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Global Alliances: The Secret of Size

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In China and elsewhere, your best joint venture partner may not be the obvious one

The chief obstacle to global expansion cited by U.S. middle-market companies is lack of knowledge about international markets, according to a study by the Economist Intelligence Unit (EIU). One mechanism for alleviating that handicap and overcoming “the liability of foreignness” is a strategic alliance with a local firm. More than half the companies surveyed by the EIU planned to use cross-border alliances to enter international markets.

Too bad that, as a rule of thumb, roughly half of international joint ventures fail.

That dispiriting statistic includes many large corporations that possess expertise, experience, and infrastructure for managing such alliances. Yet things still go wrong, resulting in losses both tangible (money) and intangible (reputation). By virtue of their limited resources and lack of experience, middle-market companies are more vulnerable than their large counterparts both to failure and to the shocks resulting from those failures. And because their bargaining power tends to be weaker than that of their partners, they are more likely to be exploited by unscrupulous partners or government agencies.

Yet middle-market companies play a vital role in the global economy: a role destined to grow. The U.S. government will be hard-pressed to achieve its goal of doubling exports within five years without the active participation of such firms, which will have to launch or ramp up their export and foreign direct investment activities. And with growth slower here than in emerging economies, and international competitors staking out domestic turf, executives will find the prospect of fresh, hungry markets to be irresistible.

So middle-market companies have to get cross-border alliances right. Some of the most critical questions relate to size. How big a company should you partner with? And what scale should the joint venture be? The answers to those questions are not what most executives expect. This article was written to help firms avoid the most common mistakes.

We chose to focus on China because it is increasingly important to the world economy; is home to hundreds of thousands of alliances; and is one of the most challenging investment environments for foreign businesses. Respondents to the EIU’s survey also designated China their top investment priority. But bear in mind that China has distinctive challenges, including a non-democratic political system that is a major player in the national economy; a high level of corruption, and widespread, intellectual property-rights violations. As a business case it is instructive but not representative.

The chief lesson from China is that middle-market companies should choose partners that maximize what they need from a joint venture: access and resources.

THE FALLACY OF THE FAMILIAR

In international joint ventures, comparably sized companies naturally gravitate toward one another. There's comfort in working with an organization whose strategic, organizational, and managerial behavior are similar to your own. Companies of comparable sizes are also more likely to have comparable cultures and levels of bureaucracy. Given the unfamiliarity of the terrain and the complexities inherent in joint ventures, common ground is welcome.

Priorities and power are also an issue. Two middle-market (or two large, or two small) companies are more likely to assign the same importance to the joint venture, reducing the possibility of conflict and assuring adequate attention paid to it. Comparable size will also likely translate into balanced bargaining positions. That means the U.S. company worries less about having its interests steamrollered by a larger partner.

Reassuring as those similarities are, middle-market companies don't form joint ventures for comfort. They form them to successfully gain a foothold in new markets. For that reason, middle-market firms are better off with large local partners. Other things being equal, research shows that organizational size contributes to economies of scale, market power, and organizational image. Moreover, greater size implies higher capability to reduce risks and mitigate uncertainty.

Put simply, large companies deliver access and resources. Particularly in emerging economies, large players will likely have connections to key government agencies, which translate into favorable policies and incentives. They will have better access to local markets. And they will have significant expertise in how to modify goods and services for those markets.

In China, of course, large firms are often equated with state ownership. State-owned enterprises bring to the table access to bank financing; influence with customers also owned by or dependent onthe state; protection from some forms of competition; and favorable taxation policies—for example, VAT rebates. All those factors can materially affect the performance of an international joint venture.

So on balance, partnering with a large firm is the better choice. But there are caveats. Large local firms are often in better bargaining positions than their smaller U.S. partners. Collusion between state-owned enterprises and local regulators can leave middle-market companies with little recourse. In the case of an unauthorized technology transfer from the joint venture to a large local partner, for example, the U.S. middle-market partner would have a tough time appealing to the authorities or seeking other remedies. Middle-market firms should study the risks of such alliances and determine whether they can be mitigated.

Another concern for mid-sized companies that partner with large firms is information-sharing, which is essential for joint-venture success. But sharing is hard to accomplish when companies of two different sizes work together--more so when the parent firms hail from different countries. Middle-market companies should try to open direct communication channels with their large partners, although lack of dedicated alliance offices or, at least, experience and expertise, may make that difficult. They can also increase the national and cultural diversity of their boards and senior management teams. Such diversity will continue to pay dividends as these firms intensify their globalization efforts.

WHERE HEFT MATTERS LESS

What works for the parents does not necessarily work for their offspring. We know that middle-market firms should look up the size scale when seeking local partners. But for the joint ventures themselves, bigger is not always better. In fact, mid-sized joint ventures perform as well as large ones. They have sufficient heft to garner attention and resources from their corporate parents. But they are small enough to respond quickly to changing circumstances, innovating and adapting on the fly.

That's good news for middle-market parents, which have the managerial and organizational experience and the appropriate processes and capabilities for running mid-sized firms. Middle-market U.S. companies should not be shy about transferring practices to the joint venture. Nor should they be intimidated by large and influential foreign partners who are more familiar with the host environment but may be less proficient in running mid-sized enterprises.

Finally, middle-market companies should think about what they, themselves, bring to the game. It turns out that the most successful joint ventures don't involve middle-market firms at all. Rather, they comprise a large local partner and a small U.S. company, defined as one that falls within the parameters of the Small Business Administration. Those companies—many of them new, entrepreneurial ventures—tend to be flexible, adaptive and innovative. Such qualities trump the advantages enjoyed by larger players.

Middle-market companies reap many benefits from their allies abroad—not just new customers and revenues but also expertise in managing complex ventures, cost advantages for new product launches, and springboards to further international expansion. They may also become stronger competitors. International joint ventures reward small companies for being nimble and creative. If middle-market companies can nurture those small-firm qualities and retain them as they grow, they will perform better wherever they compete. The broader lesson/ aspiration--be nimble like a small firm, knowledgeable like a large one.