

Sino-Foreign
Joint Ventures
after COVID-19
What to expect?

September 2020



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Executive Summary

01 The post-COVID-19 global investment environment



- COVID-19 has disrupted businesses around the globe
 - There will be increased political and economic constraints on China-Western investment
-

02 The emergence of International Joint Ventures (IJVs) to enable global investment



- Post-COVID-19 conditions (including difficulty raising capital and high market uncertainty) will encourage International Joint Ventures (IJVs)
 - Joint venture activity is strongest during economic recovery
-

03 Doors for IJVs in China are still wide open



- Despite geopolitical tensions, IJVs in China will still be attractive
 - They allow western companies to make use of their Chinese partner's local know-how, access to capital, business relationships and talent
-

04 A more welcoming way for Chinese firms to go global: IJV collaborations



- Chinese firms will increasingly invest in the west (particularly Europe) via IJVs
- IJVs can help overcome increased regulatory pressures on foreign investment

The post-COVID-19 global investment environment

A crisis on our hands

The world is currently facing a unique crisis due to the devastating effects of the COVID-19 virus. In these uncertain times companies face a number of difficulties, such as keeping cash flow up, dealing with excess labour, disruption of international supply chains and ever-changing government regulations and policies.

Understandably, most businesses are currently focusing on their immediate problems. However, COVID-19 will not last forever. After the crisis has ended, businesses will emerge into a new environment. Now is time for companies to position themselves for recovery, develop long-term strategies and start to consider what the future might look like.

The aftermath and the opportunities it presents

The crisis will fundamentally reshape global economic and business practices. One impact is that there will likely be increased political and economic constraints on investment between Western countries and China.

Politically, the crisis may create some degree of backlash against Chinese investment (Rogin, 2020). For example, the Australian Government temporarily lowered the threshold for government review of foreign investment to \$0, in a move widely perceived to be aimed at restricting Chinese investment (Remeikis, 2020). The US-China relationship, in particular, is likely to face further difficulties, as the crisis is added to the list of long-standing grievances between the two nations. In light of the COVID-19 outbreak, a bipartisan negative view of China-US trade has developed among the US public (Rogin, 2020).

There may be increased economic and political pressure for industries deemed strategically important to reduce their reliance on just-in-time-models and complex global supply chains (Foreign Policy 2020). The UK government has recently announced that it is phasing out the use of Chinese-based Huawei equipment from the nation's 5G network (Corbin, 2020). The solution may be for countries to ensure that strategically

important goods and services are able to be sourced from a variety of supply chains and not just one country (Brown, 2020).

China, however, is encouraging local entities to make international investment to bounce back from crisis and offset the downturn: "China's non-financial outbound direct investment climbed by 0.7 percent year on year in the first four months of this year" (Xinhua, 2020). At the same time, despite US-Chinese tensions, US companies continue to demonstrate interest in China. Foreign direct investment by US companies into China increased 6% in the first half of 2020 versus a year earlier (Deloitte, 2020a).

Disruption no doubt creates difficulties, but it also creates opportunities. Post-COVID-19, investors have an opportunity to benefit from first mover advantage in this new world: one of the key ways to do this will be through International Joint Ventures (IJVs).

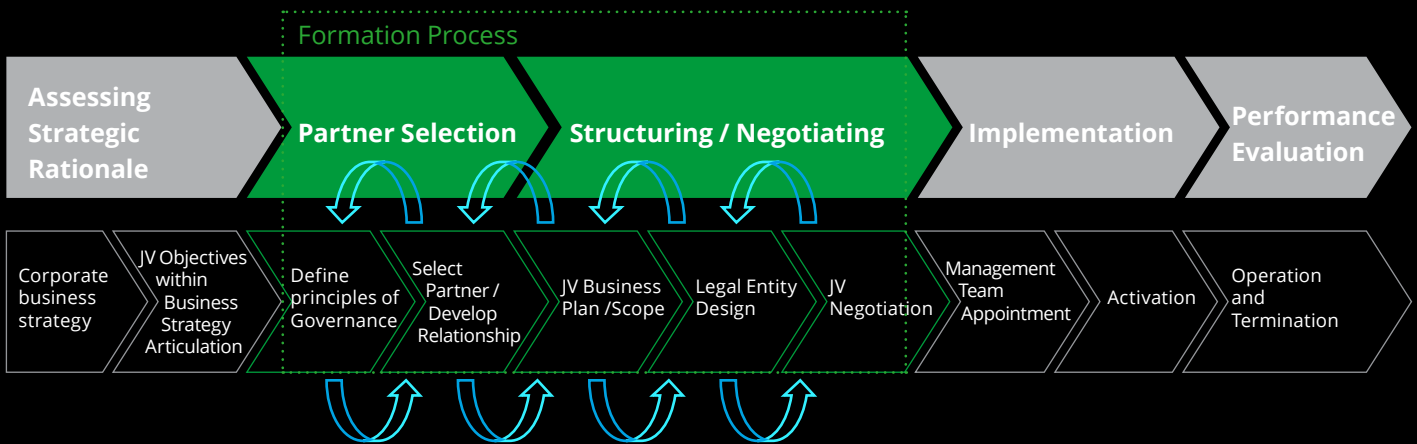
What does an IJV look like?

An IJV is an equity alliance created by two or more companies (parents) headquartered in different countries formed to perform a certain business as outlined in the Joint Venture Agreement.

Prudent businesses undertake considerable due diligence to ensure they find a partner capable of fulfilling the joint business goals.

When the companies begin negotiating, this process often begins with informal initial conversations and relationship-building before moving on to formal negotiations.

If the negotiations are successful, the end result is Joint Venture Agreement (or Shareholders Agreement under the new PRC Foreign Investment Law): a legally binding contract setting out the terms of the joint venture. The partners/ shareholders will then move into implementing the venture.



Why do IJVs occur?

Companies choose to engage in an IJV for a variety of reasons, including to:

- facilitate market access,
- leverage a partner's local knowledge and business relationships,
- leverage a partner's capabilities to expedite product development or increase scale in the market,
- bypass regulation against foreign investment, and
- provide access to the partner's technology and supply chains.



What are the risks of IJVs?

Like all investments, IJVs carry risks, such as:

- poor governance controls, and possible governance deadlocks,
- possible battles of control over the business, operation, finance etc.,
- cultural clashes or language barrier between the two companies,
- risk of competition with parent companies if markets/customers overlap,
- challenges in unwinding assets and operational entanglements when exiting,
- misalignment of business objectives, or
- IP theft.



There are a number of preventative measures prudent companies can implement to reduce the above risks; businesses can:

- engage in a frank, clear discussion of key issues before the venture starts,
- agree on a robust governance framework, and possible solutions to company deadlock,
- design and align on an efficient and fair joint venture (JV) structure,
- define an approach to periodically re-evaluating equity positions throughout the life of the JV,
- define parameters to govern exits from the JV,
- design terms and structures to safeguard critical IP rights, and
- conduct due diligence when necessary.

The emergence of IJVs to enable global investment

Economic recovery in China

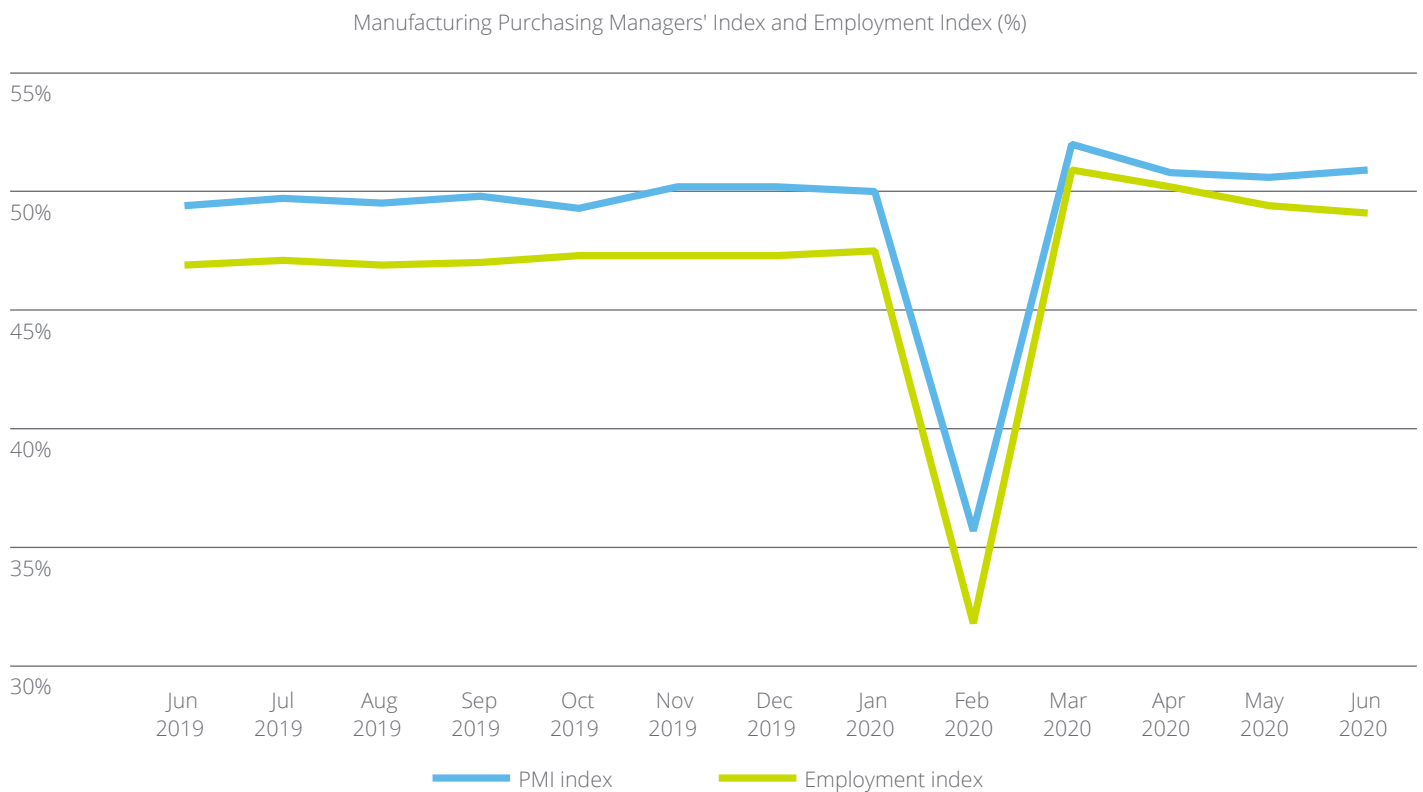
Following COVID-19's disruption, there will be considerable pent-up demand in the economy. Ideally, the world will leap back to its pre-crisis levels of economic activity (a V-shaped recovery). However, a longer, more prolonged pandemic, may result in a slower economic recovery (Kennedy & Jamrisko, 2020). As a recession deepens, consumers become increasingly pessimistic about the future and hold back on discretionary spending; this creates a

negative feedback loop as businesses suffer from reduced aggregate demand, further worsening consumer confidence (a phenomenon known as the "paradox of thrift" (Maley, 2020)).

China is likely to recover before most other nations (Economist, 2020). We witnessed a sudden jump in manufacturing output in China in March 2020, following a collapse in February; a similar V-trend can also be seen in employment in China (Figure

1 below). China's second quarter GDP growth in 2020 exceeded expectations, growing at 3.2% compared to the previous year. China was the only major economy to experience strong growth during this quarter (Deloitte, 2020a). While many developed economies are expected to experience negative overall growth this year, China is expected to grow above 3% for the year (Deloitte, 2020b).

Figure 1: The COVID-19 dip and recovery in manufacturing in China



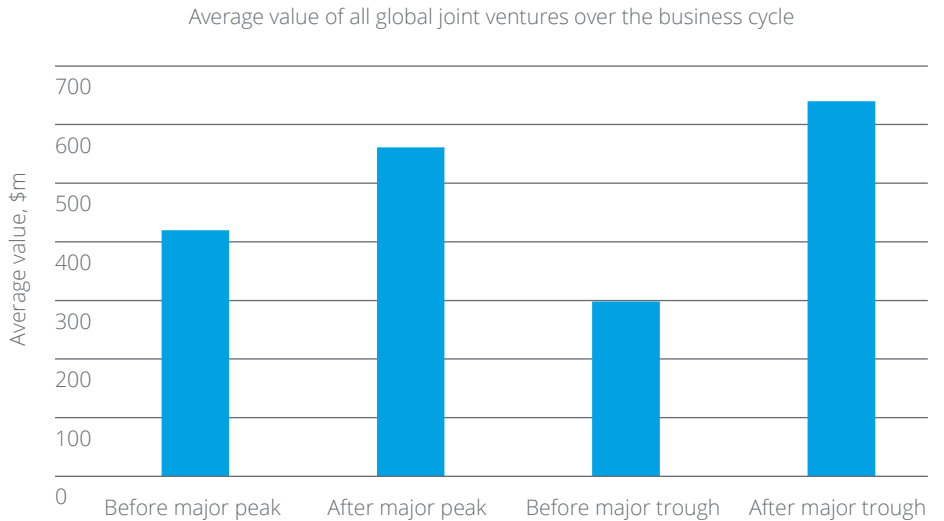
Higher index values represent more manufacturing activity/greater employment
 Source: National Bureau of Statistics of China

Pent-up demand will see an increase in IJV

Joint venture formations are cyclical: falling during economic downturns but growing during growth periods (Cass Business School, 2009). In fact, joint venture activity appears highest immediately following a major economic trough. They are over 20% more likely to occur in times of recovery compared to the overall average (Deloitte, 2010).

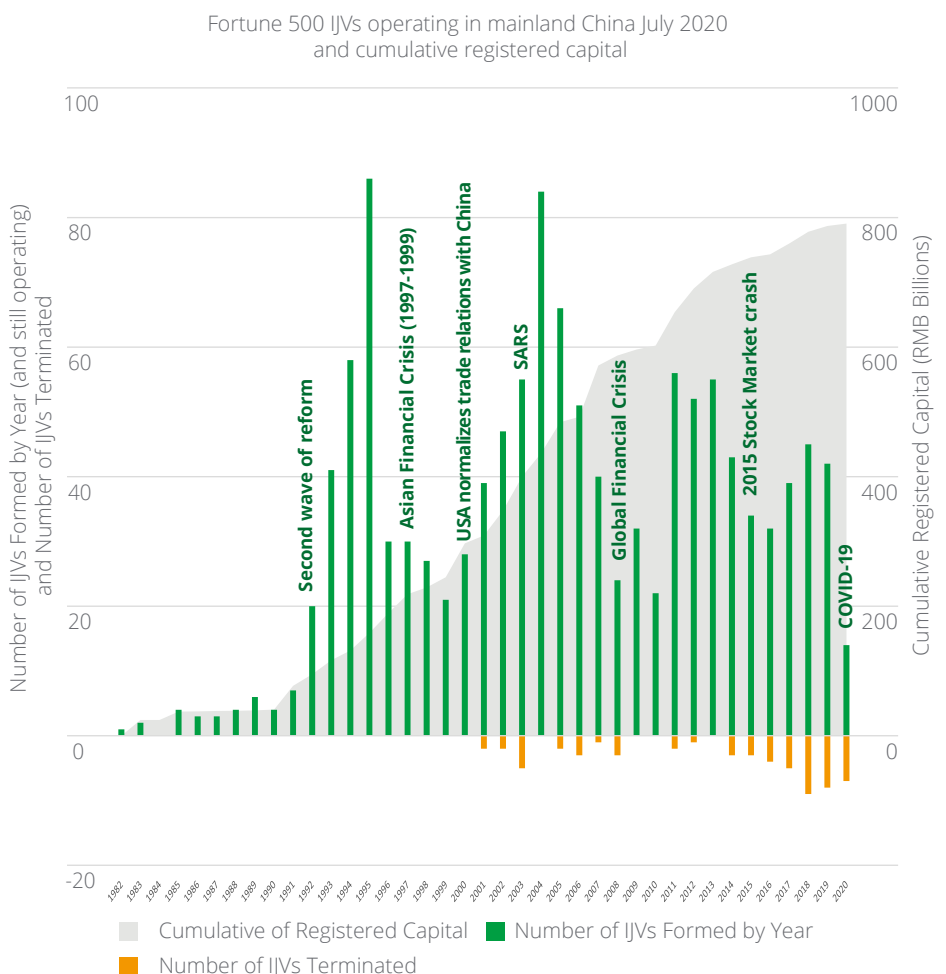
As with the rest of the world, IJV formations in China appear to fall during a recession, but grow following the crisis, in response to this pent-up demand. Figure 3 below shows the number of IJV involving Fortune Global 500 companies since 1983. There was a slowdown in major IJV formation following the Asian Financial Crisis, which lasted from 1997 to 1999; however, there was a major rebound in 2000 coinciding with normalization of the trade relationship with America. IJV formations in China likewise fell in 2008 with the Global Financial Crisis, and remained low the next few years, but began to increase in 2011.

Figure 2: Joint venture activity over the course of the business cycle



Source: Cass Business School (2009) Deloitte
Based on global business cycles from 1885 to 2009

Figure 3: Joint venture activity in China (1983-2020)



Source: Deloitte, Qichacha (2020)
Note that terminations were only included if there was public information on the date of termination. It, therefore, underestimates the absolute number of overall terminations.

Post-pandemic company situations will encourage IJVs

When entering or trying to expand their presence in a foreign market, companies are faced with a number of options: independently establish themselves in the foreign market ("Go alone"), buy a local asset outright ("M&A"), or partner with another company ("Joint venture"). The right decision will depend on the strategic needs and specific circumstances of a firm (as outlined in Figure 4 below).

As can be seen from the above framework, going alone is expensive, especially in recruiting the necessary talent, but allows for maximum product differentiation. If there is a suitable target, businesses may instead choose to acquire a local asset. Acquiring a local firm can help when the business is unfamiliar with the

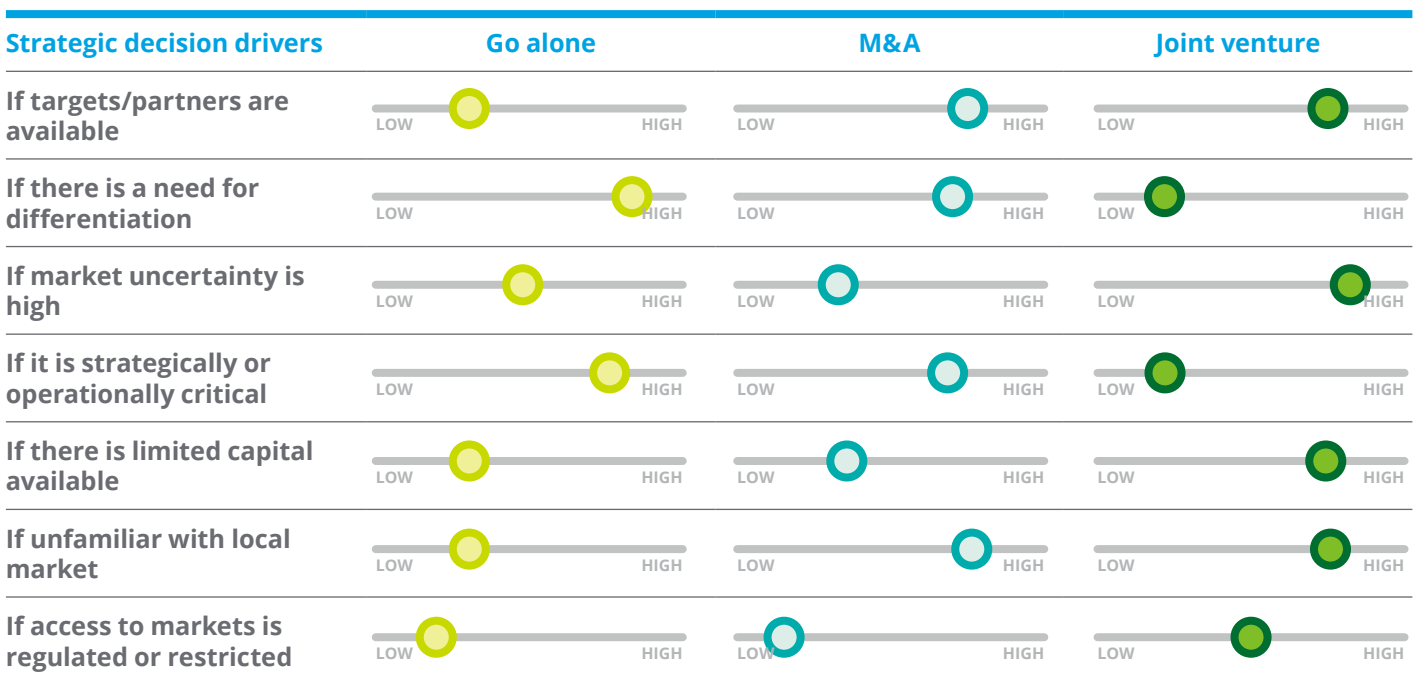
local market; however, M&A is capital and time intensive. In a JV, the fact that partners usually share the costs and the newly started enterprise can choose to exclude legacy expenses makes them preferable when capital is harder to obtain.

The economic downturn will have depleted many companies' cash and talent reserves, while creating uneven demand throughout the economy. Risk averse capital markets may drive up borrowing costs, making it difficult to access necessary capital.

The downturn has also created a high degree of market uncertainty. When uncertainty is high, joint ventures become more attractive. They require less initial investment than the alternatives and can be set up with clear exit mechanism in mind.

COVID-19 is, therefore, creating conditions that increasingly favour JVs. IJVs also offer an advantage in accessing markets with heavy regulatory restrictions. This is especially the case in China which effectively limits foreign investment in certain industries if the foreign investor does not partner with a local firm. For example, foreign ownership of value added telecommunication services cannot exceed 50% (Chinese Ministry of Commerce, 2020). There is a notable trend, however, towards opening more industries to foreign investment, with the Chinese government recently reducing foreign ownership restrictions on investments in finance and the automobile industry (Lewis, Zhou & Wang, 2020).

Figure 4: Go alone, M&A or Joint ventures: what works best?



Source: Based on Deloitte (2019) report "Strategic alliances: Powering your inorganic growth strategy", modified for this report

What does success in an IJV look like?

IJVs have developed an academic reputation for not always ending successfully (Welcher, 2019, Cui and Kumar, 2012). This reputation comes about in the academic literature which seeks to measure the success of JVs through a number of observable metrics, such as longevity, financial performance and stock market impact (Christoffersen, 2013).

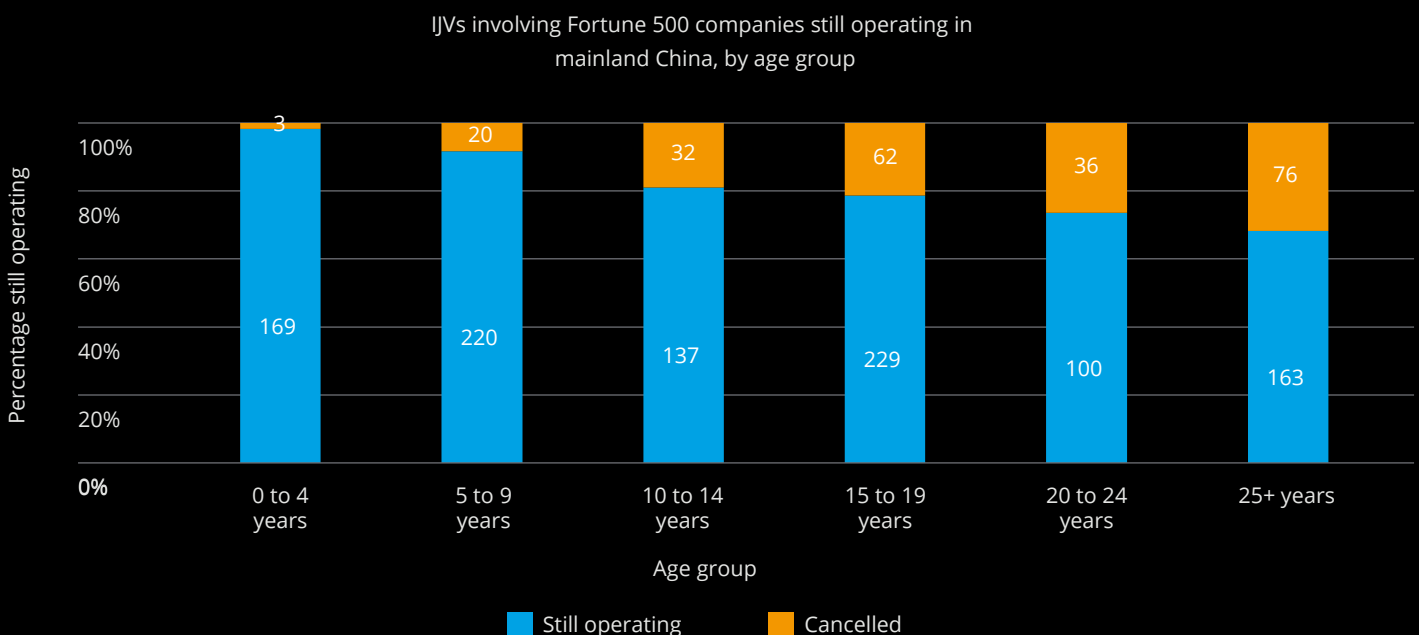
However, these metrics do not always reflect the strategic aim of a joint venture. Many joint ventures are designed to be short term, or were intended from the beginning to be sold off to a third party.

When one party sells off its stake, the legacy JV will continue to operate and generate value. Evidence also suggests that joint ventures can create relatively resilient organisations, though they may not always remain as a JV. Meschi and Riccio (2008) found, in a sample of 234 JVs in Brazil, roughly half of the JVs (120 ventures) were terminated during the study period. However, over two-thirds of these terminated ventures were still operating ventures; they simply continued on in another form (usually with one partner buying out the other partner). Put another way, only 39 of the 234 JVs (17%) ended as failures, due to conflicts or financial losses.

IJVs are a means for a business to get its foot in the door and establish itself in a new market. Consequently, measuring the success of an IJV should consider what the stated objectives of the venture were at the time of signing and ask whether the IJV achieved the desired objectives.

Figure 5 shows the survival rate of IJVs in China involving 2019 Fortune Global 500 companies over the past 35 years, by age group. While over time an increasing proportion of IJVs are cancelled, the clear majority of ventures are still operating across all age groups. Over 90% of ventures under the age of 15 are still operating today. Remarkably, nearly 70% of ventures over 25 years old are still legally operating. It is worth noting, though, that some of this extraordinarily high survival rate could be partially attributable to the legal difficulty of winding down a company in China.

Figure 5: Survival rate of IJVs in China



Source: Deloitte, Qichacha (2020)
In total, 371 of the Fortune 500 companies were eligible for consideration

Doors for IJVs in China are still wide open

International Joint Ventures make up a substantial proportion of foreign investment in China. Since 2010 roughly 40% of foreign funded capital into China has come via Joint Ventures (NBSC, 2020). Many industries require foreign businesses to partner with a local Chinese company to operate in China. IJVs also allow the foreign partner to make use of the local know-how, access to capital, business relationships and talent of its local Chinese counterpart.

Chinese-based IJVs will continue to be attractive to western companies after COVID-19. American and European firms will continue to seek to leverage the relatively high growth rates possible in the Chinese market. Firms investing in China can take advantage of China's increasingly skilled and sizable workforce and comprehensive supply chains.

The local Chinese partners

Local Chinese partners in IJVs are often large State-Owned Enterprises (SOEs). These firms are not beholden to the short-term demands of shareholders, and are more likely to have a long-term orientation (Hofstede's, 2001). SOEs' objectives are almost always more than just profit: the joint venture is an opportunity to gain something from their partner. This might mean gaining technology or know-how from their Western partner. It could also be a desire to drive employment within the SOE via foreign investment. Or the IJV could also be an opportunity for the SOE to get a foothold in the international market.

How to get the most out of IJVs in China: guiding principles

Western companies seeking to undertake joint ventures in China need to consider the idiosyncrasies of the Chinese market.

Take the time to understand the market and business culture

Western companies entering into the Chinese market need to take the effort to understand the local business culture. Assuming that businesses are run in the same manner as in the West will lead to strife. In some cases, western companies have sought to control the board, but instead found themselves locked out of key management positions, hampering their ability to make meaningful decisions (Bosshart, Luedi, & Wang, 2010).

Find the right partner

In the early years of Chinese IJVs in the 1980s, JV partners often discovered differences in strategic objectives between foreign firms, emphasizing profitability, and the Chinese partner, emphasizing growth or employment (Bosshart, Luedi, & Wang, 2010). The

opposite misalignment of goals can also occur: with the foreign company looking to use the IJV to get a foothold in China (and willing to sacrifice profits for market share), while the local Chinese company is seeking quick cash to finance other ventures (ICC, 2011). Consequently, it is vitally important for both sides to clearly understand the strategic goals of both parties: a joint venture can only succeed where interests coincide.

Much of the success of an IJV in China hinges on finding the right partner from the beginning. Firms need to take the time to assess if their potential partner has an alignment of goals, has the necessary business capability, is a cultural fit and is trustworthy.

By reviewing some of the recent cases in which Deloitte has been involved, a number of cross-industry, macro trends can be observed. Most notably, why do international companies engage in IJVs in China? Market access, financial access and access to local manufacturing are dominant themes. For the Chinese counter-party, obtaining IP or knowhow, market access and facilitating an increase in manufacturing volume are major themes. This is illustrated in Figure 6 below.

Figure 6: What are the core drivers for forming a JV for Western and Chinese companies?

Case study	Western partner			Chinese partner		
	Market access	Assets/cash	Other	Obtain IP/Knowhow	Market access	Other
Certification	✓	✓		✓		Return on own purchases
Aviation	✓	✓		✓		
Energy	✓	✓		✓	✓	Cash
Pharmaceuticals	✓	✓		✓		
Healthcare	✓		Revenue	✓	✓	
Education	✓		Asset utilization	✓		
Light manufacturing			Manufacturing		✓	Volume
Chemicals	✓		Manufacturing	✓		Manufacturing
Finance & Business	✓		Procurement			
High-tech	✓			✓		
Hospitality	✓			✓		Brand

Source: Deloitte case studies

Make sure the deal has materiality

Investors need to ask themselves: is the venture important enough – whether strategically or in terms of size – that it will demand the proper attention of both sides? Chinese IJVs are often with large SOEs. In this case, a single joint venture might not represent a significant investment. If so, they may be reluctant to invest top talent or significant oversight into the venture. It is important to establish before the venture begins

that both sides have a strong strategic and financial incentive to treat the venture with appropriate seriousness, including a willingness to invest in top management talent.

Go in with an end goal in mind

How long an IJV is intended to last differs from venture to venture. Some are only intended to last a set period of time, others are entered into without a definite end date in mind. Regardless, firms need to ensure the

venture has a clear exit mechanism. The performance of a JV, and the positions of the parent companies, can change over time. For instance, one of the parent companies of a JV might change senior leadership and choose to instigate a new overall business strategy. With that change, the two partners may no longer be aligned. In this case, there needs to be a clear and pre-determined exit mechanism for leaving the JV.

IJV best practice: a step-by-step guide

Step 1: Assessing strategy

If a company wishes to undertake an IJV, the first step is to assess the strategic rationale for entering such a venture. Management should consider alternatives, and ask themselves if an IJV is the best means of achieving their business goals.

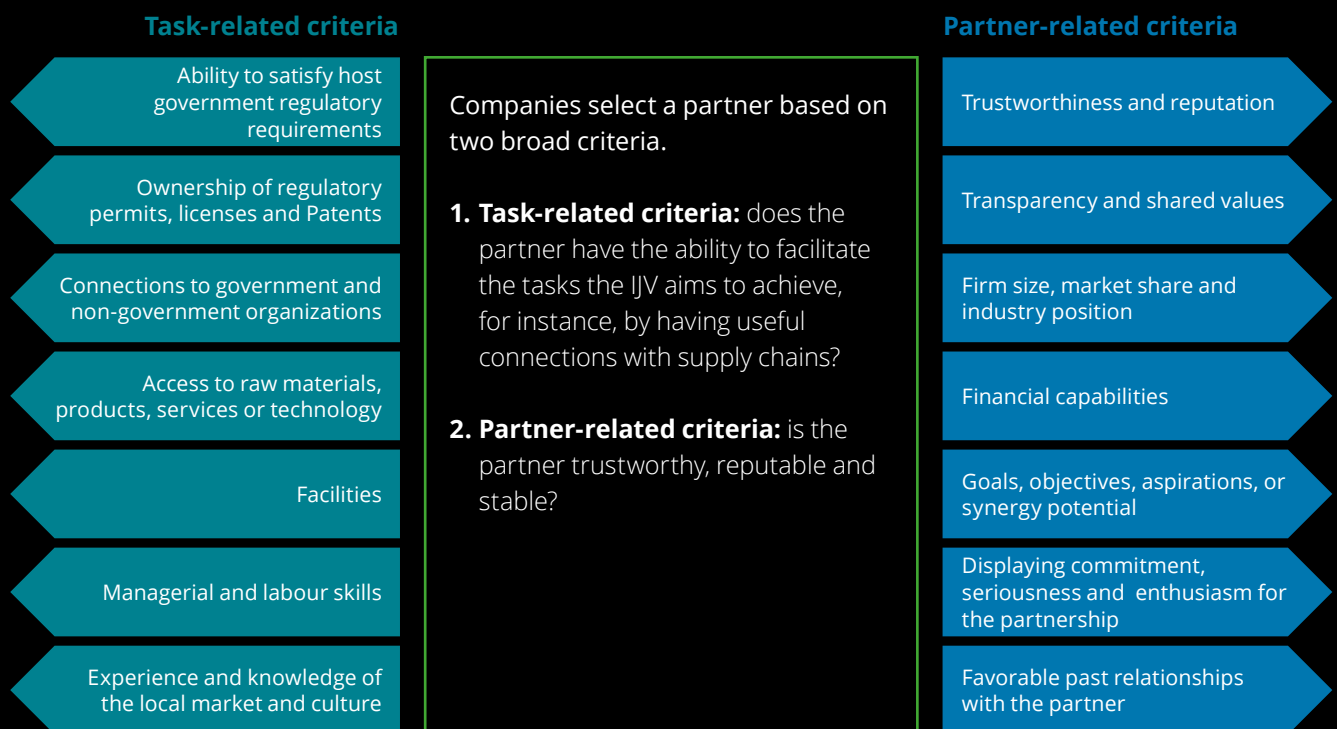
Step 2: Partner selection

Once management have determined that an IJV is the best way to achieve their strategic aims, the company must identify a suitable partner. The right partner:

- has aligned vision and goals,
- possesses critical capabilities (such as getting government approvals, recruiting competitive labour, sourcing supply chains, etc.),
- is a cultural fit, and
- is transparent and trustworthy.

Figure 7 outlines a number of key criteria to decide if a potential partner is the right fit.

Figure 7: How companies choose a partner: task- and partner-related criteria



Source: (Roy and Oliver, 2009; Geringer, 1988; Glaister, 1996; Arino et al., 1997; Glaister and Buckley, 1997; Tatoglu and Glaister, 2000; Nielsen, 2003)

Step 3: Laying out the key principles

Before a business begins to enter into negotiation with its prospective partner, it needs to establish for itself a clear set of principles for what the JV is going to look like and what it wants out of the JV. How exactly is each party going to achieve its objectives?

Before entering into negotiation, businesses should hold an internal alignment workshop to:

- determine the redlines and likely JV issues,
- develop a negotiation strategy and positions to take on key themes,
- outline business objectives, and
- brainstorm timeline and potential activation plan.

Step 4: Negotiation

Having found a suitable partner and clearly articulated their business objectives, the two businesses enter the negotiation phase. Over the course of negotiation the two businesses need to agree on what the JV will look like, including:

- setting out its scope,
- defining success for both parties,
- defining which partner controls what elements of the IJV,
- setting out the expected contribution of each partner,
- defining exclusivity arrangements,
- developing a comprehensive understanding of legal compliance,
- establishing a clear, workable governance structure, and
- negotiating a timeline for the work to be done.

Negotiation is an opportunity to properly get to know the other partner. Businesses should develop a negotiation team that includes function heads who can bring extensive operational knowledge and assess the counterparty.

A key to ensuring the success of the venture is to be willing to walk away from the deal if it cannot live up to its initial promises. Businesses need to be wary of avoiding the sunk cost fallacy: pushing through with a less-than-ideal deal because so much time has already been sunk into the negotiations.

Some element of due diligence (DD) is advisable. The degree of due diligence necessary depends on the scope of the venture. Businesses need to consider areas of due diligence depending on the specific risk factors of the deal.

Step 5: Determining the governance structure

The governance structure of a company established in China is unique. Perhaps the most distinctive aspect of businesses in China is the company chop. The company chop is a seal that acts like a signature in the West. Every business in China requires a chop to authorise documents. There is a company chop used to sign legal documents and a finance chop for financial transactions. A corollary of this system is that whoever controls the chops (plus possession of the original copy of business license) wields substantial authority. Joint ventures will need to agree to, and establish, internal controls on who has the authority to hold and use the various chops (via the approval matrix), and who has the actual control of the business license.

Figure 8 below sets out an indicative list of roles and institutions in a typical China-based joint venture.

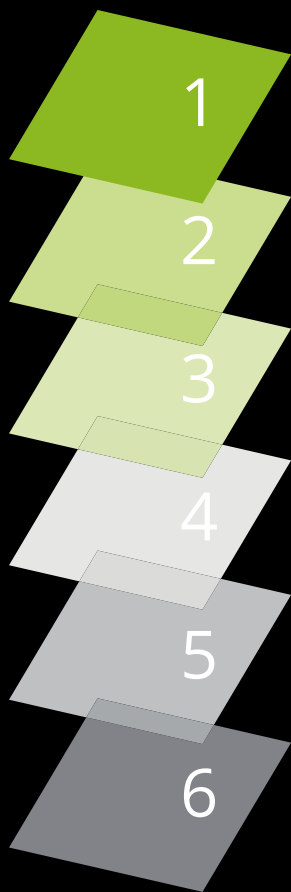


Figure 8: Six Layers of Governance

1	Joint Venture Agreement	<ul style="list-style-type: none"> The Joint Venture Agreement contract sets out the responsibilities of the parties within the JV
2	Shareholder Committee	<ul style="list-style-type: none"> Approves, business and investment plan, annual budget and profit distribution Votes on changing the Board of Directors
3	Board of Directors	<ul style="list-style-type: none"> A list of board reserved matters requiring unanimous board approval should be developed
4	Board Sub-committees (optional)	<ul style="list-style-type: none"> Key areas of concern will be governed by committees with the committees having authority over their respective areas
5	Operating Management Committee (optional*)	<ul style="list-style-type: none"> Drafts the joint venture's official Business Plan Ventures should have both immediate and long-term business plans Manages through any short term shareholder disagreements
6	Approval Matrix	<ul style="list-style-type: none"> Business rules that govern what decisions can be made at every level of the organization This tools ensures clarity while running the business. It includes the chop management protocol

Source: Deloitte
 *Seen most frequently in Continental European JVs; rarer in other cases. They are typically used to resolve a specific governance sticking point



A more welcoming way for Chinese firms to go global: IJV collaborations

China coming to the world

Chinese companies enjoy increasing opportunities to compete in developed countries, where they can take advantage of their low cost of production inputs and low financing costs (Cui, Jiang & Stening, 2011). A number of factors will encourage Chinese international investment in the West – particularly Europe – to take the form of international joint ventures.

Raising geopolitical tension

The COVID-19 crisis has escalated geopolitical tensions. For a number of years now there has been a trend of increased scrutiny of foreign investment in Western economies; the pandemic has only accelerated that trend. Within Europe, Italy, Spain, Hungary, France, Germany, among others, have all introduced new foreign investment restrictions (White & Case, 2020). As cultural and regulatory barriers rise, so to do likelihood of adapting IJVs as the means of outbound investment (Cui, Jiang & Stening, 2011). IJVs generally face lower regulatory burdens than M&A or investing alone.

Additionally, by partnering with European companies, Chinese firms will be able to leverage the good-will of local brands "to compensate for its own liabilities of foreignness" (Cui, Jiang & Stening, 2011).

Western firms will have an economic incentive to partner with Chinese firms

Many firms in the west will be cash-strapped after months of depressed economic activity. Businesses in the West will, therefore, be looking for new investment opportunities to regain revenue and profit. Those that act quickly can take full advantage of the economic rebound that eventually follows a downturn.

However, capital markets are unlikely to be in the mood to fund large, ambitious investments. Western firms will therefore be seeking new sources of capital. IJVs will provide western firms with access to Chinese capital and allow them to share the costs of their new investments with their partner.

IJVs in Europe

The fundamentals of a successful IJV in Western economies are broadly the same in China. Businesses need to follow best practice every step of the way. Firms seeking an IJV should engage with a plan in mind from the beginning. This means finding the right partner, avoiding misunderstandings, and ensuring the mechanisms of the IJV are appropriate (e.g. a robust governance structure).

Many Chinese-Western IJVs involve SOEs. Western companies are attracted to SOEs due to their large size and

access to capital. When aligning interest, however, the interest of private Chinese firms and Western multinationals may be more easily harmonized since "private firms [display] more market-seeking behaviour" (Gross, Huang & Ding, 2017).

Outbound investment by Chinese SOEs follows a unique start-to-end process as it requires the approval of the State-owned Assets Supervision and Administration Commission of the State Council (SASAC). Before undertaking an outbound IJV, Chinese SOEs must prepare a full feasibility study and deal proposal, including details on the entity structure and funding structure, for SASAC to review. Following the negotiation, the SOE then requires approval from SASAC for the project funding arrangement and to sign the Joint Venture Agreement. Outbound M&A likewise requires SASAC approval. Since 2017, SASAC has strengthened its supervision of outbound investment in an effort to reduce speculative investments (XBMA, 2017).

Outbound investments will also often require the approval of the inbound nation's government. In 2016, the European Commission chose to consider other related SOEs controlled by SASAC for the purpose of calculating market size during a joint venture review (Price, 2016). This in effect increased the regulatory barriers for Chinese SOEs looking to invest in Europe.

Conclusion: turning a crisis into an opportunity

The crisis is having a profound impact on businesses across the global. Currently many companies are in a survival mode. But as we start to recover from the COVID-19 pandemic and related economic distress, businesses that are able to bounce back quickly will enjoy a first mover advantage. Economic conditions will encourage Chinese-Western joint ventures in both China and the West. With prudent due diligence, the right partner and a robust governance framework and JV structure, IJVs can be a powerful tool for businesses in both China and abroad in times of global uncertainty.

Crisis (危机)

危机会

Opportunity (机会)

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Special Thanks:

Adam Brown, Cody Chen, Lydia Chen, Andrea Culligan, Weiheng Jia, Cecilia Lin, Pam Pang, Li Peng, Aaron Schoen, Daan Witteveen, Jeff Xu, and anybody else who contributed.

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