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Joint venture instability in developing countries under entry

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ABSTRACT

We explain the rationale for share adjustment in an international joint venture (JV) and opening up of a wholly owned subsidiary by the foreign JV partner. If the cost difference between the JV and other firms is small, the foreign firm opens a wholly owned subsidiary and completely sells-out its shares in its previously formed JV. If the cost difference is intermediate (large), the foreign firm adjusts (increases) its shareholding in the JV and opens (does not open) a competing subsidiary. JV instability may be the outcome of a friendly separation. There may also be situations with no share adjustment.

1. Introduction

International joint venture (JV) is an important form of foreign direct investment and has generated a vast literature (see, e.g., Curhan, Davidson & Suri, 1977; Hergert & Morris, 1988; Pekar & Allio, 1994). Though the theoretical literature has explained several aspects of international JVs,[1] JV instability, which implies either a complete breakdown or share adjustments in an existing JV, and opening up of a wholly owned subsidiary by the foreign JV partner that competes with the foreign firm's existing JV, is getting attention only recently.

The evidence for JV breakdown is ubiquitous. In Killing (1982), out of the 37 international JVs studied, 36 were prone to breakdown. The average lifespan of a JV studied in Harrigan (1988) was only 3.5 years. About half of the 92 JVs studied in Kogut (1988) had broken up by the sixth year. Beamish (1985) and Gomes-Casseres (1987) also show the evidence of JV breakdown. Bhandari (1996) and Ghosh (1996) study JV instability in India during the mid-1990s. Examples of the JV breakdown in India include JVs between Daewoo and DCM, GE and Apar, Procter & Gamble and Godrej, Suzuki and TVS, and GEC Alsthom and Triveni Engineering, to name a few. Though it is sometimes claimed that JVs in the developing countries have higher instability than those in the developed countries, there is no conclusive evidence on this. Yan and Zeng (1999) provide a survey on JV instability in different industries and in different countries.

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[1] See Svejnar and Smith (1984), Marjit (1990), Chan and Hoy (1991), Purakayastha (1993), Marjit et al. (1995), Al-Saadon and Das (1996), Chao and Yu (1996), Das (1998), Roy Chowdhury and Roy Chowdhury (1999)query, Sinha (2001a), Mukherjee (2003) and Lin and Saggi (2004), as a representative sample of the theoretical literature on the formation of international JVs.

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The evidence also shows that, in many situations, foreign JV partners open their wholly owned subsidiaries and compete with their existing JVs in similar products. An earlier evidence in India shows that Warner–Lambert's wholly owned subsidiary flagged off Clorets, a product similar to Warner–Lambert's other Indian subsidiary Parke–Davis' Chiclets (Business World, 6–19 September 1995). In another case, Pepsi Foods opens a wholly owned subsidiary PepsiCo India Holdings while it has a JV with Punjab Agro Industrial Corporation virtually in the same business. Gillette opens a wholly owned subsidiary while it has a JV with Indian Shaving Products Limited in the same market (Bhandari, 1996).There are several other recent evidences of this phenomenon in India. Honda motor company pushed through its wholly owned subsidiary to manufacture motorcycles while it has an existing JV with Hero Motors (Business World, 13 September 1999). Expomedia, a UK based company, has an existing JV with an Indian partner in International Trade Expo Centre and has opened its wholly owned subsidiary India Exhibition Management in the same field (The Economic Times, May 11, 2006). Many foreign firms in India had hiked their shares in their existing JVs and/or had opened up additional wholly owned subsidiaries or were waiting to do so. These cases include, e.g., Cadbury–Schweppes, Ciba–Geigy, Warner–Lambert, Unilever and Procter & Gamble in food and consumer products; Pfizer, SmithKline and Beecham, Rhone Poulenc, Hoffman LaRoche and others in drugs and pharmaceuticals; GEC Alsthom, Asea Brown Bovari and many others (Mukherjee & Sengupta, 2001). These changes in the industry structures are observed when India relaxed restrictions on the opening up of foreign wholly owned subsidiaries, thus creating the potential for more product market competition.

The present paper starts off with this background and builds up a simple model of international JV to explain the rationale for JV instability and the foreign JV partner's incentive for opening up of a wholly owned subsidiary that competes with the foreign firm's existing JV.

There are several definitions of JV instability in the literature. Franko's (1971) pioneering work considered JV instability as liquidation or buy-out either by the host-country partner or by the multinational. Sometimes the shift of control rights from one partner to another is also called JV instability (Franko, 1971; Killing, 1983).[2] In this paper, we consider JV instability as a situation of complete or partial buy-out (or sell-out) of the JV by a JV partner.

We show that the threat of entry created by the foreign JV partner's wholly owned subsidiary and other firms may induce share adjustment in the JV and may also induce the foreign JV partner to open a wholly owned subsidiary. In this respect, the cost difference between the firms plays an important role. If the cost difference between the JV and other firms is small, the foreign firm opens a wholly owned subsidiary and completely sells-out its shares in its previously formed JV. If the cost difference between the firms is large, the foreign firm increases its shareholding in the JV and does not open its wholly owned subsidiary. If the cost difference between the firms is neither very small nor very large, the foreign firm opens a wholly owned subsidiary and also adjusts shareholdings (either by selling or by buying) in its existing JV. If the threat of opening up of a wholly subsidiary by the foreign JV partner is not credible, no share adjustment occurs in the JV. We show that JV instability and opening up of a wholly owned subsidiary by the foreign JV partner can be the outcome of a friendly separation and may not be driven by the threat of opening a wholly owned subsidiary by the foreign JV partner. Thus, our result may support the view of Mr. Amit Mitra, Secretary-General, Ficci, that "… if we look at the case of Hero Honda and TVS Suzuki, we find that they reached amicable settlements within an orderly transition process with a win–win option for both" (rediff. Com, April, 09, 2003: "Should 'Press Note 18' be scrapped?").

Our focus on product market competition, the intensity of which is affected by the industrial structure and the cost difference, is supported by the literature on international business. As mentioned in Yan and Luo (2001), along with the factors such as competitive learning and changes in relative bargaining power of the partners, repositioning in the market and undertaking major growth or downsizing may create JV instability. Yan and Zeng (1999) also suggest that industrial structure may influence JV instability. Entry of firms in our analysis affects the industrial structure and may induce the JV partners to change their strategies for repositioning them in a better way.

Our paper is related to the recently growing theoretical literature on JV instability. In an earlier work, Horstmann and Markusen (1996) show the effects of the host-country firm's private information about market demand on the incentive for FDI and contractual relationships between a foreign and a host-country firm. Learning by the foreign firm through contractual arrangements may encourage it to make short-term contracts with the host-country firm. More recently, the literature has focused on organizational learning, instead of information asymmetry, for explaining JV instability. Kabiraj (1999), Roy Chowdhury and Roy Chowdhury (1999, 2000 and 2001), and Kabiraj and Lee (2004) show JV breakdown in the presence of organizational learning. After learning by one or both partners in a JV, it may be in the interest of the JV partner to break the existing JV, and operate their own wholly owned subsidiaries. Mukherjee and Sengupta (2001) show JV instability due to sequential economic liberalization, and analyze the implications of different types of controlling structure in the JV and the degree of product market competition. Sinha (2001a, b) show the importance of sequential economic liberalization, innovation and imitation for JV instability, whereas Sinha (2008) shows private information about market demand as a reason for JV instability. Kabiraj et al. (2005) show JV instability due to cultural difference between the JV partners. de Hek and Mukherjee (forthcoming) and Kabiraj and Roy Chowdhury (2008) show technology adoption and demand uncertainty as the reasons for JV instability when the firms have forward-looking behavior. Marjit and Roy Chowdhury (2004) explain JV buy-out due to demand increase. In contrast to these papers, where JV occurs between the final goods producers, Antràs (2005b) considers the incentive for JV between a foreign final goods producer, which produces certain inputs, and a host-country input supplier, which produces a complementary input. As the intensity of host-country input increases above a critical level, the foreign firm prefers to switch from a JV between the foreign firm and the host-country input supplier to an arm's length agreement.

[2] Reuer (2000) considers five types of termination of JVs: (i) a partner acquires the international JV from the other partner(s), (ii) a partner sells its equity stakes to the other partner(s), (iii) a partner sells its equity stakes to an outside party, (iv) the partners sell the international JV to an outside party, and (v) the partners liquidate the international JV.