance of the contribution of people."

## **Case Three: UK-4-JV**

### **Basic facts about UK-4**

UK-4 was established as a limited liability company in the Northeast of England. It is an innovative enterprise operating in the ELECTRONIC DEVICES industry. At the time of the interview, UK-4 had ten employees. Four of them were working in production and the rest in research and development, sales and administration. The annual output of UK-4 is 50,000 units of its ELECTRONIC DEVICES. Since 1986, UK-4 had been manufacturing and distributing its products and selling it to, exclusively, corporate customers, mainly security companies. UK-4 is jointly owned by two directors: the managing director holds 86% of the equity and the sales director 14%.

### **International business activities**

UK-4 exports its products to more than 60 countries throughout the world (UK-4 Company Catalogue, 1996) and had been carrying out development work in Germany, Canada and Australia. Although the managing director of UK-4 does not know the market shares of the individual ELECTRONIC DEVICES, he estimated them as "fairly high" since the products of UK-4 are niche market products. Competition, in particular from international companies, had been increasingly setting UK-4 under cost pressure.

At the time of the investigation, UK-4 was not active in the US market. The managing director reckoned that, although business would be good, "you need to be there." A presence of UK-4 in the US market, however, is restricted by the company's under-capitalisation - a problem that is inherent in many SMEs.

### **UK-4's China experience**

Prior to its JV establishment, UK-4 had no experience with or in the Chinese market. Neither China nor neighbouring countries in the Far East had been the target of the company's market development and penetration efforts.

### **Joint venture formation**

#### ***Joint venture planning***

Due to competitive pressure from particularly international firms that were competing with the UK SME in its traditional markets in mainly Europe, UK-4 had two alternative

go-aheads for survival: first, to invest substantially in production capital and to go for large production volumes or secondly, to produce labour-intensively. These were the options in UK-4's specific industry. Due to its chronic capital shortage, UK-4 decided to shift production out of the country to a low-cost location. "If we had millions of output, we could have stayed here," said the managing director of UK-4. Subsequently, he investigated various potential countries for production.

Initially, the managing director enquired the possibilities of shifting production to either Korea, the Philippines, India, Thailand, Hong Kong, Taiwan or China. He had approached the British embassies in these countries and had asked for details about local companies that could manufacture a selection of UK-4's products. The embassies had sent lists of potential companies that could take on production on behalf of UK-4. A longer period of faxing and lettering with these companies on the lists provided resulted, eventually, in the shortlisting of two potential companies for collaboration in the Philippines and in China.

Subsequently, the managing director of UK-4 visited the two companies that had responded to his enquiries and with whom he had made contact and the Chinese company turned out to be the one that would be most suitable, based on quality-of-labour considerations. In the end, UK-4 shifted production to China, though China was not its first choice. The managing director had rather collaborated with a firm in Korea.

### ***Motivations for production in China***

#### Motivations to engage in an FDI project

UK-4 shifted a part of its production of ELECTRONIC DEVICES to China, "not because it was cheap, but because it was cheap and had skilled labour that was available." As outlined in the section above, the managing director of UK-4 was much keener to produce in Korea than in China, since the quality of labour was perceived to be better in Korea. This was one of the reasons also why he decided not to shift to production of the ELECTRONIC DEVICES to the Philippines. For demonstration, of the selling price, material accounts for approximately 30% and labour for 5% in the UK. When produced in the JV in China, material costs account for about 25% and labour for around 1% of the selling price.

#### Motivations to form a joint venture

UK-4 had never considered the possibility of going it alone in China. Up to the time of the investigation, UK-4 had no intention even of serving the domestic Chinese market, nor of establishing a JV. UK-4's predominant interest had been to manufacture high quality ELECTRONIC DEVICES at a low cost which could have been done in the form

of contract manufacturing. UK-4's interest in China had been purely from the point of view of a resource seeker. However, UK-4's Chinese negotiation partner was exclusively interested in establishing a JV and eventually, the managing director of UK-4 agreed, because he wanted to manufacture in China.

The Chinese company had a variety of reasons for engaging in, and insisting on, a JV with UK-4, instead of contract manufacturing on behalf of UK-4. From a JV with UK-4 the Chinese company expected to receive technology in order to develop its own production. The directors of the Chinese family-owned private enterprise were sure that UK-4 would eventually agree to establish a JV. As the main advantages of their company for a collaboration with a foreign enterprise they considered to be able to offer cheap labour and the government's favourable policy towards peasant enterprises, including a direct export/import right, the ability to import (machinery) free of duty and the ability to go through formalities quicker than other Chinese companies could do. However, the Chinese government has, at the end of 1996, ended this favourable import duty treatment of JVs that were to import capital equipment for their production in China. Only after long and substantial protest of foreign investors in China was this privilege being re-introduced, though modified.

To obtain advanced technology and also contacts in other parts of the world was very important for the Chinese enterprise. This drive and desire was articulated in huge Chinese characters across the hall in the company's administration building. Self explanatory, the characters read "Creating a world famous brand - striving for a first-class enterprise." Interestingly, throughout the discussions with the researcher, the Chinese directors had repeatedly expressed their interest in establishing additional JVs with UK companies. At the time of the investigation, the Chinese enterprise had in operation two further JVs, one with another UK company (producing barrings) and one with an enterprise from Thailand (producing knitting clothes).

### ***Partner selection***

#### Finding the partner

UK-4's process of finding a partner for its JV was inevitably linked with the entire planning process of shifting its production of ELECTRONIC DEVICES to a low production cost location. Apart from approaching the British embassies in the various countries (eg the British Embassy in Beijing), UK-4 had not undertaken any other efforts to discover potential Chinese companies that would have been prepared to accept UK-4's initial proposal of collaborating in the form of contract manufacturing.

Although the Chinese company did not agree to contract manufacturing and insisted on a JV, instead, UK-4 did not continue its search process. Further research could have resulted in finding another company that would have been prepared to contract manufacture on behalf of UK-4. However, due to limited time and finance, and certainly due to only limited knowledge of the means available to search for partners, UK-4 ended up being restricted in its choice of its partner company in CITY [East China]. On the other hand, the Chinese company's proposal to joint venture was not totally unacceptable for UK-4 and perhaps a strategy the managing director of UK-4 had not considered before, because he was not familiar with it.

#### Partner selection criteria

UK-4 did not have the choice of selecting its Chinese partner from a pool of potential partner companies. It only had found one Chinese company that could produce its ELECTRONIC DEVICES.

#### ***Partner characteristics***

The Chinese partner of UK-4, based in East China, is privately owned by a Chinese family. The group comprises five companies of which three are JVs with foreign partners, two with partners from the UK and one with a Thailand-based enterprise. The Chinese group's second JV with a UK-based company had been manufacturing barrings and the JV with the Thai firm, knitting clothes. At the time of the investigation, the Chinese parent company had been existing for some 30 years, but had moved its operation into its present site in 1980 and also had changed its name. Thus, production buildings on the site are built from 1980 onwards and had a maximum age of around 15 to 16 years.

The Chinese parent company had been operating in a variety of industries, including knitting, yarn-feeding and textile appliances. It is the largest producer of Yarn feeders for knitting machines in Asia.

The total workforce of the Chinese company had been in excess of 500 staff. This, however, includes the workforce of its JVs. In 1995, the Chinese parent company had turned over in excess of RMB40.0m (£3.0m) of which more than 90% was generated in the Chinese market. The remaining 10% were earned through exports to markets in Europe, America and neighbouring Asian countries.

#### ***Joint venture negotiation process***

##### Negotiation contents and conflict

UK-4's agreement was a pure manufacturing agreement in which the JV produces according to orders from the UK SME. All the important issues such as marketing and

personnel, for instance, or the expatriation of UK-4 employees to the JV, etc. were not really relevant in this case and did not have to be negotiated in lengthy debates. UK-4 clearly laid out what kind of products it wanted at which price and when this was negotiated, the JV was sorted out.

The duration of the JV was negotiated and contractually fixed at 20 years and there was no conflict between the partners on that, though UK-4 was also prepared to agree to a shorter duration.

SME negotiation team, location, duration, language of negotiations, interpreters

Most of the negotiations and contract formalities were carried out by the chairman of the Chinese partner company and by the managing director of UK-4 plus an interpreter who was provided by the Chinese side (the Chinese company's own interpreter). "Without formalising it too much we got it right," said the managing director of UK-4. Additionally, the managing director of UK-4 consulted a Hong Kong-based solicitor firm to look after the legal aspects and the special features of the Chinese law, since his understanding of the legal issues and the content of the JV contract were only limited.

The entire process of negotiating the potential JV was carried out in China. First discussions between UK-4 and the Chinese enterprise commenced in 1992. The actual sorting out of details had taken approximately six months and most of the negotiating was done during a ten day visit of the managing director of UK-4 to China, shortly before the contract was signed.

Eventually, the JV was approved by the municipal government of CITY [East China] and its operation started - simultaneously - in March 1994. The managing director of UK-4, however, was not aware of who approved the JV. This shows clearly the strong influence of the Chinese partner in the entire JV establishment process which was more than welcomed by UK-4, whose main interest was the manufacture of qualitatively good products at a low cost. Other issues revolving around the JV management were only of marginal interest to UK-4. The managing director of UK-4 insisted that the signing of the JV contract and the operation of the business had started simultaneously. This seems rather impossible, however.

UK-4's Chinese partner's influence on the approval process by the municipal government of CITY [East China] was considerable. After only about six months the business was negotiated and approved in March 1994, though first discussions between UK-4 and the Chinese company commenced in 1992.

### ***Partner contributions***

#### SME's contribution

The original cash contribution to the JV by UK-4 was a mere US\$58,000 (£37,179), a third of what the Chinese side poured into the JV. From the interviews with both UK-4 and the Chinese company it became apparent that the know-how of UK-4 had not been valued and accepted as a contribution to the JV. The Chinese company itself is a high-tech component manufacturer and was, according to the managing director of UK-4 not interested in the acquisition of technology. However, the interviews with the Chinese side suggested the opposite and it would support the common wisdom that Chinese JV partners attempt to upgrade their operations with western technology. Further, it could also be that, after the contract between the Chinese and UK partners expires, and since the Chinese company has ambitious plans to develop also the Chinese and other markets in Asia, the Chinese company exploits the technology transferred to the JV.

#### Chinese partner's contribution

The Chinese enterprise contributed approximately US\$116,000 (£74,359) to the JV. A major contribution of UK-4's partner to the JV was the Chinese firm's municipal government connections. One of the directors of the Chinese partner company is a friend of the mayor of CITY [East China]. This good relationship to the municipal government of CITY allows the Chinese partner company to pledge that "we complete all the formalities and after five days, the JV can be set up." However, the Chinese directors have no relationship with the government at the provincial or national levels. "We know them from TV," the interviewees replied to the researcher and smiled ]...[ as had they expected the question that is a must on the interview outline of every foreign researcher who had studied the importance of relationships in the Chinese society.

The original cash contribution of both partners was used by the JV for the purchase of machinery needed for the subsequent manufacture of UK-4-JV's products. Since the Chinese company had not operated in the ELECTRONIC DEVICES business before and since UK-4 did not have second-hand machinery which it could have shipped to China, the JV had to purchase a complete set of new machines. Also, the Chinese side was not very keen on getting second-hand equipment anyway. Subsequently, both parties in the JV had poured in more funds and also the profits of the JV were being re-invested.

## **Joint venture operation**

### ***Joint venture background information***

#### Joint venture establishment, total investment and workforce

The JV between UK-4 and its Chinese partner company is an equity JV, established as a limited liability company according to Chinese law. The total investment in the joint business accounts for some US\$170,000 (£108,974). At the time of the visit to the JV in China, the JV had employed some 20 staff.

#### Joint venture location

UK-4-JV is located in CITY [East China] at China's east coast, which is a modern medium-sized city with a population of approximately 990,000 (The People's Government of CITY, 1996). According to the CITY [East China] government, the county has key industries, such as machine building, electrical appliances, light and textile, vehicle, electronics and communication, chemicals and metallurgical industry and further has trade relationships with more than 80 countries and regions. During the eighth five year plan period (1991-1995) the CITY government had invested about RMB1.0bn (£0.074bn) in water conservancy, transportation, telecommunication and municipal administration (The People's Government of CITY, 1996).

CITY [East China] economic and technological development zone, where UK-4-JV is located is a provincial zone, combining industry, science and technology, construction and trade (The People's Government of CITY, 1996). The city comprises more than 20,000 enterprises. Further, by 1996 the county had attracted more than 330 foreign-funded enterprises (ibid). The JV had been receiving preferential income tax treatment. For the first two years, the JV was exempt from income tax and from the third year on it had been paying only half the income tax of 33% for another three years. However, this is rather common in China's special economic zones or open cities.

An asset the government of CITY [East China] emphasises in its investment promotion brochure are its 'super-kids', known in the world for their "superb mental arithmetic skills based on using the abacus" (ibid).

#### Choice of location

UK-4-JV exports its entire production to the UK and imports various special parts and components from abroad. Thus, it needs the proximity to an international port - sea or air. CITY [East China] is about 60 kilometres away from China's largest port and a two hours highway drive from the next international airport. Further, at the time of the investigation, a highway was under construction that links CITY with a major economic metropolis of the country. Proximity to harbours and airports is essential for UK-4 that

relies on flexible planning. The main argument in the case of UK-4, however, was that because UK-4-JV should commence in the existing buildings of the Chinese partner, UK-4's location choice followed the 'location of the Chinese partner'.

#### Production site

To erect a new building was never the intention of either the Chinese or the UK side. Instead, the JV should rent the production space of the Chinese parent company. The eight year old building where JV production had been located has an area of approximately 400 square metres. One of the Chinese directors repeatedly symbolised that this would be only a very small workshop. Previously, the premise was used by the Chinese parent company's textile appliance business. The workshop building had been located on the site of the Chinese company, next to the accommodation blocs, the canteen and other production workshops. The entire site of the Chinese group covers some 20,000 square metres.

The workshop has different lines of assembly for the manufacture of the different series of ELECTRONIC DEVICES. Staff in the workshop have to wear white coats and the workshop is air conditioned, dust-free and the noise level is low. This was one of the requirements of the UK SME since otherwise the high quality of the ELECTRONIC DEVICES could not have been maintained. The administration of UK-4-JV is located in the main building of the Chinese parent company where the JV's accountant, interpreter, quality inspector and office manager work.

#### Product range

UK-4-JV manufactures five types of ELECTRONIC DEVICES (COMPONENT ONE) and three types of ELECTRONIC DEVICES (COMPONENT TWO). This adds up to approximately 50,000 product units per year. The volumes are produced according to the orders placed by UK-4. Compared with UK-4's product range in the UK, this represents only a small fraction, "only the specials," according to the managing director of UK-4. An expansion of the current product lines was planned, however, though there was no set time scale for this.

#### Production

To make sure the workforce of the JV manufactures the ELECTRONIC DEVICES according to the requirements of UK-4, the company had sent an engineer to CITY [East China] for three or four times. He had trained the workforce and only then gave the JV management a letter of approval to be able to manufacture ELECTRONIC DEVICES as required by UK-4.



Further to ensure product quality, UK-4-JV employs a total quality control system that is headed by the Chinese general manager of the JV. In practice this suggests a very strict quality control of all the outgoing products that are to be shipped to the UK. Each manufactured good goes through three function tests. At UK-4 incoming products are further quality controlled. UK-4 had supplied the tools necessary for testing and the JV's staff uses them to test products according to UK-4's testing programme.

Manufacturing of the security items takes approximately the same time as in UK-4's operation in Northeast England. The managing director of UK-4 is satisfied with the quality standard of the products manufactured by UK-4-JV. "There are no problems with quality," he said.

Production forecasts are planned in advance for UK-4-JV. This is the job of the managing director of UK-4. Since products on stock are dead capital, he considers the issuing of orders as an issue to be done very carefully. If major discrepancies with the forecast appear, production planning can be changed rather easily.

For labour, UK-4-JV has to pay approximately RMB1,000 (£74.2) per month plus another RMB1,000 (£74.2) per year for welfare. This remuneration package follows, according to the interviewees at the Chinese parent company, a fixed bonus system as provided for in the Sino-foreign JV law (implementation rules). The salaries that are paid to the workers in the JV are equal to those being paid to the workers in the Chinese parent company. This seems rather unusual since Chinese legislation suggests that JVs have to pay salaries that are 120 to 150% higher than those paid in Chinese enterprises. However, by paying equal salaries to the workforce in both the Chinese company and the JV, the Chinese parent company wants to avoid any discrimination of, and social unrest amongst, the workers. Equally, this example shows that the JV was clearly established as a product of the interests of the Chinese side. Otherwise the salaries paid in the JV would certainly be 120 to 150% higher than those paid in the Chinese company.

The remuneration of some administration staff appears rather interesting. For instance, the general manager of UK-4-JV is paid by the JV. The interpreter of the JV who also works for the Chinese parent company is paid by the Chinese company which charges approximately 50% of the costs to the JV. Personnel is somehow interwoven between the JV operation and the Chinese parent. Some work for both organisations and perhaps also for the other JVs where the Chinese company holds shares in.

#### Sourcing

At the time of the investigation, UK-4-JV had been sourcing about 30% of its parts in China. These components are, in particular, printed circuit boards and plastic

materials. The vast majority of components, mostly resistors and capacitors, had been sourced in Thailand and Japan - directly or from these suppliers' sales offices in China. The suppliers were appointed by UK-4. In cases where the JV had difficulties with supplies, UK-4 would help out and purchase them in the UK. In particular, these are special electronic components, including circuits. Their share of value accounts for approximately 15%. Since the JV exports its entire production output, it does not have to pay import duties for components purchased abroad. This would change when UK-4-JV starts targeting the Chinese domestic market. All components used by the JV are quality controlled.

In the future, the JV intends to increase its share of locally sourced components, with the permission of UK-4. However, there is no certain set value that has to be reached over the next years. The general manager of UK-4-JV reckoned that local sourcing would cut costs and transportation would be more convenient. The general manager of UK-4-JV believes that the JV could purchase from other Sino-foreign JVs in China. For instance, the Japanese enterprise TDK had set up a JV in Xiamen in South China in 1995. At the time of the investigation, UK-4-JV purchased resistors and capacitors from TDK in Japan. However, if the TDK JV's products are as good as those of TDK in Japan, "then we will purchase from them" for less a price. This would improve the company's cost position.

The managing director of UK-4 pointed out that "somewhere in the contract" there is the value of the local content set and he reckoned that it could become an issue of dispute in the future. He believed that "there will always be these 15% of supplies that need to be sourced in Europe (Belgium) because some of these 15% cannot be made in China." The non-availability of certain supplies in China is a rather common problem. At the time of the investigation and, perhaps, some time later, from a balance-of-foreign exchange point of view, the local sourcing of components is not essential for the JV since UK-4-JV's entire output is exported for hard currency that can be used to purchase components overseas. However, with regard to the JV's ambition to also develop the Chinese and neighbouring Asian markets, this might become an issue in the future.

#### Target market

Due to the original intention of the managing director of UK-4 to engage in a contract manufacturing agreement, UK-4-JV had not been targeting the Chinese market so far. In other words, the entire output of the JV had been shipped over to the UK. The contractual agreement provides for UK-4 to buy the entire output from the JV.

Recently, however, UK-4 and its JV managers have been undertaking efforts to also look into the development of the Chinese market and other markets in East and Southeast Asia. For that, Hong Kong, where the Chinese partner company has an office, would be used as a marketing and distribution basis. The Chinese partner would be in charge of marketing and selling into China and neighbouring markets. The proposed and planned expansion into the markets of Southeast Asia was hoped to double the JV's production.

### ***Joint venture ownership***

The UK and Chinese side agreed that it would need about US\$170,000 (£108,974) to keep the business going. Further, the parties were very clear about the distribution of equity: the Chinese wanted to have the majority stake in the business and UK-4 was happy with a minority position. Eventually, the JV's equity was split two thirds - one third. Since UK-4 had no intention of opting for a JV in the first place, its minority position was welcomed. The explanation of the Chinese parent company for having the majority stake in the JV was "because Mr. NAME is the chairman." The Chinese interviewees had not been prepared to reveal neither the total investment in the business, nor the distribution of the equity. Contractually, UK-4 could increase its share in the JV. However, "if the English party wants to have more shares, it has to send a person to China." This, however, seems very unlikely, for the reasons outlined above.

### ***Joint venture control***

In the case of UK-4-JV, the equity distribution clearly reflects on who has control of the JV. The BoD has five members. Three are from the Chinese partner company and two are from UK-4, ie the managing and sales directors of UK-4. The Chinese side had appointed the chairman of the JV. In personal union, he is also the chairman of the Chinese partner company. The Chinese side is in charge of production, management of the entire company and of technology. The managing director of UK-4 is responsible for the marketing of the JV's products and for new product development.

The BoD of UK-4-JV meets once a year for about two days either in the UK or in China. Both parties in the JV have contractually agreed that, for major decisions to be made regarding the JV's investment or management appointments, etc., the managing director of UK-4 has to agree. To ensure effective communication between the parties in the JV, UK-4 and its Chinese counterpart have established a system of telefax communication in the English language. Once a year, the managing director of UK-4 receives the JV's income statement, sales figures, balance sheet as well as profit and loss account. According to the managing director of UK-4, the Chinese directors are

familiar with western accounting practices. "They have to be," he said. However, the fact that Chinese managers "have to be" familiar with western accounting practices does not necessarily mean that they are, as is the case in many Sino-foreign JVs. The managing director's over-confident statement appears thus rather naive. Initially, however, the JV had sent an account report to the UK monthly. Since the companies did not have any problems with the reporting procedure, the frequency of sending the accounts was reduced. The accounts are set up by the venture's accountant and are checked once a year by the 'Accountant Commission CITY [East China]'.

"Mr. NAME and I get on well, we know our business very well. We are in business for a lot of years now. We agree on numbers, exchange faxes and try very hard to have an idea what business will be like," the managing director of UK-4 pointed out. To ensure unproblematic communication, the JV pays for the services of the Chinese partner company's interpreter, since the UK manager does not speak Chinese.

#### ***Joint venture management***

The general manager of the JV was appointed by the Chinese side and so was the vice-general manager. The general manager's job is the daily work of the JV such as the import/export of components, the management of the workshop and the quality assurance of the ELECTRONIC DEVICES. The general manager of UK-4-JV is an engineering graduate from a Chinese university and he had been working with the Chinese parent company for six years. Prior to his general manager appointment he was equipment manager in one of the group's companies. Since UK-4 did not intend to send a manager to China for the reasons outlined above, the appointment of the Chinese general manager was not objected by UK-4, but welcomed.

At the time of the investigation, UK-4 had not expatriated personnel to its JV in China and there were no plans for doing so in the future. The Chinese side would require UK-4 to send a manager from the UK if it was to increase its share in the JV. This, however, is very unlikely since the UK SME sought its JV with the local Chinese company solely to manufacture cheaply and thus cost-competitively to withhold the increasing competitive pressure in its niche.

#### ***Joint venture problems***

At the time of the investigation, UK-4 had no serious problems with its JV in China that the managing director of UK-4 considered worthwhile talking about. To a very large degree, this is due to the entire constellation of the partners and their interests in the JV. UK-4 sought a cheap way of producing its ELECTRONIC DEVICES and found this

in its JV partner. The managing director is required only once per year to go to China or even less if the Chinese side comes to the UK for the board meeting. Inter-personal problems did not exist at the time of the investigation. Moreover, between the partners there existed also a private relationship beyond the pure business ties. All this contributed to the fact that the JV was exposed to only little potential of collision, etc.

### **Joint venture evaluation**

#### ***Joint venture performance***

The interviewees, both the Chinese directors and the managing director of UK-4, did not release information on the JV's turnover in the financial year 1995. However, it was indicated that orders had grown approximately 10% in 1996 compared with 1995. Both parties showed satisfaction with their JV, though they did not quantify this. The Chinese partner repeatedly expressed its satisfaction with the performance of the JV, referring to UK-4-JV's profitability. The Chinese directors added another criteria for their assessment of the venture's performance. "We made a lot of friends and friendship between two countries."

## **Case Four: UK-8-JV**

### **Basic facts about UK-8**

UK-8 was established as a limited liability company. It is based in Northeast England. It had been engaged in the manufacture and installation of ROAD INFRASTRUCTURE PRODUCTS since its establishment in the early 1980s. In the UK, the SME holds about 80% of the market for ROAD INFRASTRUCTURE PRODUCTS. At the time of the investigation, UK-8 employed 90 staff in its operation in the UK.

### **International business activities**

Apart from its activities in China, at the time of the investigation, UK-8 was involved in business in Russia, Eastern Europe, the Middle East and countries in the Asia-Pacific region where it exports ROAD INFRASTRUCTURE PRODUCTS and later supervises their installation by local labour. In the past, the company had successfully completed projects in Hong Kong, the United Emirates and Pakistan. As much as 5% of its 1995 turnover was generated abroad and for 1996 the figure was similar, whereas for 1997 and 1998 both the managing and technical directors of UK-8 expected an overseas turnover share of 10 and 20%, respectively. Apart from its JV in China, UK-8 has only recently bought a 50% share in a Singaporean enterprise. In addition, UK-8 has two agents in Hong Kong and one in Dubai acquiring business on behalf of the UK SME.

## **UK-8's China experience**

Prior to its commitment in the JV in China, UK-8 was not involved in any kind of business with, or in, China. In 1992 the Chinese were searching the world markets for suitable ROAD INFRASTRUCTURE PRODUCTS "since there is a phenomenal amount of work in terms of infrastructure to be carried out in China." Without the approach by a Chinese delegation in the first place, the UK SME would not have been targeting the Chinese market at all.

## **Joint venture formation**

### ***Joint venture planning***

The SME considered the Chinese government's infrastructure modernisation plans as a huge potential for its products and services. UK-8 had all this information about the potential market for its ROAD INFRASTRUCTURE PRODUCTS obtained from its later partner. The company did not carry out any form of research into market opportunities in China itself. Instead, it relied entirely on the input from the Chinese partner company, though the managing director of UK-8 insisted that he had made enquiries into the potential of the market and its competitive situation when UK-8 was separately involved with a potential Chinese client to export and install ROAD INFRASTRUCTURE PRODUCTS.

### ***Motivations for production in China***

#### **Motivations to engage in an FDI project**

UK-8 saw great potential for its ROAD INFRASTRUCTURE PRODUCTS in the Chinese market. The UK SME had estimated approximately 100,000 kilometres of roads and bridges that are to be built in China over the next years. (As a matter of fact, by the year 2000 China plans to build another 110,000 kilometres of roads, 6,000 kilometres of which will be expressways, while 60% of the roads will be in the centre and west of the country (FT, 23.9.97, p.6). The unique characteristic of UK-8's ROAD INFRASTRUCTURE PRODUCTS is their ability to absorb the shock from traffic and guarantee a smooth running surface to accommodate thermo-movements. However, once they are broken, they need to be replaced in order to prolong the life of a bridge. In this respect, UK-8 was aiming both at the market for new ROAD INFRASTRUCTURE PRODUCTS as well as the market for their replacement. At present, there are several hundred kilometres of bridges in China and over the next ten years or so they all need to replace their broken ROAD INFRASTRUCTURE PRODUCTS. Apart from this, the ambitious efforts of the Chinese government to modernise the country's infrastructure are seen as being a huge potential for UK-8-JV.

The practice in China had been that, if repair works were carried out, bridges were closed and since the operator of a bridge charges customers for using it, this meant a loss of income for a considerable period of time. The installation of UK-8 expansion joints, however, would allow an operator to keep the bridge open while replacing the broken ROAD INFRASTRUCTURE PRODUCTS. This was also the reason for the Chinese company to seek collaboration with the UK SME.

The Chinese company that was to become UK-8's partner argued that the Chinese market needs the more sophisticated ROAD INFRASTRUCTURE PRODUCTS for the reasons above. However, importing the products was regarded as being too expensive and making the product thus not competitive.

The Chinese company that was to become UK-8's later partner in the JV, had approached the UK department of trade and industry (DTI) to find out which companies would produce ROAD INFRASTRUCTURE PRODUCTS that could be used as replacements in existing bridges (a German company offers ROAD INFRASTRUCTURE PRODUCTS that are used for bridges under construction and there are about 12 companies worldwide that are considerably active in the specific industry). Eventually, the DTI identified UK-8 as matching the Chinese company's desired profile.

Subsequently, the Chinese company sent a delegation to the UK after approaching it in the first place. The Chinese delegation spent three days with UK-8 and visited various sites where UK-8 had previously installed its joints systems. Subsequently, UK-8 went on a trade mission to Hong Kong and from there to Beijing to progress discussions. UK-8 accepted the approach by the Chinese to engage in an FDI project in the country. This was mainly due to reasons of low labour costs that would be advantageous for the company and so help develop the Chinese market.

#### Motivations to form a joint venture

UK-8 did not further pursue the idea of setting up a local manufacturing facility on its own without the participation of a local partner since "it would be simply impossible to do this alone." As reasons, both the managing and technical directors of UK-8 suggested the language problem and the different business environment in China. "We had no idea of how to conduct business in the construction industry in China." UK-8's Chinese partner was already established as one of the biggest companies in China specialising in road furniture. Further, UK-8 did not have the necessary resources, financial and managerial, to pursue the idea of going it alone.

All of UK-8-JV's potential business goes through the authorities of the Chinese Ministry of Transport. The responsibility for the construction of road infrastructure rests within so-called 'express way companies' at the level of provincial, municipal and independent regions. 'Express way companies' place orders with the construction companies that build the express ways. From the Chinese national planning bureau UK-8-JV obtains information about the express ways to be constructed, including the total value of the projects, the constructor and calculated period of construction. Subsequently UK-8-JV acquires details about the designer and builder of an express way. From the design company UK-8-JV obtains detailed information about the project; for instance, the type and size of the ROAD INFRASTRUCTURE PRODUCTS that should be used and the volume of a potential order. Eventually, UK-8-JV introduces its product to the design company and tries to convince the designer to base further drawings, etc. on the specifications of UK-8-JV's systems.

From this, it becomes clear that UK-8 needed the Chinese element in its operation in the new market which can facilitate contacts to, and relationships with, Chinese authorities and potential customers.

### ***Partner selection***

#### Finding the partner

In the case of UK-8 it was the initiative of a Chinese enterprise to find a western partner company to team up with in a JV. Would have the Chinese company not approached UK-8, a JV would not have been established and also the entering of the Chinese market would not have happened. Thus, the choice of the later partner was somewhat pre-determined in this case.

From the very beginning of its JV operation UK-8 was certain that having a suitable partner was 'very important'. When attempting to identify alternative partners, the UK SME faced considerable obstacles. It simply did not know where to look at and whom to approach.

#### Partner selection criteria

UK-8 insisted that the Chinese company that had approached the UK SME initially met approximately 80% of UK-8's partner requirements. One of those was certainly the Chinese partner's reputation as a manufacturer of ROAD INFRASTRUCTURE PRODUCTS and the fact that it would have contacts and credibility in the market and amongst customers since these criteria were considered important for UK-8-JV to further develop the Chinese market for ROAD INFRASTRUCTURE PRODUCTS.



Eventually, the UK SME decided to join forces with this particular Chinese enterprise. However, it is not clear whether the decision resulted from the difficulties experienced when searching for alternative partners or the actual assessment of the Chinese partner company. Instead, this remains subject to speculation.

### ***Partner characteristics***

The Chinese partner company in UK-8-JV is a SOE, based near a provincial capital in China's remote area. The SOE was established in the early 1960s and is directly controlled by the Chinese Ministry of Communication. The Chinese company manufactures machinery for the road and bridge construction industry. According to the managing director of UK-8, its Chinese partner "basically builds bridges and manufactures bridge furniture." The managing director of UK-8 suggested further that the Chinese partner would be a 'very large' SOE with in excess of 1,000 employees. As a matter of fact, the Chinese enterprise had a workforce of 1,200 employees, as discussions with the Chinese general manager of UK-8-JV revealed.

The managing director of UK-8 had obtained most of the information about the SOE from the company itself. However, some details about the Chinese partner were obtained also from another European company that had done business with this particular Chinese company before. Information on the actual turnover volume of the Chinese partner was not released by the Chinese side and not known by the UK SME.

### ***Joint venture negotiation process***

#### Negotiation contents and conflict

Part of the deal between UK-8 and the Chinese partner enterprise was to manufacture ROAD INFRASTRUCTURE PRODUCTS in the JV in China. All components but one should be purchased and produced locally. The one, chemical, component of the system, however, should be delivered by UK-8. This chemical component absorbs the shock of the traffic when it hits the ROAD INFRASTRUCTURE PRODUCTS and was considered an essential one for the uniqueness of the whole product. The formulation of this component was regarded as a secret by UK-8 and the SME was not prepared to release its formulation know-how since "the Chinese are notorious for copying." Although this fact was discussed by the partners in the negotiations, the exclusion of this special component from the production programme was not so much of a problem for the Chinese. "They accepted it," said the managing director of UK-8.

UK-8 and its Chinese partner also negotiated issues such as cost implementation and the business plan for the JV. UK-8 further insisted on the importation of equipment for the manufacturing and installation of ROAD INFRASTRUCTURE PRODUCTS since

the efficiency and quality of such machines were higher. The Chinese agreed to that although UK-imported equipment would cost about five times that of comparable equipment made in China. About 95% of the machines and equipment were new when they were bought. The UK SME apparently had a strong bargaining position. Due to its firm-specific advantage of being able to replace ROAD INFRASTRUCTURE PRODUCTS without closing the individual bridge, UK-8's collaboration was strongly desired by the Chinese company. Of approximately a dozen international firms that operate in this industry, the Chinese chose to invite UK-8 to joint venture. Apparently, the Chinese partner company recognised the importance for the JV to operate with sophisticated equipment and thus agreed to import the more expensive UK equipment.

Not giving the knowledge about the formulation of the special component away was very important for UK-8 since, without the knowledge about this certain component, the current Chinese partner could not really become a potential competitor of UK-8.

The partners agreed to a JV contract duration of 12 years with the possibility of an extension, subject to the mutual agreement of both parties with application to MOFTEC six months prior to its expiration.

SME negotiation team, location, duration, language of negotiations, interpreters

Negotiations were carried out, basically, between three parties both in China and in the UK: UK-8, the Chinese partner company and a Chinese commercial organisation based in Beijing (China Guangda Foreign Trade Company). UK-8-JV was negotiated, initially, by the managing director of UK-8 and later, "once we knew which route to take," he delegated this job to the technical director who went to China to get ROAD INFRASTRUCTURE PRODUCTS installed on-site. The Chinese side had sent four members, including the director of the company, its vice-director, the chief engineer and the sales manager. The composition on the Chinese side changed throughout the negotiation process. Whereas the sessions in England were attended by the director, the chief engineer and the deputy-chief engineer and the sessions in China by the deputy chief engineer and the sales manager, the director and the vice-director since the chief engineer had retired in the meantime. Of China Guangda Foreign Trade Company, one manager attended the meetings; he also took over the role as interpreter. Negotiations were held in English and it was interpreted for the Chinese directors who did not speak English.

Negotiations required four meetings between the partners with each session lasting for about three to four days. Initially, the managing director of UK-8 was involved in negotiations and later, "once we knew which route to take," the technical director of

UK-8 went to China to get ROAD INFRASTRUCTURE PRODUCTS installed on the spot. Then negotiations progressed. The Chinese side prepared the business plan and all the financial issues and UK-8 reviewed it. Since UK-8 had been separately involved in acquiring ROAD INFRASTRUCTURE PRODUCTS business in China (this was a 110 kilometres road project of which 40% were bridges), the company had a basic understanding of the issues the Chinese partner put in the business plan. For instance, this gave UK-8 insight in the potential of the market so that it had not to rely entirely on the information input from the Chinese side.

Subsequently, the contract was signed in the UK and approved on 22. January 1995 by MOFTEC and the business licence was issued by the Administrative Bureau for Industry and Commerce in Beijing - after approximately two years of preparations and negotiations, whereas nine months were planned.

The negotiation of the JV was difficult, very time consuming and expensive for UK-8. The SME first had to install successfully one of its ROAD INFRASTRUCTURE PRODUCTS in China and had to get this approved by the Ministry of Transport. "Regardless in which country, the equivalent of the UK department of transport has to approve our product before it can be used," the managing director of UK-8 made clear. Only then could the JV be approved by the authorities. In March 1994 the Chinese partner came to the UK and the JV was agreed in principle. From then, discussions were carried out in China. Eventually, the JV was established in March 1995.

The managing director of UK-8 considered the negotiation process of the JV as very long. For the SME the language barrier was a grave problem. "Everything had to be discussed through interpreters. Thus, everything took so much longer to negotiate." This was regarded as very difficult by the managing director of UK-8. It meant a considerable financial and managerial burden for the UK SME when, for instance, the technical director had to go over to China to carry out this task.

#### Factors for successful negotiations

The managing director of UK-8 considered as factors for successful negotiations to build up trust between the parties. "Otherwise there will never be a deal to sort things out." He stressed that "there is no use in establishing a JV without trusting the partner." For UK-8 trust played an important role since "the Chinese would control the JV," in which UK-8 was the junior partner.

#### ***Partner contributions***

##### SME's contribution

To the total investment in the JV of some RMB10.5m (£0.77m) UK-8 contributed cash, the product and technology to produce and install ROAD INFRASTRUCTURE SYSTEMS. Its contribution was worth RMB5.15m (£0.38m).

### Chinese partner's contribution

The Chinese contribution was in the form of cash and knowledge of the local business community, contacts, etc. Also, the Chinese partner was responsible for staffing the JV. The Chinese partner's knowledge of the business environment, contacts and links to officials was very important for the UK SME. The evaluation of the partners' contributions was not a problem for either side. "The Chinese established the figures and we were happy with this," the managing director of UK-8 said.

## **Joint venture operation**

### ***Joint venture background information***

#### Joint venture establishment, total investment and workforce

UK-8-JV was established as an equity JV in the form of a limited liability company, according to Chinese law, on 2. March 1995. The total investment in the JV accounts for US\$1.2m (£0.77m). At the time of the investigation, UK-8-JV employed 54 staff.

#### Joint venture location

Basically, UK-8-JV operates at two different locations: it is headquartered in the centre of CITY, a provincial capital in South China. There, UK-8-JV has rented office space in the sixth floor of a Chinese state-owned hotel. Accommodating offices in hotels had been rather common in China since demand for office space exceeded supply in the early 1990s. The three-room office is used, mainly as headquarters and as the basis of the marketing and sales department. The production facility of UK-8-JV is located in a village about 40 kilometres off central CITY [South China]. By car it takes about 40 minutes to get there from central CITY [South China].

#### Choice of location

UK-8 had chosen CITY [South China] as the location for its JV for several reasons, including

- the potential market of the developing city and province,
- its proximity to a major port of the country which makes the supply of the special chemical component convenient, fast and cheap,
- its lower production costs,
- its availability of trained labour, though at the time of the investigation, the majority of UK-8-JV's staff was seconded to it from the Chinese parent company,<sup>5</sup> and finally
- that it was easier to get the licence for the JV there since CITY [South China] itself is located in one of China's five special economic zones. According to the

general manager of UK-8-JV, there was no special treatment in terms of taxes, compared with other economic development areas, though it was especially tax concessions that were a reason for choosing CITY as the location for the JV, according to the managing director of UK-8. However, the tax treatment in special economic zones is no different from the tax treatment in other development zones in the case of an enterprise, such as UK-8-JV. If the managing director of UK-8 had thoroughly investigated different locations, he would have known of the similarity of tax concessions in the various development zones all over China.

#### Production site

The factory in the village near CITY [South China] is a typical green field site establishment. The construction of the factory commenced approximately at the end of 1994 and it was completed at the end of 1995. The entire site comprises, in principle, three major buildings: the workshop, an office and accommodation as well as a warehouse building. The accommodation building had to be erected since the workforce of UK-8-JV came from the remote province where the Chinese parent company is located.

The production site was built by the Chinese partner company. UK-8-JV only rents parts of the factory complex from its Chinese parent company, whereas the other parts of the factory are used by the Chinese company itself. The Chinese parent gets monthly reimbursement.

#### Product range

At the time of the investigation, UK-8-JV manufactured only one type of ROAD INFRASTRUCTURE PRODUCTS, though in the future another type would be introduced that is to be produced in UK-8's (new) Singaporean plant.

#### Production

For the manufacture of the ROAD INFRASTRUCTURE PRODUCTS the JV needs, basically, two types of components which are both manufactured from steel in the JV's workshop. Afterwards, the two components are welded together, sprayed and stored in the factory. The finished ROAD INFRASTRUCTURE PRODUCTS are then transported to the road building site where they are used for installation. At the time of the investigation, UK-8's expatriate manager supervised the installation process which was carried out by local Chinese workers.

At the time of the investigation UK-8-JV did not have an ISO certificate. However, there is a Ministry of Communication standard which has to be met, "in order to be able to sell our product." In the UK, the equivalent is the Ministry of Transport. Though UK-8 holds the ISO certificate, in China, the implementation of ISO had, at the time of the investigation, just started to be talked about.

#### Sourcing

Overall, UK-8-JV uses a variety of components for both the manufacturing and the subsequent installation of the joints. As outlined above, UK-8-JV sources, apart from a special, chemical, component all its supplies locally in China. According to the business plan of UK-8-JV, 15% of the costs for one unit (= one metre) of finished ROAD INFRASTRUCTURE PRODUCTS is labour content and as much as 85% is material content. Thus, the local sourcing of components and materials in China is economically advantageous and thus pursued by the business.

Originally, in terms of value, the share of imported supplies, at the time of the investigation, accounted for some 70% with the remaining 30% being locally sourced. 25% thereof (= certain steel components) are purchased from the Chinese partner company, as it was contractually fixed. The remaining 5% (= very simple components and materials) were sourced from a local Chinese supplier based in CITY [South China]. In the meantime, the JV has also started purchasing rubber components in China (from its Chinese parent), instead of importing them from the UK for a higher price. In the future, the share of components (by value) shipped over from the UK will be reduced to 50% even. Then, 45% will be sourced from the Chinese partner and 5% from another local supplier. Recently, the price of the special, chemical, component that is sourced in the UK, was reduced in an attempt to help the JV operate more cost competitive. Equally, this reduced the share of value of goods imported to the JV.

Problems with local sourcing had, by the time of the investigation, not occurred. Although the quality of Chinese steel is lower than that of foreign, for example Japanese, steel, it is sufficient for road steel and can thus be used without a limitation.

#### Target market

With its ROAD INFRASTRUCTURE PRODUCTS, UK-8-JV targets the Chinese market exclusively. This was fixed in the JV contract. However, subsequently, other markets in the region will be serviced and even the exporting back to the UK of certain components will be considered. This is especially finished steel components that the JV wanted to export back to the UK starting in 1997. There is no definite export ratio fixed in the JV contract. Instead, UK-8 managed to satisfy the Chinese authorities with

a “we will try” phrase that will not result in financial ‘punishment’ in case a certain ratio cannot be met in an individual year.

The Chinese Ministry of Communications is in charge of all planning and management of China’s transportation infrastructure. In China’s provinces, autonomous regions and municipal cities, express way companies are responsible for the construction of road infrastructure. The express way companies give orders to construction companies that subsequently build the express ways.

The general manager of UK-8-JV explains how the acquisition of orders works - in the case of the province, where CITY [South China] is the capital of: the JV gets information about the express way to be constructed from the Chinese national planning bureau. This is information about the total value of the project, about who is going to construct it and how long the project would take. In a next step UK-8-JV finds out who is in charge of designing and building the project. From the design company, UK-8-JV gets more information about the project, for instance, what types of ROAD INFRASTRUCTURE PRODUCTS will be used, the size of such products and the volume of the potential order.

With this information in hand, UK-8-JV introduces its product to the design company and tries to convince the designer to base further drawings, etc. on UK-8-JV’s ROAD INFRASTRUCTURE PRODUCTS. “If they are interested in our products then they will recommend our joints to the construction contractor, who builds the bridge,” the marketing manager of UK-8-JV suggested. The JV further needs to make suggestions to the construction company that builds the express way, because the builders care about price of the product and its longevity. Eventually, it is the building company and the designer that make a final decision.

As means of promoting its products, the JV applies symposiums where existing as well as potential customers (people in charge of the construction of express ways) are invited. Very important for the JV to get orders is also the word-of-mouth recommendation to potential clients by satisfied customers. Although UK-8-JV had been, at the time of the investigation, operating in China for only about two years, and the ROAD INFRASTRUCTURE PRODUCTS are a new type of product in China, the company had already several successful reference projects in the country. This makes it easier for potential customers to accept the JV’s product. The majority of these reference projects were installed in the ‘home’ province of the JV in South China. The

first type of reference project for the North of China was, at the time of the investigation, being installed and a lot of attention was being paid to it.

If UK-8-JV's first project in the North of China worth some RMB400,000 (£29,674), could be successfully installed to the entire satisfaction of the client, a construction company based in North China, the project would eventually open this northern market for UK-8-JV since most of the construction companies are in contact with each other. On the other hand, if UK-8-JV could not satisfy its client, it might be difficult the next time to get another order.

#### Market share in China

The majority of projects UK-8-JV had installed by the time of the investigation, are located in CITY [South China]. There, the company has a market share of about 20%. "For other markets it is difficult to say," the marketing manager pointed out.

#### ***Joint venture ownership***

Of the total investment in UK-8-JV of RMB10.5m (£0.78m), UK-8 holds a 49% equity share. Initially, UK-8 wanted to obtain the majority share in the venture, but the Chinese side objected to the UK SME's desire for the majority and even for an equal equity share in the JV. UK-8's bargaining position was not strong enough to push this through. Eventually, UK-8 accepted the minority share. "We are happy with 49%," said the managing director of UK-8.

#### ***Joint venture control***

The BoD of UK-8-JV has five members and the number of seats in the BoD is distributed according to the equity distribution: the Chinese side holds three seats, the UK side two. On the Chinese side, BoD positions are held by the Chinese general manager of UK-8-JV as well as by the managing director and deputy managing director of the Chinese parent company. On the UK side, positions are held by the managing director and the joint managing director of UK-8.

In the JV the Chinese side is in charge of administration and the commercial issues, whereas UK-8 oversees the technical side and, thus, expatriated one of its employees to look at the technical side and supervise the installation of ROAD INFRASTRUCTURE PRODUCTS.

The BoD of UK-8-JV meets once a year. Board meetings are held alternately in CITY [East China], in the UK and in CITY [remote China] where the Chinese parent company is located. In total, UK-8 managers go out to China three or four times a year. Very important decisions are made by the board members, including which



components are to be sourced where. By the time of the investigation, UK-8 had not experienced problems with joint decision-making.

### ***Joint venture management***

The Chinese side had appointed the general manager of UK-8-JV. This was not an issue of conflict between the two parties in the JV. The general manager is responsible for the day to day operations of the JV. Prior to his commitment in the JV, the Chinese manager was assistant director with the Chinese partner company, in charge of worldwide sales. The general manager's permanent office location is in central CITY [South China]. Three times a week he visits the workshop to supervise production.

Since the entire management of the JV is in Chinese hands, there is no conflict in decision-making styles, etc. that would be worth investigating for the purpose of this study. Also, the weight of the expatriate installation supervisor is rather weak and he has to report to the general manager.

At the time of the investigation, UK-8-JV employed one expatriate. He was sent over from the UK parent company for a duration of three years. The British citizen who had been working with UK-8 for the past 15 years, supervises the installation process of the bridge expansion joint systems on the spot. However, his contract is to expire after three years and UK-8's expatriate replacement, an engineer, is to work alongside the JV's management and to help boost domestic sales also. The Chinese side agreed that the JV would need more help to increase domestic business.

Currently, UK-8-JV covers approximately 60 to 70% of the costs of the expatriate, the rest is paid for by the UK SME. Although it is important for UK-8 to retain an expatriate in the JV since "otherwise we could lose it altogether," costs of one expatriate are about 40 times that of a local employee. The expatriation of UK personnel is thought about very carefully since it is an imposition of a high financial burden for the SME.

### **Joint venture problems**

#### Production

The managing director of UK-8 considered the quality aspect of the JV's ROAD INFRASTRUCTURE PRODUCTS as potentially problematic for the future. If the quality of the products is not up to standard, this could damage the reputation of the company. "Everyone gets a first order. But if the customer is not satisfied with the quality, you will not get another one."

Only if the quality of the work completed is recognised as such, UK-8-JV's ROAD INFRASTRUCTURE PRODUCTS would be specified for more projects by the respective Chinese ministry. Thus, UK-8-JV planned to get its operation ISO approved.

#### Local sourcing

The known problems of local sourcing, including insufficient quality of supplies, unreliable suppliers and limited supplies had not been experienced by UK-8-JV.

#### Sales and marketing

According to the managing director of UK-8, the JV has various problems with respect to marketing and sales. "Their method of marketing pisses us off." In the UK, UK-8's ROAD INFRASTRUCTURE PRODUCTS system has approximately 70 to 80% of the market and in China the company is still struggling to develop market share. "We expected more, a bigger share of the market. This is bad salesmanship." It is important for the JV to have reference projects in various places of the market. Only so can potential customers inspect the quality of UK-8-JV's products and be convinced to place an order with the JV.

Though the managing director recognised the importance that price plays in the business in China, "we do not see that the market is all about price." He criticised the passive approach of the JV's management towards the acquisition of new business in the Chinese market. "They do not really look for the repair market to solve an engineer's problem. They cannot go to prospective clients. They have not got the expertise, the knowledge."

#### Price

The ROAD INFRASTRUCTURE PRODUCTS of UK-8-JV do not only have a life expectation of some 15 years, which is at least three times higher than that of common Chinese products, and the quality of the products is the best, according to the marketing manager of the JV, the price of the JV's products had been nearly twice as much as that of its main competitors - a private Chinese and a US company. Only recently could the JV reduce the cost of the product (the special component supplies were made cheaper) and now the price is 1.5 times higher. However, since the Chinese government is short of money, price is a major issue when negotiating the sale of the JV's products. At the time of the investigation, only the province where the JV is based, and the province in North China could, or wanted to, afford these expensive ROAD INFRASTRUCTURE PRODUCTS.

#### Communication

Originally, UK-8 had faced some communication problems with the JV's management. The UK SME wanted to receive monthly reports to better be able to monitor the progress of the JV. However, the JV management did not provide reports on a monthly basis. It was prepared only, or could manage, to send them every three months.

The new expatriate manager who UK-8 is about to send to China to replace its installation supervisor, will work, together with the JV management, on establishing an accounting system. Perhaps then will the JV send its monthly reports.

## **Joint venture evaluation**

### ***Joint venture performance***

Neither the general manager of the JV nor the managing director of UK-8 were satisfied with the JV's performance in 1995. "It could be better. It was not as laid out in the business plan." A reason was certainly that building works in the factory had just finished and the JV could only then start properly to conduct business.

In 1995, instead of 5,000 metres of ROAD INFRASTRUCTURE PRODUCTS, only 1,941 metres were produced and installed. According to the general manager of UK-8-JV, the reason for this considerable discrepancy was that both partners' pledged contributions arrived too late at the JV which meant, for the JV, that it could not carry out all the necessary preparations, ie going through all procedures, including the collection of relevant stamps for getting the business approved.

The managing director of UK-8 was convinced that the JV would "run a lot better from now on." For 1996, he expected a turnover of some RMB16.0m (£1.2m), RMB27.0m (£2.0m) in 1997 and RMB40.4m (£3.0m) in 1998. Later projections by the managing director of UK-8 suggested a turnover in 1997 of US\$7.0m (£4.5m) even that would be very likely to be achieved.

The supply of components to the UK-8-JV, at the time of the investigation, contributed some 5% to UK-8's overall earnings and in 1998, the UK SME will ship some 100 tonnes of the chemical component to the JV, similar to the amount that is used by UK-8 at home.

The high price of the JV's products compared with those of competitors' is the main obstacle, according to the general manager of UK-8-JV, for achieving high sales volumes, despite all its advantages (easy installation, longevity, etc.) - apart from the economic situation in China, of a China that does not spend enough money on infrastructure projects. "At the beginning we had a lot of difficulties to market our products. After a lot of hard work, sales have increased steadily."

## Notes

<sup>1</sup> Market potential [chemical industry: £6.09m; shipping: £3.66m; power generation: £1.23m; textiles: £1.83m; pulp: £2.43m; aviation: £2.43m; agriculture: £4.85m; automotive: £3.02m; pharmaceutical: £1.83m; mining: £2.43m; petrochemical: £12.77m]; Location of potentials [Northeast China: 20%; East China: 25%; North China: 10%; Northwest China: 10%; Central China: 10%; Southwest China: 15%; South China: 10%.

<sup>2</sup> This is in contradiction with information in GER-0's newsletter (GER-0 Newsletter, January 1996) which suggests that GER-0 had prepared nearly 3,000 transparent and 1,400 paper copies.

<sup>3</sup> Note: this includes the entire overhead.

<sup>4</sup> Add-on: insurance: .12; housing fund: .20; health care: .07; welfare: .07; labour union fee: .02). For details on add-ons see Kaiser and Grimm et al. (1997). Further: at the beginning of the Winter, GER-0-JV buys hand cream for staff or drinks in the summer; or sends wives of employees to the hospital for preventive surgery. GER-0-JV provides also apples or peaches according to what is currently harvested. Additionally, one or two times per year, GER-0-JV covers the cost of the hairdresser or provides the company car when staff gets married and buys presents or lets staff take two days off if they move houses. Further, when family members of employees are ill, employees are allowed to stay at home to look after them.

<sup>5</sup> Perhaps the availability of trained labour is important for the future development of the workforce.

