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NEGOTIATING AND DESIGNING AN ALLIANCE

In Brief

The design and negotiation of an alliance is both a critical and pivotal point in the alliance process. Beyond establishing a win-win arrangement, this phase of building alliances sets the tone of the future relationship. Many signals are communicated during this stage as to whether or not an alliance is likely to become a collaborative, enduring partnership.

The negotiation process involves prenegotiation preparations such as putting together the negotiating team, conducting the negotiation itself, and finalizing the ultimate agreement. The agreement should address, among other things, the mission of the alliance, its structure and governance, ownership and control details, identification of performance objectives and milestones, conflict resolution procedures, and provision for termination of the partnership.

Finally, key to a successful alliance is a strong relationship between the partners supported by mutual trust and commitment. A good contract is no substitute for a good relationship.

The basis for effective long-term collaboration is established at the negotiation stage. But alliance negotiations can be challenging to executives steeped in the adversarial, position-maximizing style of negotiating that characterizes many types of business arrangements. Approaching alliance negotiations from an adversarial or winner-take-all perspective is an invitation to trouble. In both their tone and approach, alliance negotiations should reflect the desire of the parties to create a solid foundation for their relationship and a positive atmosphere for the partnership. Negotiations should be considered first and foremost as a means of building the linkages that will support effective collaboration between the partner companies.

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Alliance negotiations should endeavor to accomplish three things:

1. Establish the potential partners' mutual interest and test their strategic fit
2. Provide an opportunity to create a foundation of trust and to develop a problem-solving attitude
3. Establish a business and operational plan for the proposed enterprise

At the end of the process, both parties should be perceiving the benefits to be high and the risks equally shared. A venture with unhappy partners at the outset is unlikely to endure for very long.

The negotiation process is an excellent vehicle for developing some unique insights into how the other party does business. It is a good place to test compatibility and personal chemistry between key personalities. The style and approach exhibited by the key players at the negotiating table can be a good indicator of the nature of the eventual relationship.

Alliance negotiations typically deal with conflicting aims. While they must focus on achieving the greatest possible competitive advantage for the joint venture itself, each party also looks at how to get the best deal for their company. No matter how cooperative the intent, the negotiation phase is inevitably loaded with power issues and a heightened sensitivity to misunderstanding. This dilemma is most effectively mitigated when both partners negotiate generously with their primary objective so that both partners achieve a good deal. This strategy often entails suboptimizing on the immediate deal but at the same time laying the groundwork for optimizing long-term success.¹

In alliance negotiations, several areas require particular attention, including putting together the negotiating team, prenegotiation preparations, the negotiation process itself, and formalizing the ultimate agreement.

PUTTING THE TEAM TOGETHER

There is no recipe for determining who should be at the negotiating table. There is value, however, in using a two-track approach involving both senior executives and middle-level or operational managers in the negotiation process when the size of companies warrants it (see Figure 3.1). (This may be difficult in partnerships between small firms and large multinationals, but to the extent possible, attempts should be made to structure it this way.)

The executive-level team establishes the commitment and strategic parameters of the negotiation. Discussions between CEOs or senior managers are usually focused on issues related to *strategic and financial fit* of the companies involved and the forms of cooperation that might be feasible. CEO involvement and visible commitment at the early stage provide important cues for middle management and staff about commitment to the venture's strategic importance, and this backing can be an important factor in mobilizing lower-level support.

The second-level team typically comprises division heads and middle managers as well as legal, financial, market, and technical experts.² This team focuses on *operational fit* and the day-to-day issues related to the venture's implementation. This team works out the details of the contract, its structure, partner contributions, management, and so on. The participation of, and early buy-in of, key operational managers should also help pave the way for the venture to be implemented quickly. If the people who may be involved in the implementation of the proposed venture are uncomfortable with some aspect of it, the chances of success may be greatly diminished.

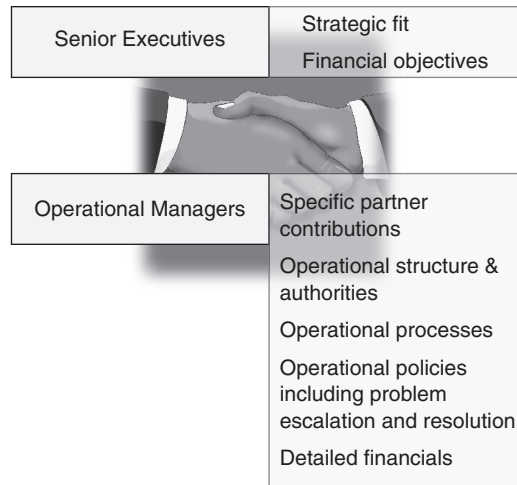


Figure 3.1 Roles of the Negotiation Team

The involvement of operational managers at this point can also help to temper inflated expectations that sometimes develop during negotiations. People who will be required to live up to the commitments made by the partners are less likely to allow them to escalate. This also provides the individual or individuals who will be ultimately responsible for the alliance an opportunity to see if they are compatible with their potential partners.

WHO SHOULD BE ON THE TEAM

Beyond identifying CEO-level and key operational managers discussed above, managers need to keep the following considerations in mind when rounding out the negotiating team with legal, financial, and other resources:

- **Experience is a definite asset.** Negotiations can be stressful and managers want to be confident that their team members will conduct themselves with poise and in a non-adversarial manner. With inexperienced members, additional role-playing in advance of the negotiations would likely be beneficial.
- **Having a “contrarian” on the team.** This is someone who can identify and counter “group think” and can cut through some of the ego involvement that takes place in negotiations. The role is to challenge assumptions and take a close look at potential problems and ensure negotiators are realistic and objective in assessing the proposal.
- It is best to **avoid involving legal counsel as a negotiator.**³ Legal and tax professionals have a very important role to play in putting a partnership together; however, their role is largely behind the scenes. Negotiations aim first to establish the business framework for the alliance. Once agreed to in principle, legal counsel should be brought in to draw up a sound document to protect both parties and provide the partnership a solid foundation. Similarly,

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tax advisers can help structure the deal for maximum financial benefit, but presence at the negotiating table may encourage similar self-interest from the potential partners and lead to an adversarial climate. Moreover, in some foreign cultures (particularly in some Asian countries), having legal counsel at the negotiating table may be interpreted as a sign of mistrust.

NEGOTIATING IN A FOREIGN BUSINESS CULTURE

When dealing in a foreign business culture, managers may want to find specialized consultants to assist in the negotiations. Consultants knowledgeable in the culture and business practices of the foreign environment and who have credibility and contacts in the area of the proposed venture can sometimes be of enormous benefit in both better understanding the potential deal and in facilitating it. It is always best, however, to avoid relying on a consultant to put the deal together. If a company doesn't have the capability to make the strategic and business decisions leading up to the deal, it is unlikely to have the ability to implement it effectively.

If interpreters are required, it is important that they be briefed on the proposed deal and the company's expectations. A well-briefed interpreter can help avoid some of the miscommunications and misunderstandings that frequently occur in cross-cultural negotiations. Using a senior executive as an interpreter could, in some cultures, diminish the perception of the executive's status and role in the eyes of the foreign partner and undermine his or her ability to make a substantive contribution to the negotiations.

PRENEGOTIATION PREPARATION

Coming to the table well prepared can smooth negotiations and substantially reduce the time it takes to put the deal together. Good preparation results in clarity of the company's expectations for the venture and the commitments that it is willing to make as well as those that it is expecting from its partner. Advanced preparation should also help assess bargaining power, understand the concessions to be made, and forecast issues that might arise.

Figure 3.2 has been designed to help in preparing for a negotiation. Responding to the first set of questions related to one's negotiating position is easy once the strategic analysis is complete. The next step entails overlaying the perceptions and expectations of the partner.

THE NEGOTIATION PROCESS

Good negotiations are characterized by honesty and an open flow of information between the partners. The parties focus on what they have in common rather than on their differences, and they actively seek solutions that meet both sides' primary goals. Figure 3.3 outlines steps in the negotiation process.

The initial meetings between the parties should focus on identifying mutual interests and building consensus on the basic strategic objectives of the alliance. There should be no pressure to close a deal. Efforts to conclude a deal quickly can lead negotiators to focus their attention on legal and financial aspects of the partnership while ignoring the relational and operational issues involved in managing the venture. Spelling out mutual benefits can also help negotiators uncover unrealistic expectations.

	Our Company	The Alliance	Our Partner
Conditions of Negotiation	<ul style="list-style-type: none"> <input type="checkbox"/> What are our objectives for the alliance? <input type="checkbox"/> How does this alliance fit with our strategy? <input type="checkbox"/> What are we expecting from this alliance? <input type="checkbox"/> How do we measure success? <input type="checkbox"/> What strengths do we bring to this alliance? <input type="checkbox"/> What are the essential requirements for the alliance to meet our objectives? <input type="checkbox"/> What potential obstacles may prevent the alliance from meeting our objectives? 	<ul style="list-style-type: none"> <input type="checkbox"/> What should be the objectives of the alliance? <input type="checkbox"/> What should be the alliance's strategy? <input type="checkbox"/> What are appropriate measures for alliance success (over time)? <input type="checkbox"/> What will be the unique strengths of the alliance as a result? <input type="checkbox"/> What risk factors may hamper the likelihood of success? 	<ul style="list-style-type: none"> <input type="checkbox"/> What do we think are the objectives of our partner? <input type="checkbox"/> How does this alliance fit with its strategy? <input type="checkbox"/> What do we think our partner is expecting from this alliance? <input type="checkbox"/> How do we think our partner measures success? <input type="checkbox"/> What strengths does our partner bring to this alliance? <input type="checkbox"/> What are the essential requirements for the alliance to meet our partner's objectives? <input type="checkbox"/> What potential obstacles may prevent the alliance from meeting our partner's objectives?
Negotiating Levers	<ul style="list-style-type: none"> <input type="checkbox"/> What needs to be safely guarded? (e.g., intellectual property) What are <i>sacred cows</i>? <input type="checkbox"/> What concessions can we offer freely that we think they will want? 	<ul style="list-style-type: none"> <input type="checkbox"/> What negotiations are in the best interest of the alliance? 	<ul style="list-style-type: none"> <input type="checkbox"/> What concessions do we think our partner will request? How can we accommodate them? <input type="checkbox"/> What concessions will we want from our partner? Which ones are deal breakers?

Figure 3.2 Preparing for a Negotiation

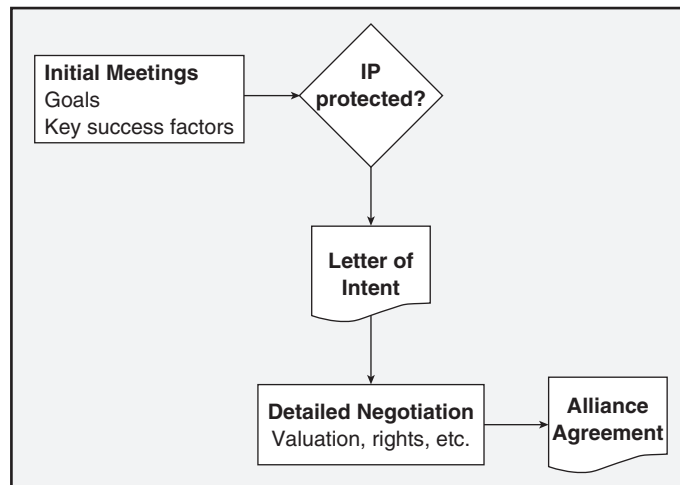


Figure 3.3 Topics for Negotiation

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The early negotiations should allow the parties to get to know each other, clarify expected benefits, and identify shared goals and objectives. At this stage, it is best to try to avoid placing too much emphasis on legal issues and technicalities, decision-making processes, and ownership formulas. Rather, focus discussions on operations planning, clarity of goals, personnel selection, resource needs, reporting systems, cost controls, and desired results.⁴

The prenegotiation stage should have identified proprietary knowledge that needs to be protected, so before disclosing proprietary data, managers should ensure their competitive advantage is adequately protected and make certain the negotiators have been well briefed on what is appropriate to share and when. Technology to be disclosed should ideally be patented, and confidentiality agreements should be signed to cover sensitive information to preclude prospective partners from using disclosures in a competitive manner. A good approach is to balance the amount of capabilities and information unveiled with what the partner unveils. A partner's negotiating history, usually known and discussed within industry circles, can be a valuable guide to decide how to approach the handling of competitive or proprietary information. If, for example, a company has previously entered negotiations in bad faith simply to obtain competitive intelligence, the industry will likely have talked about it.

There should be no pressure to rush to do the deal. It is important to take a hard look at the partner and the deal at each stage of the negotiation process and to stay attuned to warning signals, such as demands for quick commitments or partners not willing to discuss their strategic agenda.

At the end of the day, managers hope to emerge from these negotiations with a clear focus on goals and a plan for achieving them. Clarity is vital. Ambiguous goals, fuzzy directions, or uncoordinated activities will lead to disappointment. The definition of the partnership should be precise enough to ensure commitment but not so rigid that there is no potential for learning and growth.

Figure 3.4 summarizes some key issues to address during the negotiation.

LETTER OF INTENT

Once the mutual benefits and general objectives have been set out, the concepts of the venture can begin to be transferred to a nonbinding letter of intent. This document is used to move the negotiations beyond the initial conceptual stages to an operational stage where the alliance starts to have a clear description. The key players of both parties should jointly draft this document. A good letter of intent will greatly facilitate the drafting of a binding legal agreement.

Elements of the letter of intent typically include the following elements:

- Purpose of the alliance
- Scope of activity
- Key objective and responsibilities
- Method for decision making
- Resource commitments
- Assumption of risk and division of rewards
- Rights and exclusions
- Proposed structure of the alliance or venture

In some jurisdictions, a nonbinding letter of intent may, in fact, be binding. Before signing a letter of intent, check the legal ramifications of signing any documents in the course of the negotiations.

Technological Issues	Market Issues	Alliance Structure
<ul style="list-style-type: none"> <input type="checkbox"/> Ownership of technologies developed by the alliance. <input type="checkbox"/> Rights to use and market core technologies, future technologies to be developed, and those from outside sources. <input type="checkbox"/> Royalty rights if partner markets developed technology in other markets. <input type="checkbox"/> Ownership and rights of future technology enhancements. <input type="checkbox"/> Applicable decision-making process where new technology concerned. <input type="checkbox"/> Legal rights in case of third party infringement of joint technology. 	<ul style="list-style-type: none"> <input type="checkbox"/> Decision-making process on new product definition. <input type="checkbox"/> Identification of product management roles including product design, naming, quality assurance. <input type="checkbox"/> Identification of roles and cost sharing of marketing campaigns. <input type="checkbox"/> Decision-making process on product evolution (improvements, additions, etc.). <input type="checkbox"/> Identification of legal liabilities including warranty obligation, customer injury, or technology infringement. <input type="checkbox"/> Marketing rights of products and technologies if the partnership ends. 	<ul style="list-style-type: none"> <input type="checkbox"/> Management representation and, in case of a joint venture, board representation of the alliance. <input type="checkbox"/> Identification of resources to be used (e.g. new, dedicated staff or resources assigned from each partner). <input type="checkbox"/> Mechanisms for possible future business expansion. <input type="checkbox"/> Mechanisms for a partner to extract themselves from the alliance. <input type="checkbox"/> Decision-making process in the event of partner dissolution as well as division of assets and technology.

Figure 3.4 What Needs to Be Negotiated?

Source: Adapted from Marlee Myers, "Strategic Partnerships," *Pittsburgh High Technology Journal*, May 1989, 5-6.

PARTNER CONTRIBUTION VALUATION

Valuing the partners' contributions tends to be one of the most difficult and contentious issues in alliance negotiations.⁵ The assessment of a partner's value will depend on an estimate of its present and future contributions and will vary in its measurability on the choice of alliance form and the nature of the assets involved. Typical areas of contribution to be valued are as follows:

- Fixed assets
- Working capital
- Expertise
- Contact network (e.g., access to customers)
- Brand and associated goodwill
- Expected technology transfer

Partner contribution valuation is not an exact science. A partner company's attitude to alliances and how they should be controlled and managed, as well as its expectations about how a particular venture will evolve, heavily influences its approach to valuation. For example, if one or both partners bring to the valuation process a power or competitive

attitude, an agreement will likely be harder to reach. The partners' relative power is generally not a key ingredient in the success of the alliance. It is more effective to start

When Negotiations Should Stop

Springboard Wireless Networks, a spin-off of Toronto-based Kasten Chase, had developed a world-leading communications system for managing the flow of subways and trains more efficiently. While most land-based traffic systems were based on a "fixed-block" queuing approach, Springboard was set to revolutionize flow management with a wireless communications system that would support much more efficient "moving block" systems. In 1999, the City of New York subway system—known for setting global industry standards in underground transportation—was impressed with the technology and incorporated it in its reference specification for a pilot project it was about to launch. Collaboration promptly began with Alstom, Alcatel, and Siemens, which were competing for the New York project. A strong relationship emerged with Alstom representatives, and the two companies embarked on alliance discussions. For Springboard, the alliance represented an exceptional opportunity to accelerate growth in the 25-person company, and management was not opposed to acquisition as an eventual outcome. The primary concern, however, was that Springboard retain sufficient control to enable it to continue to work with the remaining two competitors in the short term and retain the option of an initial public offering (IPO) should acquisition not occur. Negotiations began well, based on their relationship foundation. As executives from France headquarters became involved, however, Springboard sensed the emergence of conflicting agendas. French executives were interested in making a small investment but were insistent on assuming effective management control. After careful consideration, Springboard concluded that the control issue presented far too much risk that directly contravened its strategic goals. Negotiations promptly terminated.

with the definition of what constitutes a contribution in light of the key success factors for the alliance and the potential payoffs that a partner expects to derive from the collaboration. In some cases, companies will not fight over the valuation of their contribution when they have determined that the tangible and intangible returns that they expect from the alliance will at least meet their initial expectations.

Resolving divergent positions on valuation, particularly non-market-based contributions such as expertise, can become a delicate matter. While some partners can agree on simple methodologies such as "splitting the difference," others may pursue much more sophisticated methodologies, including the following:

- *Discounted cash flows (DCF)* value the prospective future cash flows of the venture in terms of present-day value.
- A *capitalization approach* measures the asset value of contributions to the alliance based on the projected net income and expected rate of return.
- The *cost approach* takes into consideration the cost needed to substitute an alternative contribution that would meet the objectives of the alliance.
- An *industry benchmarking approach* places emphasis on the past valuation of similar ventures within the same industry. This approach factors in the competitive forces that would influence partner valuation.

Regardless of the approach, it is advisable to first agree on a process for resolution such as deferring to a mutually agreed-upon third party.

THE AGREEMENT

Informal alliances often do not require binding agreements. Rather, the partners maintain individual control over specific areas of responsibility but share the results jointly. Most arrangements, however, are cemented by a contractual agreement. The complexity of the agreement will be related to the proposed scope and structure of the venture.

Two companies that have never worked together before may want to consider a less formal alliance as a first step in collaboration. This could be a narrowly focused agreement that defines a small project, which allows the partners to see how the two companies interact and establish mutual trust on which to base a broader

partnership. Terminating a small alliance that is not working is infinitely easier than disengaging from a large one.

Legal agreements should be well written and set out the purpose, terms, duration, warranties, obligations, and other key understandings on which the relationship is based. They should be designed to reinforce the business objectives of the partnership and, at the same time, protect the partners. Some of the best agreements, while setting out clearly articulated ground rules, leave a lot of room for the relationship to grow and deal with changes. The following suggest areas applicable to an alliance legal agreement:

- The venture's objectives
- The level of commitments and contribution of both parties
- An organizational structure congruent with the venture's strategy with an appropriate incentive and reward structure
- Benchmarks, performance objectives, and review process
- A description of the roles and responsibilities of the parties
- An implementation plan
- Formulas for transfer pricing, earnings, and equity
- Detailed penalty, arbitration, and termination clauses
- Provisions for expansion of activity
- Procedures for adapting to change
- Conflict resolution procedures
- Mechanisms and procedures for governance of the venture
- Provisions for control (in the case of joint venture)
- Finance, tax, and legal considerations

The remainder of this section focuses on six aspects of the alliance agreement that merit particular attention: mission, structure and governance, ownership and control, establishing performance objectives, providing for termination, and establishing conflict resolution procedures.

1. Mission

Managers need to be painstakingly thorough in describing the mission or scope of the venture's activity. They should ensure that matters important to them such as business mission, access to technology, learning, financing, and dividend policy are covered to their satisfaction in the written agreement.

2. Structure and Governance

The alliance's structure provides the context for the interaction among partners. The strategic and operational objectives of the partners can only be achieved if facilitated by the alliance structure. For example, in an alliance where learning is a key objective, the venture's structure will be a determining factor in the nature of the partner interaction and the types and amounts of the information to be transferred.

As a minimum, alliance structure and governance should address the board configuration, roles, responsibilities and lines of authority, frequency of meetings, and other expected forms of communications. The key word to an alliance structure that is operationally feasible is *simplicity*. The ideal structure is one that is uncomplicated with clear lines of authority, communication, and decision making. Alliances that have very ambitious goals and involve significant

interactions between partners or complex interdependencies run a higher risk of failure, especially if partners are new to each other or have little experience managing alliances.

There are numerous possible tools for structuring a venture. While each varies in complexity and commitment, there are advantages and disadvantages to be considered. Lynch outlines the following approaches to structuring an alliance.⁶

- A *handshake* is used more often than imagined in nonequity arrangements, even by some very large corporations. This approach tends to be used where a high level of trust already exists between the partners and where no legal or contractual documentation is necessary. It may also be an interim arrangement where there is a desire to get the venture up and running before contracts or legal documents are prepared. Handshake agreements are not recommended where corporate or staffing changes may jeopardize the memory and understanding of the arrangement.

- *Contracts and written agreements* maintain an arm's-length relationship between the parties. Each outlines how the revenue is to be divided and who is responsible for specific performance tasks and deliverables. This approach is typically used for short-term relationships (under 3–5 years), where daily or close coordination is not required, or where capital investments are separately made by both parties for their own activities.

- *Partnership* is a legal structure that allocates investment, profits, losses, and operational responsibilities while maintaining the autonomy of the participants. Small entrepreneurial companies commonly choose this arrangement or in cases where the alliance is project oriented, requiring high levels of commitment and interaction for limited periods of time (likely to endure less than 5 years). It is appropriate when a separate business entity is required but there is no need for separate management. It has a great range of flexibility in what is often an uncertain environment.

- *Joint venture* is the most formal of alliance structures. It involves the parties coming together and creating a separate or stand-alone entity in which they all have an equity interest. Joint ventures—described by some as permanent solutions to temporary problems—are best used when the project is large or complex enough to require its own internal management and when the goal of the venture is long term. The structure works best when it has a certain amount of autonomy while being strategically driven by the founding parents.

The issue of equity involvement should be a strategic consideration when establishing a venture's structure. Numerous alliances operate successfully without an equity link. Equity participation can permit some control over ventures that are central to a partner's long-term competitive success or involve a substantial contribution of technological resources and shared information. The decision needs to be made in the context of balancing control and preserving agility. A company needs to be careful about locking into an equity-based alliance in an environment where technology, market conditions, and strategy are constantly evolving.

3. Ownership and Control

In equity-based joint ventures, ownership and control should be treated as separate issues. Control is about the ability to influence behaviors and decisions in a partnership (see Figure 3.5 for examples of control mechanisms). For instance, a company in a minority equity position may still be able to control key decisions. Many executives believe that,

irrespective of the ownership structure of a joint venture, it should be run as much as possible as if it was a 50/50 arrangement. The power associated with majority ownership should be used very selectively to preserve the spirit of the partnership, although, where compromise is not possible, the majority partner needs to exercise his or her voting authority to ensure the continuation of the joint venture's affairs.

But even with 50/50 ownership, one partner should be clearly responsible for ultimate management control. In some cases, partners agree to maintain control over specific functions of the venture that are critical to them. In fact, a 2002 study of international joint ventures in Korea found that split control yielded higher performance than shared control.⁷ It is noteworthy that the McKinsey and Company study also found no instances of a successful joint venture where management control was shared evenly between the owners.

The resolution of the control issue, particularly in joint venture agreements, should result in a decision-making structure that is efficient, collaborative, and synergistic. Control should be a business decision first and a legal decision second. Control should not be approached in terms of who has more or less control but rather in terms of three key questions:

- Who should control what?
- How should control be exercised over key areas?
- When should control be exercised?

Addressing these questions forces both partners to determine who is in the best position to contribute to areas critical to the alliance's success and to allocate responsibilities accordingly.

4. Establishing Performance Objectives

Successful partnerships require regular and frequent care and attention. Periodic reviews based on prespecified benchmarks allow both parties to assess the progress and

Hard Mechanisms	Soft Mechanisms
Design/participate in planning process	Board of Directors
Design/approve capital appropriation	Approval requirements for
Formulation of policies & procedures	<ul style="list-style-type: none"> • Specific decisions • Plans, budgets • Resource allocation
Staffing: Alliance general manager, Key functional executives	Appointment of alliance GM
Set objectives for alliance GM	Screening of issues before discussion with partner
Reporting structure	
Training programs	
Staff services	
Set performance measurement	
Set compensation formula	

Figure 3.5 What Control Mechanisms Work Best?

identify problem areas. They also help manage expectations and enable partners to make any necessary adjustments early rather than wait until deviations become substantial and the alarm bells ring. Benchmarks can also be used to manage infusions of capital and technology transfer in ways that protect partner interests. Some companies use performance objectives to build trust and enthusiasm by moving from simple to more complex interdependencies throughout a series of easily achievable milestones.

5. Providing for Termination

A good relationship and a well-conceived agreement make provisions for changing circumstances and the possibility that the alliance will be terminated. Relationships can outlive their usefulness even when they have a mutually productive and beneficial history. The directions of companies change. New management may have a different vision for the corporation. The founder of a company may decide it's time to sell out and do something different. Hence, it is important to insist on a termination clause that details how separation occurs if one partner wants out. It is always a painful process to work through a separation without guidance from an agreement.⁸

Termination should include agreement on the allocation of rights and assets emerging from the alliance. One way to avoid unmet expectations is to spell out, in the contract, the terms and conditions for continuation of the relationship. Put in writing the outcomes that must be achieved for the partnership to continue and list things that can lead to the termination of the arrangement. A requirement that the principals meet at least every year, review progress, agree on future plans and goals for the collaboration, and revise terms and conditions for renewal and termination as needed is also a useful way to ensure the relationship continues to benefit both parties. If there are phases or stages in the contract, the collaboration agreement needs to say what they are.

6. Establishing Conflict Resolution Procedures

Strategic alliances often involve partners with different corporate and national cultures, capabilities, and, in some cases, ultimate objectives. A certain amount of conflict, therefore, is inevitable. However, to minimize their consequences, companies incorporate in contracts clauses that spell out the handling of disputes.

A moderate degree of conflict in an alliance can be quite healthy and a stimulus to creativity and improved performance. As a first step, partners should look at mitigating potential conflicts structurally or managerially. Where the potential exists for a high level of conflict, it may be best to start off with a highly focused venture with a simple structure and work on building the relationship. Work to find solutions to potential conflicts before attempting a more complex arrangement.

A mutually agreed-to, clearly articulated alliance strategy will divert many conflicts, and asking, "What is in the best interest of the alliance strategy?" will often eliminate the conflict. Similarly, consistent and mutually agreed-upon management principles for the venture will help as many of the conflicts that arise during alliances are the result of misunderstandings between the partners.

A 1999 study among 40 Russian-based international joint ventures revealed nine successful strategies for minimizing conflict, many of which are discussed here.⁹ Of particular interest is the recommendation to have a process in place *before* real conflicts arise. A process could include dialogs, written statements, parent intervention, and ultimately

arbitration. A formal method for resolving disputes should be outlined within the agreement and be consistent with the nature of the venture and the resources of the partners.

In closing, good contracts, whether formal or informal, are essential to alliances; however, no contract can specify all of the eventualities and anticipate all of the future opportunities. The key to a successful alliance is a strong relationship between the partners supported by mutual trust and commitment. These relationship factors will greatly facilitate getting access to the partner capabilities needed and overcoming some of the rough spots that the alliance will go through during its lifetime. A good contract is no substitute for a good relationship.

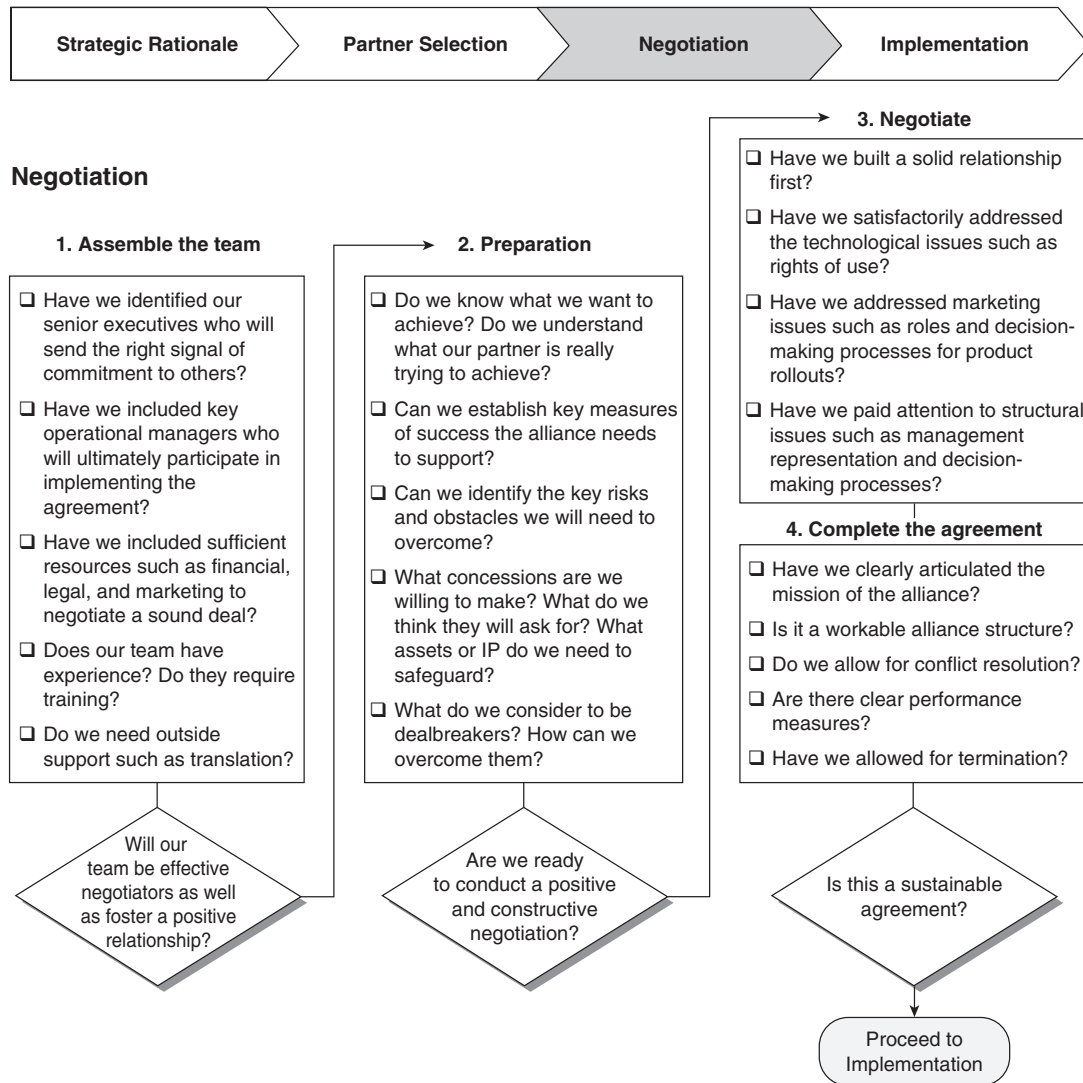


Figure 3.6 Negotiation Flowchart

CASES

Blue Ridge Spain

Blue Ridge Spain was a joint venture established between a well-known U.S. fast-food chain and an “old guard” family-run agricultural company that was seeking to diversify in the wake of Spain’s entry into the European Union. The European regional director of the company has been dealt an unexpected professional blow. After several years of fostering a successful joint venture, the regional director is stunned to find out that the new owners of Blue Ridge want out of the arrangement. Despite the fact that this particular joint venture has been profitable since its inception and the company has experienced brisk growth during that time, the new owners are determined to end the partnership. The regional director is left examining how he is to respond to a request that he feels is not only detrimental to his company but also contrary to his principles. He questions the ethics of secretly undermining the joint venture in order to achieve the upper hand in buyout negotiations. As a Greek, the importance of personal relationships and social contracts only adds to his dilemma.

Assignment Questions

1. What led the joint venture partners to this impasse? What were the major difficulties between the joint venture partners over the years?
2. Be prepared to argue for an action plan from the perspectives below (you will be assigned to one of them). You also want to think about some of the following:
 - As Sodergran and Dryden, representing Delta, how much is Blue Ridge Spain worth to Delta? Would you push ahead with the dissolution strategy? Why or why not? What implementation issues should you consider, and how would you address them? Be prepared to negotiate the price and conditions for ending the joint venture.
 - As Terralumen management, if Delta pursues the dissolution strategy, what would you do? How much is the company worth, and how much do you want for your share of the company? What other issues should they consider? Be prepared to negotiate the price and conditions for ending the joint venture.
3. As Costas, would you go ahead and develop a dissolution strategy for the joint venture? Why or why not? Would you do something else? What issues should you consider in making your decision? What would you do as Costas?

TeqSwitch Inc.: Business in Buenos Aires

Engineers formed TeqSwitch Inc. to design and produce faster networking equipment. Five years after they began, the company has 120 employees in Canada, England, and Australia and sales in the tens of millions. The company decided to expand into Latin America and has worked out a \$15 million joint venture with Unitas in Argentina to sell components. TeqSwitch establishes an office in Buenos Aires and works with Unitas to develop sales personnel and business processes. As the company is about to launch its next generation of products, the vice president international of TeqSwitch receives information from the joint venture partner about terminating the agreement. He must determine what has gone wrong.

Assignment Questions

1. Why did this joint venture fail?
2. What advice would you give to TeqSwitch for its next Argentinean joint venture?

Textron Ltd.

Textron Ltd. is a family-owned manufacturer of cotton- and sponge-fabricated items. The company wants to expand its business with an offshore manufacturing enterprise that will fit with the company's policy of caring for its employees and providing quality products. The company is looking at two options: a guaranteed outsourcing purchase agreement or a joint venture. After several meetings with offshore alliance candidates, the vice president of the company must analyze the cross-cultural differences to established corporate guidelines of global ethics and social responsibility that the company can use in its negotiations with a foreign manufacturing firm.

Assignment Questions

1. As an outside consultant brought into the situation to address all issues, advise Gary Case as to appropriate action he should contemplate taking.
2. As a member of the board of directors of Textron Ltd., what guidance would you offer to the executive involved?
3. Draft a corporate code of conduct as a model for global companies built around the *absolute* business practices (*core human values* practiced through the doctrine of *ethical imperialism*). These are the points that shall not be compromised regardless of which host country a multinational enterprise operates in. It should recognize *relative* business practices (respect for local traditions and context practiced via the doctrine of cultural relativism) that recognize the differences in economic and social environments that multinational firms locate their activities within.

Nora-Sakari: A Proposed JV in Malaysia (Revised)

This case presents the perspective of a Malaysian company, Nora Bhd, which was in the process of trying to establish a telecommunications joint venture with a Finnish firm, Sakari Oy. Negotiations have broken down between the firms, and students are asked to try and restructure a win-win deal. The case examines some of the most common issues involved in partner selection and design in international joint ventures.

Assignment Questions

1. How important is the joint venture to Nora and Sakari?
2. If the joint venture is important, why have the negotiations failed to this point?
3. Should Nora and Sakari renegotiate? If yes, how should they restructure the deal to reach a win-win situation?

Majestica Hotel in Shanghai?

Majestica Hotels Inc., a leading European operator of luxury hotels, was trying to reach an agreement with Commercial Properties of Shanghai (CPS) regarding the management contract for a new hotel in Shanghai. A series of issues requires resolution for the deal to proceed, including length of contract term, name, staffing, and many other control issues. Majestica was reluctant to make further concessions for fear that doing so might jeopardize its service culture, arguably the key success factor in this industry. At issue was whether Majestica should adopt a contingency approach and relax its operating philosophy or stick to its principles, even if it meant not entering a lucrative market.

Assignment Questions

1. How many issues require resolution between Majestica and CPS?
2. As Majestica, where, if anywhere, would you make concessions?
3. As CPS, if Majestica refuses to make concessions, will you walk away?

Eli Lilly in India: Rethinking the Joint Venture Strategy

Eli Lilly and Company is a leading U.S. pharmaceutical company. The new president of intercontinental operations is reevaluating all of the company's divisions, including the joint venture with Ranbaxy Laboratories Limited, one of India's largest pharmaceutical companies. This joint venture has run smoothly for a number of years despite their difference in focus, but recently, Ranbaxy was experiencing cash flow difficulties due to its network of international sales. In addition, the Indian government was changing regulations for businesses in India, and joining the World Trade Organization would have an effect on India's chemical and drug regulations. The president must determine if this international joint venture still fits Eli Lilly's strategic objectives.

Assignment Questions

1. Did Eli Lilly pursue the right strategy to enter the Indian market?
2. Carefully consider the evolution of the joint venture. Evaluate the three successive international joint venture (IJV) leaders. Identify the unique challenges faced by each.
3. How would you assess the overall performance of the joint venture (JV)? What did the partners learn from the IJV?
4. What action would you recommend regarding the Ranbaxy partnership? What are the implications of your recommendation? How would you implement this?

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5. For a discussion of valuation issues, see Child and Faulkner, *Strategies of Cooperation*, 157–60; Y. Doz and G. Hamel, *Alliance Advantage: The Art of Creating Value Through Partnering* (Boston: Harvard Business School Press, 1998), 66–72; R. Spekman, L. Isabella, and T. MacAvoy, *Alliance Competence* (New York: John Wiley, 2000), 147–8.

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BLUE RIDGE SPAIN

*Prepared by Jeanne M. McNett under the supervision of
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Yannis Costas, European managing director of Blue Ridge Restaurants, found it difficult to control the anger welling up inside him as he left the meeting with the company's regional vice-president (VP) earlier in the day. That evening, he began to reflect on the day's events in the relative peace of his London flat. "Ten years work gone down the drain," he thought to himself, shaking his head. "What a waste!"

Costas recalled the many years he had spent fostering a successful joint venture between his company, Blue Ridge Restaurants Corporation, and Terralumen S.A., a mid-sized family-owned company in Spain. Not only had the joint venture been profitable, but it had grown at a reasonably brisk pace in recent years. Without a doubt, partnering with Terralumen was a key reason for Blue Ridge's success in Spain. Therefore, Costas was somewhat dismayed to find out that Delta Foods Corporation, Blue Ridge's new owner, wanted out. Yes, there had been recent tension between Terralumen and Delta over future rates of growth (see Exhibits 2 and 3), but the most recent round of talks had ended in an amicable compromise—he thought. Besides, Delta's senior managers should have realized that their growth targets were unrealistic.

They had gone over the arguments several times, and Costas tried every angle to convince his superiors to stick with the joint venture, but to no avail. To make matters worse, Costas had just been assigned the unpleasant task of developing a dissolution strategy for the company he had worked so hard to build.

BLUE RIDGE RESTAURANTS CORPORATION

Blue Ridge was founded in Virginia in 1959, and quickly established a reputation for quality fast

food. In 1974, after establishing more than 500 food outlets in the United States and Canada, Blue Ridge was sold to an investment group for US\$4 million.

Over the next five years, the company experienced sales growth of 96 per cent annually. However, international sales were haphazard and there was no visible international strategy. Instead, whenever a foreign restaurateur wanted to begin a Blue Ridge franchise, the foreign company would simply approach Blue Ridge headquarters with the request. As long as the franchise delivered royalties, there was little concern for maintaining product consistency or quality control in foreign markets.

In 1981, Blue Ridge was acquired by an international beverages company for US\$420 million. Under new ownership, the company made its first major foray into international markets, and international operations were merged with the parent company's existing international beverage products under a new international division.

The strategy at the time was to enter into joint ventures with local partners, thereby allowing Blue Ridge to enter restricted markets and draw on local expertise, capital and labor. Partnering also significantly reduced the capital costs of opening new stores. The strategy of local partnering combined with Blue Ridge's marketing know-how and operations expertise, quickly paid off in Australia, Southeast Asia and the United Kingdom, where booming sales led to rapid international expansion.

On the other hand, there were some glaring failures. By 1987, Blue Ridge decided to pull out of France, Italy, Brazil and Hong Kong where infrastructure problems and slow consumer acceptance resulted in poor performance. Some

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managers, who had been accustomed to high margins and short lead times in their alcoholic beverages division, did not have the patience for the long and difficult road to develop these markets and would tolerate only those ventures that showed quick results.

These early years of international expansion provided important learning opportunities as more managers gained a personal understanding of the key strategic factors behind successful foreign entry. The success of the company's international expansion efforts helped Blue Ridge become the company's fastest growing division. When Blue Ridge was sold to Delta Foods in 1996 for US\$2 billion, it was one of the largest fast-food chains in the world and generated sales of US\$6.8 billion.

Delta was a leading soft drink and snack food company in the United States, but at the time of the Blue Ridge acquisition, it had not achieved significant success internationally. It had managed to establish a dominant market share in a small number of countries with protected markets in which its main competitors were shut out. For example, one competitor was shut out of many Arabic countries after deciding to set up operations in Israel.

The company's senior managers disliked joint ventures, in part because they were time-consuming, but also because they were viewed as a poor way to develop new markets. Delta was an aggressive growth company with brands that many believed were strong enough to support entry into new overseas markets without the assistance of local partners. When needed, the company either hired local managers directly or transferred seasoned managers from the soft drink and snack food divisions.

Delta also achieved international growth by directly acquiring local companies. For example, in the late 1990s, Delta acquired the largest snack food companies in Spain and the United Kingdom. However, given that joint ventures had been the predominant strategy for Blue Ridge, and that some countries, such as China, required local partnering, Delta had no choice but to work with joint venture partners.

YANNIS COSTAS

Yannis Costas was an American-educated Greek who held degrees in engineering and business (MBA) from leading U.S. colleges. Although college life in a foreign country had its challenges, it afforded him an opportunity to develop an appreciation and understanding of American culture and business practices. Therefore, upon completing his MBA, Costas turned-down several offers of employment from leading multinational corporations that wanted him to take management positions in his native country. Such positions, however appealing they may have been at the time, would have doomed him to a career as a local manager, he thought. He chose instead to accept a position in international auditing at Blue Ridge headquarters in Virginia, mainly because of the opportunity for extended foreign travel.

The transition from university to corporate life was a difficult one. Social life seemed to revolve around couples and families, both at Blue Ridge and in the larger community. Although Costas met some single women from the local Greek community, his heavy travel schedule prevented him from establishing any meaningful relationships. Instead, he immersed himself in his work as a way to reduce the general feeling of isolation.

Costas was fortunate to have an office next to Gene Bennett, the company's director of business development. Bennett had served as a lieutenant in the U.S. Navy before working in the pharmaceutical industry setting up joint ventures in Latin America and Europe. He was hired by Blue Ridge specifically to develop international joint ventures. As Costas' informal mentor, Bennett passed on many of the lessons Costas would come to draw on later in his career.

It was at the urging of Bennett that Costas applied for a transfer to the international division in 1985. Three years later, Costas was asked to relocate to London, England, in order to take on the role of European regional director for Blue Ridge. In this position, he became responsible for joint ventures and franchises in Germany, the Netherlands, Spain, Northern Ireland, Denmark, Sweden and Iceland.

In 1993, Costas was transferred to Singapore where, under the direction of the president of Blue Ridge Asia,¹ he advanced in his understanding of joint ventures, market entry and teamwork. Over the next five years, Costas built a highly productive

management team and successfully developed several Asian markets. He was eager to apply these new skills when he returned to London in 1998 to once again take up the role of European director (see Exhibit 1 for a summary of Costas' career).

Year	Blue Ridge Restaurants	Yannis Costas
1959	Company founded in Virginia	
1974	Blue Ridge Sold for \$4 million	
1975–1980	96 per cent annual growth	Leaves Greece to study in United States
1981	Blue Ridge sold for \$420 million	
1982	International expansion	Completes his BS in United States
1983	Begin negotiations for JV in Spain	
1984		Completes MBA and is hired by Blue Ridge; moves to Virginia
1985	JV agreement with Terralumen S.A.	Applies for transfer to International Div.
1986	Rodrigo appointed managing director of Blue Ridge Spain	
1987	Company pulls out of France, Brazil, Hong Kong and Italy	
1988		Promoted to European regional director; moves to London
1988–1993	Spanish JV grows slower than expected	
1993	U.S. manager sent to oversee Spanish JV	Transfer to Singapore
1995	Rodrigo replaced by Carlos Martin	
1996	Blue Ridge sold to Delta for \$2 billion	
1995–1998	Spanish JV grows more rapidly	
1998	5-year plan for 50 restaurants in Spain, Blue Ridge has 600 stores in Europe/ME	Costas asked to return to London
Jan. 1999		Rescues JV in Kuwait
May 1999	Södergran hired as Delta VP for Europe	
June 1999	Directors meeting for Spanish JV	
December 1999	Dryden withholds Delta payment to JV; Alvarez sells prime Barcelona property	
January 2000		Asked to develop dissolution strategy for Spain

Exhibit 1 Timeline

THE SPANISH DECISION

When the decision was first made to enter the Spanish market, Bennett was sent overseas to meet with real estate developers, construction companies, retail distributors, agribusiness companies, lawyers, accountants and consumer product manufacturers in order to gather the preliminary knowledge needed for such an undertaking. Bennett soon realized that Blue Ridge would need a credible Spanish partner to navigate that country's complex real estate and labor markets.

Few Spaniards among Bennett's peer generation spoke English. However, Bennett had a basic knowledge of Spanish, a language that he had studied in college, and this helped open some doors that were otherwise shut for many of his American colleagues. Still, Bennett knew that finding a suitable partner would be difficult, since Spaniards frequently appeared to distrust foreigners. The attitude of one investment banker from Madrid was typical:

Many Spaniards do not want to eat strange-tasting, comparatively expensive American food out of paper bags in an impersonal environment. We have plenty of restaurants with good inexpensive food, a cozy atmosphere and personal service, and our restaurants give you time to enjoy your food in pleasant company. Besides, we don't even really know you. You come here for a few days, we have enjoyable dinners, I learn to like you, and then you leave. What kind of relationship is that?

Luckily, Bennett had a banker friend in Barcelona who recommended that he consider partnering with Terralumen.

TERRALUMEN S. A.

Terralumen was a family-owned agricultural company that had later expanded into consumer products. In doing so, Terralumen entered into several joint ventures with leading American companies. In recent years, Terralumen had also begun to experiment with the concept of establishing full-service restaurants.

Bennett was introduced to Francisco Alvarez, Terralumen's group vice-president in charge of restaurant operations and the most senior non-family member in the company. In time, Bennett had many opportunities to become well acquainted with Terralumen and its managers. On weekends he stayed at Alvarez's country home, attended family gatherings in Barcelona and had family members visit him in Virginia. Over the span of their negotiations, Bennett and Alvarez developed a solid friendship, and Bennett began to believe that Terralumen had the type of vision needed to be a successful joint venture partner.

After two years of negotiations, Blue Ridge entered into a joint venture with Terralumen to establish a Blue Ridge restaurant chain in Spain. Upon returning to Virginia, Bennett could not hold back his euphoria as he related to Costas the details of what he considered to be the most difficult joint venture he had ever negotiated.

BLUE RIDGE SPAIN

Alvarez hired Eduardo Rodrigo to head up the joint venture as its managing director. An accountant by trade, Rodrigo was a refined and personable man who valued his late afternoon tennis with his wife and was a professor at a university in Barcelona. He also spoke fluent English.

Before assuming his new role, Rodrigo and another manager went to Virginia to attend a five-week basic training course. Upon his return, Rodrigo's eye for detail became quickly apparent as he mastered Blue Ridge's administrative and operating policies and procedures. He knew every detail of the first few stores' operating processes and had an equally detailed grasp of each store's trading profile. As a result, Blue Ridge Spain began to show an early profit.

Profitability was one thing; growth was another. Although the Blue Ridge concept seemed to be well received by Spanish consumers, Rodrigo was cautious and avoided rapid expansion. Moreover, one of the most important markets in Spain was Madrid. Rodrigo, who was Catalan,² was not fond of that city and avoided travelling to Madrid

whenever possible. As personal contact with real estate agents, suppliers and others was necessary to develop new stores, Blue Ridge's expansion efforts remained confined to the Barcelona area. Terralumen, becoming impatient with Blue Ridge's sluggish growth, decided to focus more resources on its consumer product divisions and less on the restaurant business.

For Costas, one of the challenges during his first assignment as European director was to convince Terralumen to focus more on the joint venture and support faster growth. Rodrigo positively opposed more rapid growth, even though Alvarez, his direct superior, voiced support for the idea. Although he had been very cordial in his interactions with his American counterparts, Rodrigo believed himself to be in a much better position to judge whether or not the Spanish market would support faster growth.

In 1993, shortly after Costas was transferred to Singapore, Blue Ridge decided to send one of its own managers to oversee the Spanish joint venture. Under pressure, Rodrigo began to ignore criticism about the company's lack of growth. On one occasion, Rodrigo decided to close the Blue Ridge offices for an entire month just as Blue Ridge's international director of finance arrived in Barcelona to develop a five-year strategic plan.³

Terralumen finally replaced Rodrigo with a more proactive manager who had just returned from a successful assignment in Venezuela. Under the new leadership of Carlos Martin, Blue Ridge Spain began to prosper. Soon everyone was occupied with the difficult task of acquiring new sites, as well as recruiting and training employees.

COSTAS RETURNS TO EUROPE

In late 1998, Costas was transferred from Singapore to London to resume the role of European managing director. The previous director had performed poorly and it was felt that Costas had the experience needed to repair damaged relations with some of Blue Ridge's Middle Eastern joint venture partners. By this time, Blue Ridge had more than 600 stores in Europe and the Middle East.

One of Blue Ridge's more lucrative joint ventures was in Kuwait. However, the partners were threatening to dissolve the enterprise after the previous managing director became upset that the Kuwaitis were not meeting growth targets. The partners were especially concerned when they discovered that he had begun to seek other potential partners.

Costas decided to schedule a visit to Kuwait in early January. The partners counselled against the visit since Costas would be arriving during Ramadan,⁴ and therefore would not be able to get much work done. Nevertheless Costas went to Kuwait, but spent nearly all of his time having dinners with the partners. He recalled:

Most American managers would have considered my trip to be a waste of time, since I didn't get much "work" done. But it was a great opportunity to get to know the partners and to re-establish lost trust, and the partners felt good about having an opportunity to vent their concerns.

Costas returned to London confident that he had reassured the Kuwaiti partners that Blue Ridge was still committed to the joint venture.

Costas was also happy to be working with his old friend Alvarez again, as the two began working on an ambitious plan to develop a total of 50 stores by 2002 (see Exhibit 2).⁵ As Blue Ridge Spain continued to grow, stores were opened in prime locations such as the prestigious Gran Via in Madrid and Barcelona's famous Las Ramblas shopping district. Costas and Alvarez, both of whom had been involved from the beginning of the joint venture, were delighted to see how far the company had come.

EUROPEAN REORGANIZATION

Delta began to take a more direct and active role in the management of Blue Ridge. In Europe, for example, Delta created a new regional VP position with responsibility for Europe, the Middle East and South Africa. When Costas became aware of the new position, he asked

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	1998	2000	2001	2002	2003	2004
No. of Stores	12	24	37	50	65	80
Avg. Annual Sales	700	770	847	932	1,025	1,127
Gross Sales	\$8,400	18,480	31,339	46,600	66,625	90,160
Cost of Goods Food	1,680	3,322	5,474	8,141	11,639	15,770
Cost of Goods Direct Labor	1,680	3,323	5,641	8,374	11,646	15,766
Advertising/Promotion	504	1,109	1,880	2,796	3,998	5,410
Occupancy Costs	1,260	1,848	3,129	4,660	6,663	9,016
Fixed Labor	840	1,478	2,507	3,728	5,330	7,213
Miscellaneous	168	277	470	699	999	1,352
Royalties to Blue Ridge U.S.	420	924	1,560	2,330	3,331	4,508
Total Costs	6,552	12,281	20,662	30,728	43,606	59,035
Contribution to G&A	1,848	6,199	10,677	15,872	23,019	31,125
Salaries and Benefits	875	1,531	2,641	3,493	4,580	5,899
Travel Expenses	120	240	300	375	469	586
Other	240	312	406	527	685	891
Occupancy Costs	240	720	828	952	1,095	1,259
Total G&A	1,475	2,803	4,175	5,347	6,829	8,635
Earnings Before Interest/Tax	\$ 373	3,396	6,502	10,525	16,190	22,490
% of Gross Sales	4.44	18.38	20.75	22.59	24.30	24.94
Office Employees (Spain)	10	20	30	35	40	45

Exhibit 2 Development Plan Agreed Between Blue Ridge Restaurants and Terralumen (as of December 1998) (in US\$000s)

Source: Company files.

- This plan was agreed before Yannis Costas' appointment to Blue Ridge Europe in late 1998.
- End 2004 plan: 20 stores in Barcelona, 30 in Madrid, 30 in other cities
- Capital Investment per store \$700,000 to \$1 million
- Site identification, lease or purchase negotiation, permits, construction: 18 to 24 months. Key Money is a part of occupancy costs. It is a sum paid to property owner at signing; varies by site \$100,000 plus. Up to 1999, many owners wanted Key Money paid off the books, often in another country.
- Store Staffing (at the average sales level):
 - One manager, two assistants full time (larger stores three to four assistants)
 - 10 to 12 employees per eight-hour shift (40 hours per week); 980 employee hours per week
- Store employees needed by end of 1999: 300; by the end of 2004: 2,250 (approx.)
- Store employee attrition: approximately 25 per cent per year
- Dividends from earnings were declared periodically and then were shared equally between partners.

whether or not he was being considered, given his extensive experience in managing international operations. The human resources department in the United States explained that they wanted to put a seasoned Delta manager in

place in order to facilitate the integration of the two companies.

Although disappointed, Costas understood the logic behind the decision. He also considered that by working under a seasoned Delta manager,

he could develop contacts in the new parent company that might prove favorable to his career at some future date.

In May 1999, Costas received a phone call from Bill Sawyer, Blue Ridge's director of human resources, whom Costas had known for many years.

Sawyer: We hired someone from Proctor and Gamble. He's 35 years old and has a lot of marketing experience, and he worked in Greece for three years. You'll like him.

Costas: That's great. Have your people found anyone for the VP job yet?

The line was silent, then Sawyer replied in an apologetic tone, "He *is* the new VP." Costas was dumbfounded.

Costas: I thought you said you were planning to transfer a Delta veteran to promote co-operation.

Sawyer: Nobody from Delta wanted the job, so we looked outside the company. Kinsley (president, international division) wanted a "branded" executive, so we stole this guy from P&G.

Sawyer went on to explain that Mikael Södergran, who was originally from Finland, had

no background in restaurant management, but had achieved a reputation for results in his previous role as a P&G marketing manager for the Middle East and Africa. He had recently been transferred from Geneva, Switzerland to P&G European headquarters in Newcastle upon Tyne.⁶ Södergran was not happy in Newcastle and saw the Delta position both as an opportunity to take on greater responsibility and to move back to the civilization of London.

"You couldn't find anyone better than *that*?" Costas exclaimed. He was furious, not only for having been deceived about the need to have a Delta manager as VP, but also that he, with 10 years experience managing international operations, had been passed over in favor of someone with no experience managing operations, joint ventures or a large managerial staff. Nevertheless, the decision had been made, and Södergran was scheduled to start in two weeks.

THE DIRECTORS' MEETING

It was Södergran's first day on the job when he met with Blue Ridge Spain's board of directors to discuss a recently drafted consultants' report and negotiate new five-year growth targets (see Exhibit 3). The study, which was conducted by a leading U.S.-based management consulting firm, projected significant expansion potential for

	1998	2000	2001	2002	2003	2004
Stores						
Spain	12	30	65	100	135	170
France	0	10	20	55	90	130
Germany	3	15	30	65	100	150
Total	15	55	115	220	325	450
Regional Managers (London)	1	15	20	22	24	26
<i>Country Staff/Managers</i>	12	40	90	180	220	250
<i>Store Employees</i>	215	1,650	3,450	6,600	9,750	13,500

Exhibit 3 Consultants' Recommendations, Blue Ridge European Expansion (Selected Markets)

Source: Company files.

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Blue Ridge in Spain, as well as in France and Germany, where Blue Ridge had no visible presence.⁷ Delta also wanted to increase the royalties and fees payable from the joint venture partner in order to cover the cost of implementing new technologies, systems and services (see Exhibit 4).

Other Blue Ridge managers at the meeting included Yannis Costas and Donald Kinsley, Blue Ridge's new international president. Although Kinsley had formerly been president of a well-known family restaurant chain in the United States, this was his first international experience. Terralumen was represented by company president

Andres Balaguer, Francisco Alvarez and Carlos Martin, Blue Ridge Spain's managing director.

Even before the meeting began, Delta's management team assumed that Terralumen was content to keep growth rates at their current levels and would have to be pressed to accept more aggressive targets. As expected, Martin protested that his team of 10 managers could not handle the introduction of 30 new stores a year, as suggested by the study. The meeting's cordial tone quickly dissolved when Södergran unexpectedly began to press the issue. His aggressive stance was not well received by Terralumen, who in turn questioned

	Blue Ridge U.S. Desired Objective	Blue Ridge Spain - Variance
Joint Venture Outlets		
Royalty	At least 4 per cent	No royalty
Fees	\$20,000	\$5,000
Term	10 years	5 years
Exclusivity	Avoid exclusivity	Spain, Canary Islands, Spanish Sahara, Belears Islands
Advertising	5 per cent, right of approval	No obligations
Outlet Renewal Requirements	Renewal fee at least \$2,000; Upgrading or relocation	No fee or other specific requirements
Delta Products Development Program	Required Schedule for required development of territory	No requirement No requirement
Non-Competition Assignment	Restrictions on similar business First refusal right; approval of assignee	No provision No provision
Sub-Franchising		
Contract privity	Blue Ridge U.S. should be a party and successor to franchisor	Blue Ridge cited; Blue Ridge succeeds on JV dissolution
Royalty	At least 4 per cent	None
Fees	\$20,000	None
Joint Venture Operation		
Equity Participation	More than 50 per cent	50 per cent
Profit Distribution	At least 50 per cent	Additional 20 per cent when profits are greater than 20 per cent
Actual Management	Blue Ridge U.S. should appoint General Manager	General Manager is from JV partner
Board Control	Blue Ridge U.S. should have majority	Equal number of board members

Exhibit 4 Blue Ridge Spain, Exceptional Term Highlights

Source: Company files.

the ability of the consulting firm's young freshly minted American MBAs to understand the intricacy of the Spanish fast-food market. Balaguer simply brushed off the study as "a piece of American business school cleverness."

Södergran became visibly annoyed at Balaguer's refusal to consider Delta's targets. "The contract says that you are required to grow the markets," Södergran demanded. Balaguer, a tall, elegant man, slowly stood up, lifted a sheaf of papers and replied, "If this is your contract, and if we rely on a contract to resolve a partnership problem, well, here is what I think of it and of you." He walked across the room and dropped the papers into a garbage can. Then upon returning to his seat, he remarked in Spanish, "If this meeting had been conducted in my language, you would have known what I *really* think of you," in reference to Södergran.

After a long pause, Costas tried to mend the situation by pointing out that Terralumen had already committed to considerable growth, and had therefore already come some way toward Delta's expansion goals. He suggested that the two companies break to consider alternatives.

A few weeks later, Costas sent an e-mail to Södergran outlining his recommendations (see Exhibit 5).

EMERGING CONFLICTS

Costas tried his best to keep an open mind with regard to Södergran and to support him as best he could. However, as time went on, Costas began to seriously question Södergran's ability. He never seemed to interact with anyone except to conduct business. On one occasion Costas suggested that they have dinner with the joint venture partners. Södergran replied, "Oh, another dinner! Why don't we get some work done instead?"

Costas became more concerned after Södergran rented a suite two floors below the company offices "in order to have some peace and quiet." Some of the regional headquarters staff began to wonder if Södergran had taken on too much responsibility and whether he was avoiding them because of the pressure he was

under. Costas also believed that Södergran was uncomfortable with him, knowing that he resented not being offered the VP position.

In October 1999, Delta sent a finance manager from the snack foods division to become the company's new VP of finance for Europe. Geoff Dryden had no overseas experience, but when he was in the United States, he had been involved in several large international acquisitions. Dryden, who was originally from North Carolina, was pleasant, well polished in his manners and dress, and very proud of his accomplishments at Delta. For him, the European assignment was an opportunity to move out of finance and, if all went well, to assume greater managerial responsibilities.

Costas, who had specialized in finance when doing his MBA, had always done his own financial projections and was not very fond of the idea of surrendering this responsibility to someone else. Still, he helped Dryden as much as needed to make accurate projections, taking into account the unique aspects of each market.

A NEW STRATEGY

Over the next six months, the joint venture board of directors met four times. In the end, Terralumen committed to half the growth rate originally proposed by Delta and agreed to make upward revisions if market conditions proved favorable. Delta's managers were clearly becoming frustrated by what they perceived to be their partner's entrenched position.

After the final meeting, Södergran and Costas met with their European staff to discuss the results. Dryden asked why they put up with it. "Why don't we just buy them out?" he asked, calling to mind Delta's successful acquisition of a Spanish snack food company. Costas reminded Dryden that not only were snack foods and restaurants two very different enterprises, but all the joint venture managers had come from Terralumen, and most would leave Blue Ridge if Delta proceeded to buy out the partners.

After the meeting, Dryden discussed the situation privately with Södergran. Noting that a

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From: Yannis Costas [Costas@deltafoods.co.uk]
Sent: Wednesday, July 7, 1999 10:16 AM
To: 'Sodergran@deltafoods.co.uk'
Subject: Key Issues – Here is what I believe we should be going for in Spain.

Mikael:

Here are my recommendations for Spain.

A. PRESERVE PARTNERSHIP

- Need a “real” market success while developing markets elsewhere in Europe.
 - Fuel interest of potential partners elsewhere.
 - Keep Blue Ridge and Delta believing in European potential.
 - Market for real testing of concepts and ideas.
 - No complete reliance on UK for “successes.”

B. REVERSAL NOT EASY TO OVERCOME

- May have to pay a high premium to buy out joint venture.
- Will lose all key managers (*no substitutes on hand*)
- If we inherit “green field”
 - Down time close to 2 years.
 - Why? From decision to opening will take approximately nine months to one year.
 - In a new market this will be longer as we have no human resource experience to draw on.
 - Potential new partners need to be convinced about why we broke up with a “good” partner.
 - Real estate market does not want to deal with foreigners or raises the price.
- If the divorce is messy, we may be bound by the current contract for another year.

C. WORK TOWARDS ACHIEVING ACCEPTABLE INTEGRATION WITH OUR DESIRABLE CONTRACT FRAMEWORK OVER CURRENT DELTA PLANNING HORIZON (5 YEARS)

- Strong development schedule for joint venture.
- Royalty integration over mutually acceptable period.
- Designated “agency” for franchisees immediately, but fee flow indirectly to Blue Ridge only the amount *over* current terms with existing franchisees. Phase-in higher flow on schedule similar to royalties.
- Accept the notion of phasing in royalties as *we* phase in systems and services (If we *don't* phase them in there won't be much of a business anyhow!)

D. KEY RATIONALE

- We may have the perfect contract, but no stores to apply it to for three years – hence no income to cover overheads. *SO . . .*
- Accept half the current growth targets with the full expectation that by year 3 or 5, there will be a decent system for the contract's objectives to be meaningful.

Exhibit 5 Costas' Recommendations

major loan payment would soon be due to one of their creditors (a major Spanish bank), Dryden suggested holding back Delta's contribution, thereby forcing the joint venture company to default on the loan. If all went according to plan, the joint venture would have to be dissolved and the assets divided between the partners. This, he noted, would be much less expensive than trying to buy out their partner.

As expected, Terralumen requested matching funds from Delta, but Dryden simply ignored the request. However, unbeknownst to Dryden or anyone else at Delta, Alvarez proceeded to sell one of the company's prime real estate properties and lease back the store as a means of paying the loan.

Costas happened to be in Barcelona working on Blue Ridge Spain's marketing plan with Carlos Martin. One evening, Costas was dining with his

counterparts from Terralumen when Alvarez mentioned the sale of the company's Barcelona property. Costas, who at the time was unaware of Dryden's strategy, was dismayed. Real estate values in Barcelona were expected to appreciate significantly over the short term. Selling now seemed illogical. Furthermore, Costas was surprised to discover that Alvarez had been given power of attorney to make real estate transactions on behalf of the joint venture. Alvarez explained:

Quite a few years ago, when you were in Singapore, Blue Ridge decided to give Terralumen this authority in order to reduce the amount of travel required by your managers in the United States. Besides, as you know, it is not often that good properties become available, and when they do, we must act quickly.

On his return to London, Costas discussed the real estate transaction with Dryden, who, upon hearing the news, furiously accused Costas of "siding with the enemy." Costas was quick to remind Dryden that he had not been privy to the dissolution strategy and, besides, the whole thing was unethical. Dryden retorted, "Ethics? Come on, this is strategy, not ethics!"

Dryden was clearly surprised by the news, especially given the fact that Delta would never have given such powers of attorney to a joint venture partner. The company's lawyers could have warned Dryden, but he had not been very fond of the "old hands" at Blue Ridge's legal affairs department, and therefore had chosen to not disclose his plan. Now that his strategy had failed, an alternative plan would have to be devised.

Costas felt torn between his responsibility to his employer and his distaste for the company's new approach. This whole thing was a mistake, he believed. Costas discussed his views with Södergran:

We cannot hope to take over the stores in Spain while simultaneously developing new markets in Germany and France. Where are we going to find suitable managerial talent to support this expansion? People in Europe don't exactly see the fast-food industry as a desirable place to grow their careers. And besides, Delta hasn't given us sufficient financial resources for such an undertaking.

Why don't we focus on France and Germany instead, and continue to allow Terralumen to run the Spanish operation? Revenue from Spain will help appease Delta headquarters while France and Germany suffer their inevitable growing pains. In the meantime, we can continue to press Terralumen for additional growth.

Södergran dismissed these concerns and instead gave Costas two weeks to develop a new dissolution strategy. Costas was furious that all his suggestions were so easily brushed off by someone who, he believed, had a limited understanding of the business.

On his way home that evening Costas recalled all the effort his former mentor, Gene Bennett, had put into the joint venture 16 years earlier, and all the good people he had had the privilege to work with in the intervening years. Just as all that work was about to pay off, the whole business was about to fall apart. Why hadn't he seen this coming? Where did the joint venture go wrong? Costas wondered what to do. Surely he had missed something. There had to be another way out.

NOTES

1. At the time, Blue Ridge Asia was one of the company's most successful operations with nearly 800 restaurants in Singapore, Malaysia, Taiwan and Thailand.
2. Catalonia, a state in northeast Spain, had a distinct culture and language (Catalan).
3. In Spain, the month of August was traditionally set aside for vacations.
4. Ramadan is the holy month of fasting ordained by the Koran for all adult Muslims. The fast begins each day at dawn and ends immediately at sunset. During the fast, Muslims are forbidden to eat, drink or smoke.
5. The plan to develop 50 stores was agreed to in 1998, prior to Costas' arrival.
6. Newcastle upon Tyne, United Kingdom, was an important industrial and transportation center located in northeast England (approximately 3 hours from London). It had a population of 263,000 (1991 census).
7. Large restaurant chains served only four per cent of fast food meals in Spain, compared with 15 per cent for the rest of Western Europe, and 50 per cent for the United States.

APPENDIX 1: MANAGEMENT STYLES FOR SELECTED NATIONALITIES¹

Spain

In Spain, a strong differentiation of social classes and professional occupations exists. Business communication is often based on subjective feelings about the topic being discussed. Personal relationships are very important as a means to establish trust, and are usually considered more important than one's expertise. Established business contacts are essential to success in Spain. Therefore, it is important to get to know someone prior to conducting business transactions. Only intimate friends are invited to the home of a Spaniard, but being invited to dinner is usual.

Spaniards are not strictly punctual for either business or social events, and once a business meeting is started, it is improper to begin with a discussion of business. National pride is pervasive, as is a sense of personal honor. To call someone "clever" is a veiled insult. Only about 30 per cent of local managers speak English, while French is often the second language of choice for many older Spaniards.

Greece

Greek society employs a social hierarchy with some bias against classes, ethnic groups and religions. For Greeks, interpersonal relationships are very important when conducting business, and decisions are often based on subjective feelings. Much importance is placed on the inherent trust that exists between friends and extended families. Authority lies with senior members of any group, and they are shown great respect. They are always addressed formally.

While punctuality is important, it is not stressed. Greeks have a strong work ethic and often strive for consensus.

United States

Americans are very individualistic, with more stress placed on self than on others. Friendships are few and usually based on a specific need. Personal contacts are considered less important than bottom line results. Americans have a very strong work ethic, but a person is often considered to be a replaceable part of an organization. Great importance is placed on specialized expertise. Punctuality is important.

Business is done at lightning speed. In large firms, contracts under \$100,000 can often be approved by a middle manager after only one meeting. Often companies and individuals have a very short-term orientation and expect immediate rewards. Small talk is very brief before getting down to business, even during dinner meetings and social gatherings.

Finland

Finns have a strong self orientation. More importance is placed on individual skills and abilities than on a person's station in life. Decisions are based more on objective facts than personal feelings. Privacy and personal opinions are considered very important. Finns often begin business immediately without any small talk. They are very quiet and accustomed to long periods of silence, but eye contact is important when conversing. Authority usually rests with the managing director. Punctuality is stressed in both business and social events.

1. Based on *Kiss, Bow, or Shake Hands: How to do Business in Sixty Countries*, Adams Media, 1994. The descriptions do not account for individual differences within each nationality or culture.

TEQSWITCH INC.: BUSINESS IN BUENOS AIRES

Prepared by Ken Mark under the supervision of Professor Christina Cavanagh

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INTRODUCTION

It was the middle of August 2001, and Kyle Keppie, vice-president international of TeqSwitch Inc. had just received confusing news from their joint venture partner, Unitas S.A. in Buenos Aires, Argentina: Unitas was preparing to walk away from their Cdn\$15 million agreement to sell TeqSwitch's networking equipment in Latin America.

The relationship between Toronto-based TeqSwitch and Unitas had seemed fine, thought Keppie. Early on, TeqSwitch had established an office in Buenos Aires to help Unitas sales personnel in the business development process. What in the world was wrong?

BACKGROUND OF THE JOINT VENTURE DEAL

In August 2000, James Munroe, vice-president international for TeqSwitch had signed a Memorandum of Understanding (MOU) with the partners of Unitas, a spinoff company of a well-known Argentinian consulting firm.

The MOU stipulated that TeqSwitch would sell Cdn\$15 million of its cutting-edge networking equipment at 15 per cent less than Canadian wholesale prices to Unitas, over a period of two years. In addition, TeqSwitch would acquire a 15 per cent stake in Unitas by issuing stock options to the four partners at Unitas.

A final agreement was signed in September and the news media were notified. TeqSwitch's stock soared 20 per cent to Cdn\$12.20 that day.

Through his network of contacts, Keppie had hired Rick Lang, a consultant who had worked

in Mexico for the last eight years, to be TeqSwitch's contact with Unitas. While in Mexico, Lang had worked for a large multinational telecommunications company, dealing extensively with Mexican government officials and large Mexican businesses. Essentially, Keppie wanted Lang to represent TeqSwitch in Argentina, to monitor the operations of Unitas and ultimately to guide Unitas representatives along in the sales process.

TEQSWITCH

Founded in 1993, TeqSwitch was the brainchild of two Bell Canada engineers, Kyle Keppie and David Jacobson, who believed they could design, produce and market faster networking equipment. Technology available at that time could only transmit at two megabits per second—Keppie and Jacobson knew that they could design equipment to transmit at more than 50 megabits per second. Frustrated by the bureaucratic new product approval process at Bell, they decided to start their own company, luring away six fellow engineers. After securing seed financing from a regional venture capital firm, they were able to produce and launch their new product, the TS-30 (transmitting at 30 megabits per second) within two years. Within four years, they went public.

Five years after they began, TeqSwitch counted 120 employees in three countries: Canada, England and Australia. Their sales grew into the tens of millions. Careful about managing their cash flow, Keppie and Jacobson were able to survive the stock market decline from mid-2000 to 2001 without having to return to the capital markets.

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Interested in diversifying their customer base, Keppie instructed that TeqSwitch's business development efforts were to focus on Latin America. Here, he thought, was a market prime for TeqSwitch's advanced products. Most large multinational corporations were enamored with the Asian markets, including China, Japan, South Korea and Southeast Asia. Keppie had noticed that there were very few companies targeting Latin American countries. Coupled with the fact that he had contacts in Argentina (and no contacts in Asia), Keppie was confident that TeqSwitch could first expand into Latin America.

The telecommunications equipment market in Latin America was nascent—most companies were using equipment that dated from the early 1990s—Keppie thought that there lay a tremendous opportunity to establish a lead in the market.

EXPANSION PLANS

Keppie explained:

We cannot do everything, enter every market, pitch every customer, we have a current list of North American companies we'd like to have relationships with—potential co-marketers, manufacturers and service providers. But the real growth will be partnering with firms in Latin America.

“Relationships are the foundation of international business and we know that. It's all about people who know people,” mentioned Munroe. Through their Australian business contacts, Keppie and Munroe got to know four Argentinian immigrants who were working in the telecommunications industry. By 1999, these four were lured back to Buenos Aires by a major strategy consulting company.

Keppie decided to entice the four Argentinians into starting up a sales company selling TeqSwitch components. The four were very receptive and began a dialogue that lasted eight months.

WORKING OUT AN AGREEMENT

TeqSwitch believed that it would enjoy steady growth, with (long-term) growing demand for telecommunications equipment around the world outstripping supply. By signing a substantial deal in Latin America, TeqSwitch would take steps towards gaining credibility outside of the English-speaking world. Thus, Keppie decided to work on a deal with the four Argentinians, who now called their startup Unitas S.A. The four partners assured Keppie that they had a general director, a sales manager and one information technology (IT) support person. Even with this force, Unitas was by no means a large entity, however, the partners assured TeqSwitch that they could draw upon their own network of contacts, in the event that additional personnel were needed.

Negotiations between TeqSwitch and Unitas stalled in late 1999 and early 2000, as both parties disagreed on terms such as revenue progression and exclusivity. Keppie began to worry that these disagreements might be a precursor of things to come, but he needed to drive ahead to gain market presence in Argentina.

Because of the need to move quickly, TeqSwitch was willing to make concessions. In exchange for exclusivity, TeqSwitch wanted to extract volume commitments from Unitas. Since options for TeqSwitch stock were to be granted to Unitas, Keppie wanted guarantees in return. Unitas was also looking for favorable discounts, an increase of between 10 per cent to 30 per cent, relative to what TeqSwitch was selling to other carriers and customers. Effectively, Unitas wanted to be able to sell to their customers at the same prices that TeqSwitch was selling to its customers. From Unitas, TeqSwitch wanted strict quarterly performance targets for revenue progression, but Unitas balked, only wanting to commit to a total of Cdn\$15 million over two years.

POST-AGREEMENT

In July 2000, Unitas returned to the negotiating table and a compromise was worked out to

eliminate the “show stoppers.” Moving on from the MOU, Munroe wanted to start understanding Unitas’s business plan, sales strategy, target customers and the resources that it would allocate to its plan to become part of the TeqSwitch network. Munroe was assured that everything would go smoothly—a copy of the Unitas business plan would be forwarded to him as soon as possible. By September, Munroe received the extensively detailed business plan and was pleased. He shared the plan with his senior management in Toronto.

Keppie was cautiously optimistic, and decided to proceed with establishing a “beach head” office in Buenos Aires, in close proximity to Unitas. Lang, freshly hired, was fluent in Spanish, and was assigned the task of being TeqSwitch’s representative in Buenos Aires. His task was to ensure that Unitas “learned the ropes” with as little trouble as possible.

“We need Unitas to be TeqSwitch Latin America,” said Munroe. “We needed to issue options tied to revenue to drive motivation. To facilitate communication, I expect to fly to Buenos Aires at least once per month to handle the details.”

TEQSWITCH’S PARTNER MANAGEMENT STRATEGY

Keppie and Munroe believed that the two biggest issues in their minds were trust and turnover. They needed to know that both parties (referring to Lang and the salespeople at Unitas) were working with TeqSwitch’s interests in mind. They were careful to set incentives and sales targets in collaboration with Unitas, ensuring that a solid commitment was achieved.

TeqSwitch management also believed that recognition played a large role in motivating sales. They considered updates to each other’s companies regarding the progress the salespeople would be making.

SLOW STARTUP PROCESS

Lang was in daily contact with Keppie and Munroe, keeping a log of his meetings with Unitas representatives. He assured them that the training was on track.

Keppie and Munroe expected that it would take a few months for Unitas to begin selling. By April 2001, TeqSwitch was beginning to get frustrated with the “lack of action.” Munroe’s frequent visits had led him to believe that things were going as planned. Whenever he inquired about the progress Unitas was making towards sales of the Cdn\$15 million worth of equipment in the year and a half that remained, he was told:

My friend, you have to put aside your North American business attitude. This is Latin America and we do things differently here. Business is based on trust, and trust is not gained in a day, or a week. It takes time. We are motivated to sell, yes, but we’ve got to do it our way.

NOW WHAT

In August 2001, Keppie was preparing to welcome the four Unitas partners for their second visit to Toronto (the first meeting in Toronto had taken place during the initial negotiations). TeqSwitch was ready to launch its next generation of products, the TS-50 (50 megabits per second) and the partners at Unitas had hinted that they were interested in attending the launch.

Two days before they were scheduled to arrive, Keppie received an e-mail message:

Dear Kyle,

We regret to inform you that our efforts to sell your TeqSwitch products have not been successful. Believe me, we’ve tried our best. We don’t believe that your product meets the requirements of telecommunications firms here in Latin America. Because of this, we have decided to request termination of our previously signed agreement. It is in both our best interests.

TEXTRON LTD.

Prepared by Lawrence A. Beer

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INTRODUCTION

Gary Case, executive vice-president of Textron Ltd., sat at his desk and slowly drew a circle around the words *ethics* and *social responsibility*. Above the circle he wrote in bold letters the phrase “public opinion,” and sat back to ponder his symbolic illustration of a potential problem that only he seemed to envision.

Case was thinking ahead and letting his mind focus on an issue that seemed out of the realm of the tenants of basic managerial principles that his undergraduate and MBA studies had prepared him for during his scholastic years. While he well appreciated the strategic decision-making concepts of running a transnational business, he felt himself personally wondering how to approach the complex subject of applying global ethics and social responsibility to an international venture that was being pushed on his company.

BACKGROUND

Textron Ltd. was a 65-year-old, family-held business based in Youngstown, Ohio. As a producer of cotton and sponge fabricated items for the beauty trade, selling to intermediate users as components in their make-up compact cases as well as direct to the retail trade for onward sale to consumers, the company was under constant attack from Far Eastern manufacturers. The need to enter into some type of offshore manufacturing enterprise was now evident in order to maintain a cost competitive position for the firm to continue to prosper and grow.

As a maker of cotton puffs for the application of make-up cosmetics, the company had grown from a loft in Brooklyn, New York, back in the mid-1930s to a medium-sized enterprise with

sales of \$25 million and pre-tax earnings of \$1 million plus. In the category of cosmetic applicators, Textron's fine reputation had been built on years of excellent service to the trade with attention to detail. Using at first the hand sewing abilities of seamstresses from the garment centres of lower Manhattan, the company had been a pioneer in developing customized machinery to produce quality cotton puffs to the precise custom requirements of modern cosmetic manufacturers. Today, 100 per cent virgin cotton rolls would enter Textron's factory at one end and exit as soft velour pads in numerous shapes, contoured sizes and colors at the other end of the process.

These puffs would be either sewn or glued with ribbon bands and satin coverings bearing the well-known brand names of the major franchised cosmetics companies of the world from Revlon, Estee Lauder, Maybelline and Max Factor as well as numerous others. They might also contain the names of retail store house brands or the internationally recognized trademarks of their own company. Currently, a new collection had been created through a licensing arrangement bearing the name of a highly respected fashion beauty magazine, whose instant recognition with the teenage trade was propelling the company to new sales levels. While historically Textron Ltd. primarily had produced components, supplying cosmetic companies with custom applicators tailored to their cosmetic ingredient requirements, the growth of its retail business in this sub-category was developing at a rapid pace. Major drug store chains, supermarkets and specialty shops featured Textron brands and their lines were becoming synonymous with the best in cosmetic applicators and assorted beauty accessories. With the launch of an additional range under the guise of a high fashion authority, featuring highly

stylized “cool shapes” and “hot colors” designed to entice younger adolescent buyers, their reputation was achieving enhanced public notice. Such products using uniquely descriptive trendy phrases evoked an image of “hip to use applicators” and a whole new generation of teenage users was being developed.

The firm also was a key purveyor to the entertainment industry directly servicing the Hollywood movie and TV production companies, Broadway and the theatrical community, along with indirect sales to professional make-up artists and modeling studios thanks to the quickly developing beauty store trade. All in all, the future for Textron Ltd. was most promising.

Gary Case, a college friend of the company’s president and principal owner, was brought into the business because of his experience at the retail sales and marketing level. The chief executive officer, who possessed an engineering background, was more than capable of overseeing the manufacturing side of the business; however, the strong movement of the organization into direct consumer goods, coupled with the overall expansion of the company, necessitated Case’s hiring.

As the company began to prosper in the early 1970s, other stateside competitors emerged, but none could match the quality and inherent reputation of Textron Ltd. Their attention to detail and expertise of their original equipment manufacturer (OEM) sales staff servicing the franchise cosmetic companies gave Textron a competitive edge. They were called upon to work closely with their industrial customers to develop cotton puffs that matched the trends in new cosmetic ingredients and application methods at the research and development (R&D) stage of such developments. Such progressive fashion-oriented but facially skin-sensitive cosmetic formulas required applicators that matched the demanding specifications of these new advances in the cosmetic field. Cotton materials were needed to sustain the look on the skin and provide the user with the same result that the cosmetic cream, lotion or powder promised. While women, the prime purchasers of such products, wanted to obtain the dramatic results

the franchise cosmetic companies advertised, professional make-up artists had long known that the choice of applicators to transfer the pressed powder in the compact, the lotion in the bottle or the cream in the jar, was the key to the process. The right puff was therefore needed to complement the make-up process.

In the late 1980s, Far Eastern manufactures of cosmetic applicators began to emerge, offering cheaper versions of such items. While the detailed processing of the raw cotton material used in such production was inferior to the quality and exacting details of those manufactured by Textron Ltd., the cost considerations necessitated a strong consideration of their offerings by the company’s clients. As textile manufacturing began to develop in the Indochina region and more and more American firms brought their expertise to the area, the overall quality of goods as well as the base materials used began to improve. As an outgrowth of improvements in the generic textile business emerged, better methods of production, selection of raw materials and attention to quality filtered down into the cosmetic cotton applicator category.

Case, along with the president of the company, David Grange, and the head of product development group, Nancy Adams, had made periodic trips to the Hong Kong Beauty Exhibition to constantly gauge Far Eastern competitors. For many years, they observed a display of poor offerings and found themselves returning from such trips visits confident that the threat of offshore competition was not yet emerging as a viable alternative for their clients. Their regular customers, both beauty companies and retailing organizations, were rarely evident at such conventions and hence their positive feelings were continuously strengthened.

CURRENT ISSUES

Over the last few years, however, it became evident that startup companies, beginning as derivative plants of the large textile manufacturers throughout China, Taiwan, Korea and Thailand, could become a real danger to their

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ever-growing global business. While many of these enterprises still produced inferior merchandise, Textron noticed that a number of their American competitors were now forming alliances with such organizations. These associations brought with them the knowledge of how to deal with the beauty industry both in America and Europe, instilling in them a deep appreciation for quality and endurance of raw materials to work with the new cosmetic preparations. Once such considerations took a foothold and a reputation for delivering such competitively detailed quality merchandise with vastly lower costs was discovered by Textron's clients, the company could be in for some rough times ahead. During the last visit to the Hong Kong show, Grange had bumped into a number of his key franchise cosmetic component buyers as well as a few of his retail chain merchandise managers. They had all acknowledged the quality advances made by these emerging new players. It was felt however that the distance of such suppliers from their own factories and key decision-making staffs and the fact that the shapes and designs were still not up to the innovative expertise of the Textron company created a hesitation among clients wanting to deal with them. Grange knew full well however that with advanced global communication technology and the alliances with American-based representative organizations, the gap would be closed shortly. If such alterations were made and a fully competitive quality product could be offered with the inherent deep labor and overhead cost advantages that Far Eastern firms possessed, Textron was due for some major sales competition in the future.

After their last trip to the Asian convention in September of 1999, Grange and Case spent the hours on the return trip discussing strategic alternatives for the company in the years ahead. This wasn't the first time such matters were approached and, in fact, two years earlier, the company entered into an alliance with a United Kingdom manufacturer for the production on a joint basis of cosmetic sponges. Grange had always been reluctant to place his production

facilities out of his geographical everyday domain. He was a "hands on" entrepreneur who felt strongly that all facets of one's business should be at arm's reach. Grange was deeply committed to his people and his door was always open to everyone in his organization. He was involved in every area of the business and it was not until Case joined Textron that Grange began to relinquish control over selective daily operations. This desire to closely preside over and monitor his people was born out of a heritage of family involvement as exemplified by his father. His dad had instilled in Grange a great empathy for workers and staff, and even today the company's culture still carried such roots of benevolent carrying.

When the firm had moved from the greater New York area to Youngstown, key personnel were given liberal incentives to move to the new location, and great care was given to those who could not make the journey. Still today, the company showed great pride in its relationship with employees. Textron's human resources department was not merely a conduit for processing applications for employment and overseeing payroll but a large fully functional multitiered group that ran off-site improvement seminars and cross training exercises. Besides offering a full array of benefit packages, the company had a well-supervised child-care facility on the premises at no charge to employees. The human resources director attended all managerial meetings, thereby maintaining a strong presence in all company decision-making and the position was considered on par with senior management executives. The commitment to maintaining hands-on control of his organization and the strong, caring relationship with his people made for a close-knit family and a kind of patriarchal role for Grange. He prided himself on the fact that union attempts to organize his factory labor force never got off the ground, as his employees felt that they were best represented by Grange himself.

Years ago, a satellite retail packaging assembly plant and distribution facility in San Antonio, Texas, which had been part of the purchase of a small professional beauty applicator business,

was dissolved in favor of consolidating all operations in Youngstown. All personnel at this redundant factory were given an opportunity to relocate in Youngstown or they received good termination benefits.

The United Kingdom alliance was finalized due to Grange's long and valued friendship with the principal of that company. The two also shared similar feelings about managing people and a common cultural background. Both parties had spent many years working together and enjoyed a special relationship, which had been fostered by the fact that the U.K. managing director's family resided in Ohio, thereby bringing the two executives together on a monthly basis as the Englishman came home often. Grange also visited the British facility every two months and the two executives spoke weekly on the phone. Both men viewed the alliance as more of a partnership than an arm's length sourcing arrangement.

Grange always felt that one of his prime differentiated product marketing characteristics was that up until the U.K. association for sponge material applicators, all his products were made in the United States. He believed that such designation symbolized quality of material and manufacturing excellence as well as innovative styling and technologically advanced, state-of-the-art compliance. Even with the English sponge production unit, all the cotton puff applicators were still made in the States. To drive home this important selling issue, all packages of retail cotton finished goods bore the American flag proudly stamped on them next to the words "Made in the U.S.A." Grange had recently seen consumer products bearing the slogan "Designed in America" as well as "Product Imported From China and Packaged in the U.S.A." but felt that the global customer still valued the U.S.A. slogan indicating the country of origin on his retail line. But in Grange's recent discussions with component buyers in the cosmetic and fragrance industry, such designation did not seem so important, given the fact that both the sponges and cotton puffs were slightly undistinguishable or hidden parts in the total presentation of the

makeup compact, the accent being on the brand name, ingredients and plastic case; imported items could be utilized if quality was maintained. The recent acceptance of the sponges made in England by Textron's clients gave credence to the fact that quality, price and service were the prime criteria for the industry, rather than the country of origin.

DECISION-MAKING TIME

Following the conference on the plane ride home from the Orient, Grange and Case had assembled their managerial staff and charged them with putting together a preliminary plan to form an association with a Far Eastern manufacturer of cotton puffs. At the initial briefing meeting, samples of cotton puff merchandise collected from a variety of Far Eastern producers were evaluated by the manufacturing quality control people as well as by representatives of the marketing and sales groups from the retail and OEM divisions. The immediate consensus was that with a little direction in fashion styling composition and adjustment in fixative dyes to sustain color in the cotton velour, a quality comparative range to supplement their domestic manufacturing output could be produced abroad. When Case presented the factory cost quotations for the samples being reviewed, the vice-president of finance exclaimed, "Such values were way below our own manufacturing standard costs before administrative overhead." He further added that "even with anticipated duty and freight via containerized shipments, the projected landed price at our door would eclipse our costs by a good 20 per cent or more reduction." When Case noted that, "These foreign price quotations were based on minimum quantities and could be subject to economies of scale discounting," all participants quickly realized that their projected stock keeping unit (SKU) sales for 2000 would easily allow for even greater margins.

When the meeting broke up, Chris Jenkins, the vice-president of finance, cornered Grange and Case in the hallway.

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Guys, if these numbers can be confirmed, and if future production of these Chinese puffs can be modified to accommodate our quality stability color standards and slightly altered for design modification, we need to jump on this as soon as possible. Better still, if we can manufacture over there ourselves via our own factory or through a joint venture, our profit potential would be magnified at least three times.

ALTERNATIVE PROPOSALS

It was now six months since that initial meeting. In the interim, Case had been back and forth a number of times, holding substantial discussions with what was now a short list of two potential alliance candidates, both of which were co-operative ventures, with local Chinese governmental bodies holding a share in them. While these companies' abilities to alter their production to accommodate changes in the color additive process and make design modifications were verified, and the exchange of cost quotations were proceeding well, Case had not yet proposed the final type of alliance he wanted.

In the back of his mind, Case wanted to form his own subsidiary but felt that such initial market entry strategy was both costly and risky, given the large investment required. Besides Case and Grange, the company did not have any other executives familiar with managing abroad. Given such considerations, Case's discussions to date with his Chinese associates had produced only two feasible alternatives to begin the relationship:

1. An initial three-year guaranteed outsourcing purchase agreement wherein, following the detailed specifications of Textron Ltd., supplies of cotton powder puffs would be produced at base prices. Such quotations would be subject to preset quantity discounting but offset slightly by an inflationary yearly adjustment. The right to pre-approve the samples of each and every shipment before departure would also be included in the arrangement. In essence a simplistic arm's-length purchasing association was contemplated.

2. The creation of a joint venture wherein Textron Ltd. would own 48 per cent of the company and the alliance partner would own the rest. Textron would be primarily responsible for sales and marketing worldwide along with periodic on-site technical assistance as to product design, quality assurances and engineering considerations by their technical staff. The plant facility, the manufacturing process itself and everyday operations would be under the direct control of the Chinese partner. Textron Ltd. would contribute a yet-to-be-finalized small dollar investment to help upgrade machinery and in general modernize the physical facilities. The partners would share the revenue generated by the sales efforts of Textron for the items produced in the plant.

Although exacting details of either proposed strategy needed to be worked out, with the former option requiring more legal and regulatory considerations, Case was confident that both situations could be accomplished. With the additional help of some local Chinese alliance specialists whom Case had utilized during the days when he had actually lived and worked in Hong Kong for a former employer, all seemed to be progressing nicely. Case knew he had to give additional thought to many other operational and administrative issues, and he wanted to obtain some sound advice from his internal teams before deciding which alternative to pursue. Questions as to the capital investment and how such funds would be utilized would require more discussions with the potential partners if the joint-venture route was chosen, but such issues would be addressed during Case's next trip to the Far East.

CHINA AS THE PRIME CHOICE OF SUPPLY

The focus on China was due mainly to Case's familiarity with the people and business environment. He felt very comfortable, given his prior experiences in the region and his knowledgeable

appreciation of the culture and the way relationships were constructed. Beyond Case's personal considerations, the Chinese manufacturers he had encountered already had the necessary machinery and were well versed in the production of cotton puffs. Many already supplied the worldwide beauty trade, but did not possess the sophisticated marketing and sales competencies practised by Textron, nor had they gained the reputation Textron historically enjoyed with the franchise cosmetic industry. An alliance with Textron would enhance the Chinese manufacturers' technical abilities and provide them with a wider entrée to the trade. The annual beauty show in Hong Kong attracted a global following, which would allow Textron to even create an offshore sales office and showroom close to the prime production facility to entertain prospective clients. Besides the Chinese connection, Case had opened initial discussion with makers of sponge applicators and other beauty accessories in Japan and Korea so that his trips to the China could be combined with other business opportunities he wanted to pursue in the Far East.

Case had entertained pursuing a Mexican manufacturer, as he had had prior dealings with companies producing a variety of cotton products in Mexico. Given the background of many of them in the cotton and aligned textile trade, this seemed a natural consideration, especially given the NAFTA accords and geographical proximity to Textron's major market, the United States. All potential companies Case visited, however, were located in the central part of the country, none near the border where the *Maquiladores* were available. Case's Mexican contacts were not familiar with the specific production of cotton puff applicators as their cotton experience was in the manufacturing of surgical dressings, bandages, feminine hygiene pads and simple cotton balls. They would need to buy machinery and train a staff in such manufacturing operations. If Textron would fund such investment and provide technical assistance, a number of them agreed to manage such a facility on the U.S.-Mexican border through a joint venture. Case was hesitant to provide the

funding, and he was worried that starting up a new plant would not let Textron achieve the inherent historical benefits that the more mature existing production in China would instantly allow.

Besides the economic considerations, Case found the Mexican manager's attitude a bit troublesome. Textron had once used a Mexican plant to supply, in final packaged form, cotton pads for the removal of facial cosmetic make-up. While his dealings with the principals of this family owned and operated business was most cordial and personally gratifying, Case had found that their attention to manufacturing details left much to be desired. The quality inspection of the raw cotton coming into their plants had given Case cause for concern. Many openly told him they mixed first quality fibres with "seconds" and remnants from the textile manufacturers in their local areas to achieve cost efficient production. As Textron always claimed its materials for cotton puff applicators were of "100 per cent virgin cotton," such an assertion using might be difficult to enforce and supervise, given the pronouncements by his prior supplier. When discussions as to the importance of schedules to insure timely supply arose, the Mexican sources seemed to give the impression that they would do their best to comply. This slight hesitation bothered Case, as his component buyers demanded on-time delivery and were always changing specifications at the last minute.

Case had deep reservations on the business competencies exhibited by such Mexican firms, as his communications with them in the past, wherein days would go by before he heard from them, had left a poor impression on him. Many times, when he had repetitively inquired by e-mail, fax and telephone as to shipping dates for packaged finished products, he was eventually told that third-party suppliers of the packaging materials for the cotton pads caused the assembly delay. Inquiring further, during a visit with his Mexican supplier, Case learned that when local Mexican firms contract with each other, time promises are flexible and it seemed that an attitude of "when they are available, we get them"

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took precedence over definite schedules. During the year the company utilized the Mexican supplier, not one shipment was dispatched within the required period, and Case had given up contacting them, even paraphrasing the Mexican explanation when queried by his own inventory/warehouse manager.

The decision to go with a Chinese partner in some format seemed to be the best solution.

CASE'S PERSONAL REFLECTIONS

As Case pondered what other matters needed to be resolved, his mind began to focus on his three-year posting, back in the early 1990s in Hong Kong, with an electronics manufacturer to oversee their Chinese network of suppliers. When Case and his family had first arrived in the then-British colony, the excitement of this new foreign land and its unique culture had made a lasting impression on him. He had marveled at the sights, sounds, smells and overall ambience of the city state that mixed East and West. Coming from a middle class American lifestyle, the treatment the family received was like being transformed into a rich conclave of the elite. His children went to a specialized English-type boarding school and rarely mixed with local natives of their own age. In fact, such young Chinese children were lucky to get a basic elementary school education before being forced out into the real world and into the working community. The outskirts of the city, and even sections within, contained deep pockets that were below some extreme poverty levels Case had seen in other depressed regions of the world. Within a severely overpopulated area that was strained every day with new immigrants from the mainland, the concept of work, any job, took on a new meaning. People would work for what seemed like slave wages to Case, and he wondered how they survived, just attaining a mere sustenance level. His wife could afford household maids and cooks that were more like indentured servants than domestic employees. They worked long hours at meagre wages and never complained.

During Case's visits to plants in mainland China, both during his expatriate posting years

and subsequent trips back in the mid-1990s, the conditions at such facilities had initially deeply disturbed him. The environments he witnessed were nothing like he had ever seen in the United States. Factories were like prison compounds. The laborers seemed to toil at their job stations never looking up, never smiling and always looked like they were staring out with blank facial expressions. Rarely had Case seen them take a break, with many workers eating lunch at their desks and at their worktables or machinery. He seldom witnessed the laborers even taking bathroom breaks. The air in the facilities was always stale with no ventilation except for a few fans, and it was always very hot or very cold, depending on the outside temperature. He witnessed children, younger it seemed than his two adolescent kids, toiling in the plants alongside the elderly. He watched infants placed alongside their mothers on the floor of the factories being rocked by feet as the mothers' hands moved on the table above them. As these visits become more frequent, Case's disdain for such initially horrific working conditions began to lessen and he began to accept what he saw.

Many times, in social conversations with other executives and managers, Case had voiced his concerns about the treatment of the workers. He listened as they tried to get him to understand and appreciate that while the conditions were terrible, the alternative might be even worse. With the expanded population, growing at a massive rate, the supply of people outstripped employment opportunities. In order to survive, people would take any job and children as well as the elderly all had to work. Public governmental assistance was not only inadequate but almost impossible to administer, even if the resources could be found. The old communist philosophy of all society working for the good of the common proletariat, and hence the state, had been indoctrinated with the birth of the Mao regime; people saw it as their duty and obligation to endure hard times.

Case's Chinese friends had often remarked that if China were to catch up to the Western capitalistic nations and be a participant in the world's expanded trading economies, its people were its greatest competitive asset. In order to be a member in the world community and to provide enrichment

for future generations, sacrifices had to be made. Capital for the improvement of factory environmental conditions was secondary to the need to update basic machinery and gain technology. The government had to build a sound internal infrastructure of roadways, rail and port facilities to ship its goods before the physical welfare of its people could be considered. With power still a scarce commodity, any electricity flowing into a factory needed to be first used to run the machinery and not for hot or cool air to be produced. The only way to achieve the goal of making mainland China competitive with the rest of the world was through the exportation route which was founded in the country's ability to produce cheaper goods than the rest of the globe. This simple fact necessitated low labor and overhead operating costs that contributed to poor working conditions in the factories.

Obviously, Case understood this economic argument was the main reason his company—and therefore he himself—had come to the region. In order for his own organization to remain competitive in the cotton puff business both at home and abroad, it would have no choice but to locate a portion of its operations in China or some other emerging nation.

Case had seen the TV footage of the protesters at the 2000 WTO conference in Seattle who had destroyed that meeting and in latter months had done the same in Washington, D.C., and Ottawa, Canada. He heard them voicing and physically demonstrating their deep concerns against governments and transnational companies as to worker rights and environmental conditions in emerging and developing nations. Case was well aware of the attention the press gave to large multinational companies like Levi Strauss, Reebok and others over their treatment of employees accusing them of almost slavlike practices in their foreign factories. Even personalities that lent their names to the labels of garments, like Kathy Lee Gifford, had come under strong pressure for allowing their third party licensees in the United States to operate sweat shops and mistreat workers. Companies that did not even have a direct relationship wherein they exercised straight control over employee conditions were still questioned about the suppliers they used

abroad as the social conscience of the world seem to be focused on these issues.

Although Case himself deplored the hiring of adolescent children, he understood the economic and social context that existed in China for their use. China wasn't America. Young kids grew up much faster and much more was expected of them as contributors to the family unit. Even with the government mandate, made within the framework of the message of a collective good of the nation for families to have only one child, did not alleviate the problem. In fact, in many families it just made the burden deeper. Most Chinese families were made up of extended relatives who grouped together to pool their resources for their common survival. In these family units, all members had to work. The simple luxury of going to a public school, playing games and watching TV, as American children enjoyed, was not part of their world. In numerous families, children, mostly young girls, were sent away from their rural villages to emerging urban industrial centres to look for work. After paying large portions of their meagre weekly salaries back to their employees for dormitory housing and food within the confines of the factory compound, any amount left over was sent to the family.

Even the elderly felt such pressure to work, as retirement after years of service and a reasonable pension was almost a non-existent consideration. No true governmental program like social security existed, and the family had to care for the elderly in their homes, putting a great burden on the whole extended unit. Political dissidents and even criminals were conscripted into the labor force to help offset the cost of the State having to provide for them. Plant conditions, treatment of workers and even caring about the environment were not primary issues for an emerging country trying to first find work for its population during the transformation process into a competitive world economic nation.

Case pondered if it was time for the company to prepare a written corporate moral compass. Should it publish a code of ethics, as many transnational firms had been doing? What should it consist of, what specific criteria defining norms of behavior should be stated? and should it be

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incorporated as an obligation in the arm's length purchasing agreement being considered with the Chinese supplier? If the announced provisions were violated, should this be viewed as an automatic right for Textron to terminate the agreement, or should there be a time frame in which to cure such conditions? Case also wondered how his firm could monitor such matters to ensure compliance. If the alternative joint venture were chosen, how should such values be incorporated into the partnership agreement and how should Case process such matters during the negotiation?

Case was comfortable with discussions on costs, quality and delivery specifications as they had a finite measurable logic to them. Social responsibility and ethics touched upon many emotional areas that were harder to define. He had seen firsthand how different cultures approached them from divergent viewpoints, and he had gained a respect for the saying "when in Rome do as the Romans do." He also, however, maintained the feeling that there were core human values that at times transcended such local traditions and social context.

MORAL DILEMMAS— UNANSWERED QUESTIONS

What worried Case was even if the business decision were the right one, could the company be entering a relationship that might some day

backfire? If a factory that Textron brought merchandise from or, because of the joint venture, was more deeply involved in was alleged to be mistreating employees, would public opinion injure the company's reputation? Was the focus of the world now on China and its historic practices of human rights abuse? Would someone be watching companies more closely that associated themselves with Chinese partners in any form?

What if Textron's buyers of components, the franchised cosmetic houses, were themselves chastised for using slave-type labor in the supplies used in their own manufacturing of their brand named products? Would they in turn cease to buy from Textron Ltd.? What if consumers of the retail packaged lines decided to boycott the products for similar reasons? What if the licensor of the new collection felt that such foreign sourcing of items bearing their trademark was injurious to their image and reputation, and they objected?

Given his company's strong traditional organizational culture of placing employees first, Case also wondered what effect any such ethical and socially responsibility issues stemming from a Chinese association could have on his own domestic operational employees.

He wondered about such matters again as he thought to himself that going global was more than just an exercise in financial, legal and operational logistical decision making; it involved taking a moral position in Textron's commercial relationships with overseas entities.

NORA-SAKARI: A PROPOSED JV IN MALAYSIA (REVISED)

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On Monday, July 15, 2003 Zainal Hashim, vice-chairman of Nora Holdings Sdn Bhd¹ (Nora), arrived at his office about an hour earlier than usual. As he looked out the window at the

city spreading below, he thought about the Friday evening reception which he had hosted at his home in Kuala Lumpur (KL), Malaysia, for a team of negotiators from Sakari Oy²

(Sakari) of Finland. Nora was a leading supplier of telecommunications (telecom) equipment in Malaysia while Sakari, a Finnish conglomerate, was a leader in the manufacture of cellular phone sets and switching systems. The seven-member team from Sakari was in KL to negotiate with Nora the formation of a joint-venture (JV) between the two telecom companies.

This was the final negotiation which would determine whether a JV agreement would materialize. The negotiation had ended late Friday afternoon, having lasted for five consecutive days. The JV Company, if established, would be set up in Malaysia to manufacture and commission digital switching exchanges to meet the needs of the telecom industry in Malaysia and in neighbouring countries, particularly Indonesia and Thailand. While Nora would benefit from the JV in terms of technology transfer, the venture would pave the way for Sakari to acquire knowledge and gain access to the markets of South-east Asia.

The Nora management was impressed by the Finnish capability in using high technology to enable Finland, a small country of only five million people, to have a fast-growing economy. Most successful Finnish companies were in the high-tech industries. For example, Kone was one of the world's three largest manufacturers of lifts, Vaisala was the world's major supplier of meteorological equipment, and Sakari was one of the leading telecom companies in Europe. It would be an invaluable opportunity for Nora to learn from the Finnish experience and emulate their success for Malaysia.

The opportunity emerged two and half years earlier when Peter Mattsson, president of Sakari's Asian regional office in Singapore, approached Zainal³ to explore the possibility of forming a cooperative venture between Nora and Sakari. Mattsson said:

While growth in the mobile telecommunications network is expected to be about 40 per cent a year in Asia in the next five years, growth in fixed networks would not be as fast, but the projects are much larger. A typical mobile network project amounts to a maximum of € 50 million, but fixed network projects can be estimated in hundreds of

millions. In Malaysia and Thailand, such latter projects are currently approaching contract stage. Thus it is imperative that Sakari establish its presence in this region to capture a share in the fixed network market.

The large potential for telecom facilities was also evidenced in the low telephone penetration rates for most South-east Asian countries. For example, in 1999, telephone penetration rates (measured by the number of telephone lines per 100 people) for Indonesia, Thailand, Malaysia and the Philippines ranged from three to 20 lines per 100 people compared to the rates in developed countries such as Canada, Finland, Germany, United States and Sweden where the rates exceeded 55 telephone lines per 100 people.

THE TELECOM INDUSTRY IN MALAYSIA

Telekom Malaysia Bhd (TMB), the national telecom company, was given the authority by the Malaysian government to develop the country's telecom infrastructure. With a paid-up capital of RM2.4 billion,⁴ it was also given the mandate to provide telecom services that were on par with those available in developed countries.

TMB announced that it would be investing in the digitalization of its networks to pave the way for offering services based on the ISDN (integrated services digitalized network) standard, and investing in international fibre optic cable networks to meet the needs of increased telecom traffic between Malaysia and the rest of the world. TMB would also facilitate the installation of more cellular telephone networks in view of the increased demand for the use of mobile phones among the business community in KL and in major towns.

As the nation's largest telecom company, TMB's operations were regulated through a 20-year licence issued by the Ministry of Energy, Telecommunications and Posts. In line with the government's Vision 2020 program which targeted Malaysia to become a developed nation by the year 2020, there was a strong need for the upgrading of the telecom infrastructure in the rural areas. TMB estimated that it would spend more than

RM1 billion each year on the installation of fixed networks, of which 25 per cent would be allocated for the expansion of rural telecom. The objective was to increase the level of telephone penetration rate to over 50 per cent by the year 2005.

Although TMB had become a large national telecom company, it lacked the expertise and technology to undertake massive infrastructure projects. In most cases, the local telecom companies would be invited to submit their bids for a particular contract. It was also common for these local companies to form partnerships with large multinational corporations (MNCs), mainly for technological support. For example, Pernas-NEC, a JV company between Pernas Holdings and NEC, was one of the companies that had been successful in securing large telecom contracts from the Malaysian authorities.

NORA'S SEARCH FOR A JV PARTNER

In October 2002, TMB called for tenders to bid on a five-year project worth RM2 billion for installing digital switching exchanges in various parts of the country. The project also involved replacing analog circuit switches with digital switches. Digital switches enhanced transmission capabilities of telephone lines, increasing capacity to approximately two million bits per second compared to the 9,600 bits per second on analog circuits.

Nora was interested in securing a share of the RM2 billion contract from TMB and more importantly, in acquiring the knowledge in switching technology from its partnership with a telecom MNC. During the initial stages, when Nora first began to consider potential partners in the bid for this contract, telecom MNCs such as Siemens, Alcatel, and Fujitsu seemed appropriate candidates. Nora had previously entered into a five-year technical assistance agreement with Siemens to manufacture telephone handsets.

Nora also had the experience of a long-term working relationship with Japanese partners which would prove valuable should a JV be formed with Fujitsu. Alcatel was another potential partner, but the main concern at Nora was that the technical

standards used in the French technology were not compatible with the British standards already adopted in Malaysia. NEC and Ericsson were not considered, as they were already involved with other local competitors and were the current suppliers of digital switching exchanges to TMB. Their five-year contracts were due to expire soon.

Subsequent to Zainal's meeting with Mattsson, he decided to consider Sakari as a serious potential partner. He was briefed about Sakari's SK33, a digital switching system that was based on an open architecture, which enabled the use of standard components, standard software development tools, and standard software languages. Unlike the switching exchanges developed by NEC and Ericsson which required the purchase of components developed by the parent companies, the SK33 used components that were freely available in the open market. The system was also modular, and its software could be upgraded to provide new services and could interface easily with new equipment in the network. This was the most attractive feature of the SK33 as it would lead to the development of new switching systems.

Mattsson had also convinced Zainal and other Nora managers that although Sakari was a relatively small player in fixed networks, these networks were easily adaptable, and could cater to large exchanges in the urban areas as well as small ones for rural needs. Apparently Sakari's smaller size, compared to that of some of the other MNCs, was an added strength because Sakari was prepared to work out customized products according to Nora's needs. Large telecom companies were alleged to be less willing to provide custom-made products. Instead, they tended to offer standard products that, in some aspects, were not consistent with the needs of the customer.

Prior to the July meeting, at least 20 meetings had been held either in KL or in Helsinki to establish relationships between the two companies. It was estimated that each side had invested not less than RM3 million in promoting the relationship. Mattsson and Ilkka Junttila, Sakari's representative in KL, were the key people in bringing the two companies together. (See Exhibits 1 and 2 for brief background information on Malaysia and Finland respectively.)

Malaysia is centrally located in South-east Asia. It consists of Peninsular Malaysia, bordered by Thailand in the north and Singapore in the south, and the states of Sabah and Sarawak on the island of Borneo. Malaysia has a total land area of about 330,000 square kilometres, of which 80 per cent is covered with tropical rainforest. Malaysia has an equatorial climate with high humidity and high daily temperatures of about 26 degrees Celsius throughout the year.

In 2000, Malaysia's population was 22 million, of which approximately nine million made up the country's labour force. The population is relatively young, with 42 per cent between the ages of 15 and 39 and only seven per cent above the age of 55. A Malaysian family has an average of four children and extended families are common. Kuala Lumpur, the capital city of Malaysia, has approximately 1.5 million inhabitants.

The population is multiracial; the largest ethnic group is the Bumiputeras (the Malays and other indigenous groups such as the Ibans in Sarawak and Kadazans in Sabah), followed by the Chinese and Indians. Bahasa Malaysia is the national language but English is widely used in business circles. Other major languages spoken included various Chinese dialects and Tamil.

Islam is the official religion but other religions (mainly Christianity, Buddhism and Hinduism) are widely practised. Official holidays are allocated for the celebration of Eid, Christmas, Chinese New Year and Deepavali. All Malays are Muslims, followers of the Islamic faith.

During the period of British rule, secularism was introduced to the country, which led to the separation of the Islamic religion from daily life. In the late 1970s and 1980s, realizing the negative impact of secularism on the life of the Muslims, several groups of devout Muslims undertook efforts to reverse the process, emphasizing a dynamic and progressive approach to Islam. As a result, changes were introduced to meet the daily needs of Muslims. Islamic banking and insurance facilities were introduced and prayer rooms were provided in government offices, private companies, factories, and even in shopping complexes.

Malaysia is a parliamentary democracy under a constitutional monarchy. The Yang DiPertuan Agung (the king) is the supreme head, and appoints the head of the ruling political party to be the prime minister. In 2000 the Barisan Nasional, a coalition of several political parties representing various ethnic groups, was the ruling political party in Malaysia. Its predominance had contributed not only to the political stability and economic progress of the country in the last two decades, but also to the fast recovery from the 1997 Asian economic crisis.

The recession of the mid 1980s led to structural changes in the Malaysian economy which had been too dependent on primary commodities (rubber, tin, palm oil and timber) and had a very narrow export base. To promote the establishment of export-oriented industries, the government directed resources to the manufacturing sector, introduced generous incentives and relaxed foreign equity restrictions. In the meantime, heavy investments were made to modernize the country's infrastructure. These moves led to rapid economic growth in the late 1980s and early 1990s. The growth had been mostly driven by exports, particularly of electronics.

The Malaysian economy was hard hit by the 1997 Asian economic crisis. However, Malaysia was the fastest country to recover from the crisis after declining IMF assistance. It achieved this by pegging its currency to the USD, restricting outflow of money from the country, banning illegal overseas derivative trading of Malaysian securities and setting up asset management companies to facilitate the orderly recovery of bad loans. The real GDP growth rate in 1999 and 2000 were 5.4% and 8.6%, respectively (Table 1).

Malaysia was heavily affected by the global economic downturn and the slump in the IT sector in 2001 and 2002 due to its export-based economy. GDP in 2001 grew only 0.4% due to an 11% decrease in exports. A US \$1.9 billion fiscal stimulus package helped the country ward off the worst of the recession and the GDP growth rate rebounded to 4.2% in 2002 (Table 1). A relatively small foreign debt and adequate foreign exchange reserves make a crisis similar to the 1997 one unlikely. Nevertheless, the economy remains vulnerable to a more protracted slowdown in the US and Japan, top export destinations and key sources of foreign investment.

In 2002, the manufacturing sector was the leading contributor to the economy, accounting for about 30 per cent of gross national product (GDP). Malaysia's major trading partners are United States, Singapore, Japan, China, Taiwan, Hong Kong and Korea.

Table 1 Malaysian Economic Performance 1999 to 2002

Economic Indicator	1999	2000	2001	2002
GDP per capita (US\$)	3,596	3,680	3,678	3,814
Real GDP growth rate	5.4%	8.6%	0.4%	4.2%
Consumer price inflation	2.8%	1.6%	1.4%	1.8%
Unemployment rate	3.0%	3.0%	3.7%	3.5%

Source: IMD. Various years. "The World Competitiveness Report."

Exhibit 1 Malaysia Background Information

Sources: Ernst & Young International. 1993. "Doing Business in Malaysia." Other Online Sources.

NORA HOLDINGS SDN BHD

The Company

Nora was one of the leading companies in the telecom industry in Malaysia. It was established in 1975 with a paid-up capital of RM2 million. Last year, the company recorded a turnover of RM320 million. Nora Holdings consisted of 30 subsidiaries, including two public-listed companies: Multiphone Bhd, and Nora Telecommunications Bhd. Nora had 3,081 employees, of which 513 were categorized as managerial (including 244 engineers) and 2,568 as non-managerial (including 269 engineers and technicians).

The Cable Business

Since the inception of the company, Nora had secured two cable-laying projects. For the latter project worth RM500 million, Nora formed a JV with two Japanese companies, Sumitomo Electric Industries Ltd (held 10 per cent equity share) and Marubeni Corporation (held five per cent equity share). Japanese partners were chosen in view of the availability of a financial package that came together with the technological assistance needed by Nora. Nora also acquired a 63 per cent stake in a local cable-laying company, Selangor Cables Sdn Bhd.

The Telephone Business

Nora had become a household name in Malaysia as a telephone manufacturer. It started in 1980 when the company obtained a contract to supply telephone sets to the government-owned Telecom authority, TMB, which would distribute the sets to telephone subscribers on a rental basis. The contract, estimated at RM130 million, lasted for 15 years. In 1985 Nora secured licenses from Siemens and Nortel to manufacture telephone handsets and had subsequently developed Nora's own telephone sets—the N300S (single line), N300M (micro-computer controlled), and N300V (hands-free, voice-activated) models.

Upon expiry of the 15-year contract as a supplier of telephone sets to the TMB, Nora suffered a major setback when it lost a RM32 million contract to supply 600,000 N300S single line telephones. The contract was instead given to a Taiwanese manufacturer, Formula Electronics, which quoted a lower price of RM37 per handset compared to Nora's RM54. Subsequently, Nora was motivated to move towards the high end feature phone domestic market. The company sold about 3,000 sets of feature phones per month, capturing the high-end segment of the Malaysian market.

Nora had ventured into the export market with its feature phones, but industry observers predicted that Nora still had a long way to go as an exporter. The foreign markets were very competitive and many manufacturers already had well-established brands.

The Payphone Business

Nora's start-up in the payphone business had turned out to be one of the company's most profitable lines of business. Other than the cable-laying contract secured in 1980, Nora had a 15-year contract to install, operate and maintain payphones in the cities and major towns in Malaysia. In 1997, Nora started to manufacture card payphones under a license from GEC Plessey Telecommunications (GPT) of the United Kingdom. The agreement had also permitted Nora to sell the products to the neighbouring countries in South-east Asia as well as to eight other markets approved by GPT.

While the payphone revenues were estimated to be as high as RM60 million a year, a long-term and stable income stream for Nora, profit margins were only about 10 per cent because of the high investment and maintenance costs.

Other Businesses

Nora was also the sole Malaysian distributor for Nortel's private automatic branch exchange (PABX) and NEC's mobile telephone sets. It was also an Apple computer distributor in Malaysia

Finland is situated in the north-east of Europe, sharing borders with Sweden, Norway and the former Soviet Union. About 65 per cent of its area of 338,000 square kilometres is covered with forest, about 15 per cent lakes and about 10 per cent arable land. Finland has a temperate climate with four distinct seasons. In Helsinki, the capital city, July is the warmest month with average mid-day temperature of 21 degrees Celsius and January is the coldest month with average mid-day temperature of -3 degrees Celsius.

Finland is one of the most sparsely populated countries in Europe with a 2002 population of 5.2 million, 60 per cent of whom lived in the urban areas. Helsinki had a population of about 560,000 in 2002. Finland has a well-educated work force of about 2.3 million. About half of the work force are engaged in providing services, 30 per cent in manufacturing and construction, and eight per cent in agricultural production. The small size of the population has led to scarce and expensive labour. Thus Finland had to compete by exploiting its lead in high-tech industries.

Finland's official languages are Finnish and Swedish, although only six per cent of the population speaks Swedish. English is the most widely spoken foreign language. About 87 per cent of the Finns are Lutherans and about one per cent Finnish Orthodox.

Finland has been an independent republic since 1917, having previously been ruled by Sweden and Russia. A President is elected to a six-year term, and a 200-member, single-chamber parliament is elected every four years.

In 1991, the country experienced a bad recession triggered by a sudden drop in exports due to the collapse of the Soviet Union. During 1991-1993, the total output suffered a 10% contraction and unemployment rate reached almost 20%. Finnish Markka experienced a steep devaluation in 1991-1992, which gave Finland cost competitiveness in international market.

With this cost competitiveness and the recovery of Western export markets the Finnish economy underwent a rapid revival in 1993, followed by a new period of healthy growth. Since the mid 1990s the Finnish growth has mainly been bolstered by intense growth in telecommunications equipment manufacturing. The Finnish economy peaked in the year 2000 with a real GDP growth rate of 5.6% (Table 2).

Finland was one of the 11 countries that joined the Economic and Monetary Union (EMU) on January 1, 1999. Finland has been experiencing a rapidly increasing integration with Western Europe. Membership in the EMU provide the Finnish economy with an array of benefits, such as lower and stable interest rates, elimination of foreign currency risk within the Euro area, reduction of transaction costs of business and travel, and so forth. This provided Finland with a credibility that it lacked before accession and the Finnish economy has become more predictable. This will have a long-term positive effect on many facets of the economy.

Finland's economic structure is based on private ownership and free enterprise. However, the production of alcoholic beverages and spirits is retained as a government monopoly. Finland's major trading partners are Sweden, Germany, the former Soviet Union and United Kingdom.

Finland's standard of living is among the highest in the world. The Finns have small families with one or two children per family. They have comfortable homes in the cities and one in every three families has countryside cottages near a lake where they retreat on weekends. Taxes are high, the social security system is efficient and poverty is virtually non-existent.

Until recently, the stable trading relationship with the former Soviet Union and other Scandinavian countries led to few interactions between the Finns and people in other parts of the world. The Finns are described as rather reserved, obstinate, and serious people. A Finn commented, "We do not engage easily in small talk with strangers. Furthermore, we have a strong love for nature and we have the tendency to be silent as we observe our surroundings. Unfortunately, others tend to view such behaviour as cold and serious." Visitors to Finland are often impressed by the efficient public transport system, the clean and beautiful city of Helsinki with orderly road networks, scenic parks and lakefronts, museums, cathedrals, and churches.

Table 2 Finnish Economic Performance 1999 to 2002

Economic Indicator	1999	2000	2001	2002
GDP per capita (US\$)	24,430	23,430	23,295	25,303
Real GDP growth rate	3.7%	5.6%	0.4%	1.6%
Consumer price inflation	1.2%	3.3%	2.6%	1.6%
Unemployment	10.3%	9.6%	9.1%	9.1%

Source: IMD. Various years. "The World Competitiveness Report."

Exhibit 2 Finland: Background Information

Sources: Ernst & Young International. 1993. "Doing Business in Finland." Other Online Sources.

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and Singapore. In addition, Nora was involved in: distributing radio-related equipment; supplying equipment to the broadcasting, meteorological, civil aviation, postal and power authorities; and manufacturing automotive parts (such as the suspension coil, springs, and piston) for the local automobile companies.

The Management

When Nora was established, Osman Jaafar, founder and chairman of Nora Holdings, managed the company with his wife, Nora Asyikin Yusof, and seven employees. Osman was known as a conservative businessman who did not like to dabble in acquisitions and mergers to make quick capital gains. He was formerly an electrical engineer who was trained in the United Kingdom and had held several senior positions at the national Telecom Department in Malaysia.

Osman subsequently recruited Zainal Hashim to fill in the position of deputy managing director at Nora. Zainal held a master's degree in microwave communications from a British university and had several years of working experience as a production engineer at Pernas-NEC Sdn Bhd, a manufacturer of transmission equipment. Zainal was later promoted to the position of managing director and six years later, the vice-chairman.

Industry analysts observed that Nora's success was attributed to the complementary roles, trust, and mutual understanding between Osman and Zainal. While Osman "likes to fight for new business opportunities," Zainal preferred a low profile and concentrated on managing Nora's operations.

Industry observers also speculated that Osman, a former civil servant and an entrepreneur, was close to Malaysian politicians, notably the Prime Minister, while Zainal had been a close friend of the Finance Minister. Zainal disagreed with allegations that Nora had succeeded due to its close relationships with Malaysian politicians. However, he acknowledged that such perceptions in the industry had been beneficial to the company.

Osman and Zainal had an obsession for high-tech and made the development of research and

development (R&D) skills and resources a priority in the company. About one per cent of Nora's earnings was ploughed back into R&D activities. Although this amount was considered small by international standards, Nora planned to increase it gradually to five to six per cent over the next two to three years. Zainal said:

We believe in making improvements in small steps, similar to the Japanese kaizen principle. Over time, each small improvement could lead to a major creation. To be able to make improvements, we must learn from others. Thus we would borrow a technology from others, but eventually, we must be able to develop our own to sustain our competitiveness in the industry. As a matter of fact, Sakari's SK33 system was developed based on a technology it obtained from Alcatel.

To further enhance R&D activities at Nora, Nora Research Sdn Bhd (NRSB), a wholly-owned subsidiary, was formed, and its R&D department was absorbed into this new company. NRSB operated as an independent research company undertaking R&D activities for Nora as well as private clients in related fields. The company facilitated R&D activities with other companies as well as government organizations, research institutions, and universities. NRSB, with its staff of 40 technicians/engineers, would charge a fixed fee for basic research and a royalty for its products sold by clients.

Zainal was also active in instilling and promoting Islamic values among the Malay employees at Nora. He explained:

Islam is a way of life and there is no such thing as Islamic management. The Islamic values, which must be reflected in the daily life of Muslims, would influence their behaviours as employers and employees. Our Malay managers, however, were often influenced by their western counterparts, who tend to stress knowledge and mental capability and often forget the effectiveness of the softer side of management which emphasizes relationships, sincerity and consistency. I believe that one must always be sincere to be able to develop good working relationships.

SAKARI OY

Sakari was established in 1865 as a pulp and paper mill located about 200 kilometres north-west of Helsinki, the capital city of Finland. In the 1960s, Sakari started to expand into the rubber and cable industries when it merged with the Finnish Rubber Works and Finnish Cable Works. In 1973 Sakari's performance was badly affected by the oil crisis, as its businesses were largely energy-intensive.

However, in 1975, the company recovered when Aatos Olkkola took over as Sakari's president. He led Sakari into competitive businesses such as computers, consumer electronics, and cellular phones via a series of acquisitions, mergers and alliances. Companies involved in the acquisitions included: the consumer electronics division of Standard Elektrik Lorenz AG; the data systems division of L.M. Ericsson; Vantala, a Finnish manufacturer of colour televisions; and Luxury, a Swedish state-owned electronics and computer concern.

In 1979, a JV between Sakari and Vantala, Sakari-Vantala, was set up to develop and manufacture mobile telephones. Sakari-Vantala had captured about 14 per cent of the world's market share for mobile phones and held a 20 per cent market share in Europe for its mobile phone handsets. Outside Europe, a 50-50 JV was formed with Tandy Corporation which, to date, had made significant sales in the United States, Malaysia and Thailand.

Sakari first edged into the telecom market by selling switching systems licensed from France's Alcatel and by developing the software and systems to suit the needs of small Finnish phone companies. Sakari had avoided head-on competition with Siemens and Ericsson by not trying to enter the market for large telephone networks. Instead, Sakari had concentrated on developing dedicated telecom networks for large private users such as utility and railway companies. In Finland, Sakari held 40 per cent of the market for digital exchanges. Other competitors included Ericsson (34 per cent), Siemens (25 per cent), and Alcatel (one per cent).

Sakari was also a niche player in the global switching market. Its SK33 switches had sold well in countries such as Sri Lanka, United Arab Emirates, China and the Soviet Union. A derivative of the SK33 main exchange switch called the SK33XT was subsequently developed to be used in base stations for cellular networks and personal paging systems.

Sakari attributed its emphasis on R&D as its key success factor in the telecom industry. Strong in-house R&D in core competence areas enabled the company to develop technology platforms such as its SK33 system that were reliable, flexible, widely compatible and economical. About 17 per cent of its annual sales revenue was invested into R&D and product development units in Finland, United Kingdom and France. Sakari's current strategy was to emphasize global operations in production and R&D. It planned to set up R&D centres in leading markets, including South-east Asia.

Sakari was still a small company by international standards (see Exhibit 3 for a list of the world's major telecom equipment suppliers). It lacked a strong marketing capability and had to rely on JVs such as the one with Tandy Corporation to enter the world market, particularly the United States. In its efforts to develop market position quickly, Sakari had to accept lower margins for its products, and often the Sakari name was not revealed on the product. In recent years, Sakari decided to emerge from its hiding place as a manufacturer's manufacturer and began marketing under the Sakari name.

In 1989 Mikko Koskinen took over as president of Sakari. Koskinen announced that telecommunications, computers, and consumer electronics would be maintained as Sakari's core business, and that he would continue Olkkola's efforts in expanding the company overseas. He believed that every European company needed global horizons to be able to meet global competition for future survival. To do so, he envisaged the setting up of alliances of varying duration, each designed for specific purposes. He said, "Sakari has become an interesting partner with

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Rank	Company	Country	1998 telecom equipment sales (US\$ billions)
1	Lucent	USA	26.8
2	Ericsson	Sweden	21.5
3	Alcatel	France	20.9
4	Motorola	USA	20.5
5	Nortel	Canada	17.3
6	Siemens	Germany	16.8
7	Nokia	Finland	14.7
8	NEC	Japan	12.6
9	Cisco	USA	8.4
10	Hughes	USA	5.7

Exhibit 3 Ten Major Telecommunication Equipment Vendors

Source: International Telecommunication Union. 1999. Top 20 Telecommunication Equipment Vendors 1998. http://www.itu.int/ITU-D/ict/statistics/at_glance/Top2098.html.

which to cooperate on an equal footing in the areas of R&D, manufacturing and marketing.”

The recession in Finland which began in 1990 led Sakari's group sales to decline substantially from FIM22 billion⁵ in 1990 to FIM15 billion in 1991. The losses were attributed to two main factors: weak demand for Sakari's consumer electronic products, and trade with the Soviet Union which had come to almost a complete standstill. Consequently Sakari began divesting its less profitable companies within the basic industries (metal, rubber, and paper), as well as leaving the troubled European computer market with the sale of its computer subsidiary, Sakari Macro. The company's new strategy was to focus on three main areas: telecom systems and mobile phones in a global framework, consumer electronic products in Europe, and deliveries of cables and related technology. The company's divestment strategy led to a reduction of Sakari's employees from about 41,000 in 1989 to 29,000 in 1991. This series of major strategic moves was accompanied by major leadership succession. In June 1992, Koskinen retired as Sakari's

President and was replaced by Visa Ketonen, formerly the President of Sakari Mobile Phones. Ketonen appointed Ossi Kuusisto as Sakari's vice-president.

After Ketonen took over control, the Finnish economy went through a rapid revival in 1993, followed by a new period of intense growth. Since the mid 1990s the Finnish growth had been bolstered by intense growth in telecommunications equipment manufacturing as a result of exploding global telecommunications market. Sakari capitalized on this opportunity and played a major role in the Finnish telecommunications equipment manufacturing sector.

In 2001, Sakari was Finland's largest publicly-traded industrial company and derived the majority of its total sales from exports and overseas operations. Traditionally, the company's export sales were confined to other Scandinavian countries, Western Europe and the former Soviet Union. However, in recent years, the company made efforts and succeeded in globalizing and diversifying its operations to make the most of its high-tech capabilities. As a result, Sakari

emerged as a more influential player in the international market and had gained international brand recognition. One of Sakari's strategies was to form JVs to enter new foreign markets.

THE NORA-SAKARI NEGOTIATION

Nora and Sakari had discussed the potential of forming a JV company in Malaysia for more than two years. Nora engineers were sent to Helsinki to assess the SK33 technology in terms of its compatibility with the Malaysian requirements, while Sakari managers travelled to KL mainly to assess both Nora's capability in manufacturing switching exchanges and the feasibility of gaining access to the Malaysian market.

In January 2003, Nora submitted its bid for TMB's RM2 billion contract to supply digital switching exchanges supporting four million telephone lines. Assuming the Nora-Sakari JV would materialize, Nora based its bid on supplying Sakari's digital switching technology. Nora competed with seven other companies short listed by TMB, all offering their partners' technology—Alcatel, Lucent, Fujitsu, Siemens, Ericsson, NEC, and Samsung. In early May, TMB announced five successful companies in the bid. They were companies using technology from Alcatel, Fujitsu, Ericsson, NEC, and Sakari. Each company was awarded one-fifth share of the RM2 billion contract and would be responsible in delivering 800,000 telephone lines over a period of five years. Industry observers were critical of TMB's decision to select Sakari and Alcatel. Sakari was perceived to be the least capable in supplying the necessary lines to meet TMB's requirements, as it was alleged to be a small company with little international exposure. Alcatel was criticized for having the potential of supplying an obsolete technology.

The May 21 Meeting

Following the successful bid and ignoring the criticisms against Sakari, Nora and Sakari held a major meeting in Helsinki on May 21 to

finalize the formation of the JV. Zainal led Nora's five-member negotiation team which comprised Nora's general manager for corporate planning division, an accountant, two engineers, and Marina Mohamed, a lawyer. One of the engineers was Salleh Lindstrom who was of Swedish origin, a Muslim and had worked for Nora for almost 10 years.

Sakari's eight-member team was led by Kuusisto, Sakari's vice-president. His team comprised Junttila, Hussein Ghazi, Aziz Majid, three engineers, and Julia Ruola (a lawyer). Ghazi was Sakari's senior manager who was of Egyptian origin and also a Muslim who had worked for Sakari for more than 20 years while Aziz, a Malay, had been Sakari's manager for more than 12 years.

The meeting went on for several days. The main issue raised at the meeting was Nora's capability in penetrating the South-east Asian market. Other issues included Sakari's concerns over the efficiency of Malaysian workers in the JV in manufacturing the product, maintaining product quality and ensuring prompt deliveries.

Commenting on the series of negotiations with Sakari, Zainal said that this was the most difficult negotiation he had ever experienced. Zainal was Nora's most experienced negotiator and had single-handedly represented Nora in several major negotiations for the past 10 years. In the negotiation with Sakari, Zainal admitted making the mistake of approaching the negotiation applying the approach he often used when negotiating with his counterparts from companies based in North America or the United Kingdom. He said:

Negotiators from the United States tend to be very open and often state their positions early and definitively. They are highly verbal and usually prepare well-planned presentations. They also often engage in small talk and 'joke around' with us at the end of a negotiation. In contrast, the Sakari negotiators tend to be very serious, reserved and 'cold.' They are also relatively less verbal and do not convey much through their facial expressions. As a result, it was difficult for us to determine whether they are really interested in the deal or not.

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Zainal said that the negotiation on May 21 turned out to be particularly difficult when Sakari became interested in bidding a recently-announced tender for a major telecom contract in the United Kingdom. Internal politics within Sakari led to the formation of two opposing “camps.” One “camp” held a strong belief that there would be very high growth in the Asia-Pacific region and that the JV company in Malaysia was seen as a hub to enter these markets. Although the Malaysian government had liberalized its equity ownership restrictions and allowed the formation of wholly-owned subsidiaries, JVs were still an efficient way to enter the Malaysian market for a company that lacked local knowledge. This group was represented mostly by Sakari’s managers positioned in Asia and engineers who had made several trips to Malaysia, which usually included visits to Nora’s facilities. They also had the support of Sakari’s vice-president, Kuusisto, who was involved in most of the meetings with Nora, particularly when Zainal was present. Kuusisto had also made efforts to be present at meetings held in KL. This group also argued that Nora had already obtained the contract in Malaysia whereas the chance of getting the U.K. contract was quite low in view of the intense competition prevailing in that market.

The “camp” not in favour of the Nora-Sakari JV believed that Sakari should focus its resources on entering the United Kingdom, which could be used as a hub to penetrate the European Union (EU) market. There was also the belief that Europe was closer to home, making management easier, and that problems arising from cultural differences would be minimized. This group was also particularly concerned that Nora had the potential of copying Sakari’s technology and eventually becoming a strong regional competitor. Also, because the U.K. market was relatively “familiar” and Sakari has local knowledge, Sakari could set up a wholly-owned subsidiary instead of a JV company and consequently, avoid JV-related problems such as joint control, joint profits, and leakage of technology.

Zainal felt that the lack of full support from Sakari’s management led to a difficult negotiation when new misgivings arose concerning Nora’s capability to deliver its part of the deal. It was apparent that the group in favour of the Nora-Sakari JV was under pressure to further justify its proposal and provide counterarguments against the U.K. proposal. A Sakari manager explained, “We are tempted to pursue both proposals since each has its own strengths, but our current resources are very limited. Thus a choice has to be made, and soon.”

The July 8 Meeting

Another meeting to negotiate the JV agreement was scheduled for July 8. Sakari’s eight-member team arrived in KL on Sunday afternoon of July 7, and was met at the airport by the key Nora managers involved in the negotiation. Kuusisto did not accompany the Sakari team at this meeting.

The negotiation started early Monday morning at Nora’s headquarters and continued for the next five days, with each day’s meeting ending late in the evening. Members of the Nora team were the same members who had attended the May 21 meeting in Finland, except Zainal, who did not participate. The Sakari team was also represented by the same members in attendance at the previous meeting plus a new member, Solail Pekkarinen, Sakari’s senior accountant. Unfortunately, on the third day of the negotiation, the Nora team requested that Sakari ask Pekkarinen to leave the negotiation. He was perceived as extremely arrogant and insensitive to the local culture, which tended to value modesty and diplomacy. Pekkarinen left for Helsinki the following morning.

Although Zainal had decided not to participate actively in the negotiations, he followed the process closely and was briefed by his negotiators regularly. Some of the issues which they complained were difficult to resolve had often led to heated arguments between the two negotiating teams. These included:

1. Equity Ownership

In previous meetings both companies agreed to form the JV company with a paid-up capital of RM5 million. However, they disagreed on the equity share proposed by each side. Sakari proposed an equity split in the JV company of 49 per cent for Sakari and 51 per cent for Nora. Nora, on the other hand, proposed a 30 per cent Sakari and 70 per cent Nora split. Nora's proposal was based on the common practice in Malaysia as a result of historical foreign equity regulations set by the Malaysian government that allowed a maximum of 30 per cent foreign equity ownership unless the company would export a certain percentage of its products. Though these regulations were liberalized by the Malaysian government effective from July, 1998 and new regulations had replaced the old ones, the 30-70 foreign-Malaysian ownership divide was still commonly observed.

Equity ownership became a major issue as it was associated with control over the JV company. Sakari was concerned about its ability to control the accessibility of its technology to Nora and about decisions concerning the activities of the JV as a whole. The lack of control was perceived by Sakari as an obstacle to protecting its interests. Nora also had similar concerns about its ability to exert control over the JV because it was intended as a key part of Nora's long-term strategy to develop its own digital switching exchanges and related high-tech products.

2. Technology Transfer

Sakari proposed to provide the JV company with the basic structure of the digital switch. The JV company would assemble the switching exchanges at the JV plant and subsequently install the exchanges in designated locations identified by TMB. By offering Nora only the basic structure of the switch, the core of Sakari's switching technology would still be well-protected.

On the other hand, Nora proposed that the basic structure of the switch be developed at the JV company in order to access the root of the

switching technology. Based on Sakari's proposal, Nora felt that only the technical aspects in assembling and installing the exchanges would be obtained. This was perceived as another "screw-driver" form of technology transfer while the core of the technology associated with making the switches would still be unknown.

3. Royalty Payment

Closely related to the issue of technology transfer was the payment of a royalty for the technology used in building the switches. Sakari proposed a royalty payment of five per cent of the JV gross sales while Nora proposed a payment of two per cent of net sales.

Nora considered the royalty rate of five per cent too high because it would affect Nora's financial situation as a whole. Financial simulations prepared by Nora's managers indicated that Nora's return on investment would be less than the desired 10 per cent if royalty rates exceeded three per cent of net sales. This was because Nora had already agreed to make large additional investments in support of the JV. Nora would invest in a building which would be rented to the JV company to accommodate an office and the switching plant. Nora would also invest in another plant which would supply the JV with surface mounted devices (SMD), one of the major components needed to build the switching exchanges.

An added argument raised by the Nora negotiators in support of a two per cent royalty was that Sakari would receive side benefits from the JV's access to Japanese technology used in the manufacture of the SMD components. Apparently the Japanese technology was more advanced than Sakari's present technology.

4. Expatriates' Salaries and Perks

To allay Sakari's concerns over Nora's level of efficiency, Nora suggested that Sakari provide the necessary training for the JV technical employees. Subsequently, Sakari had agreed to provide eight engineering experts for the JV company on two types of contracts, short-term

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and long-term. Experts employed on a short-term basis would be paid a daily rate of US\$1260 plus travel/accommodation. The permanent experts would be paid a monthly salary of US\$20,000. Three permanent experts would be attached to the JV company once it was established and the number would gradually be reduced to only one, after two years. Five experts would be available on a short-term basis to provide specific training needs for durations of not more than three months each year.

The Nora negotiation team was appalled at the exorbitant amount proposed by the Sakari negotiators. They were surprised that the Sakari team had not surveyed the industry rates, as the Japanese and other western negotiators would normally have done. Apparently Sakari had not taken into consideration the relatively low cost of living in Malaysia compared to Finland. In 2000, though the average monthly rent for a comfortable, unfurnished three-bedroom apartment was about the same (660 US\$) in Helsinki and Kuala Lumpur, the cost of living was considerably lower in KL. The cost of living index (New York = 100) of basket of goods in major cities, excluding housing, for Malaysia was only 83.75, compared to 109.84 for Finland.⁶

In response to Sakari's proposal, Nora negotiators adopted an unusual "take-it or leave-it" stance. They deemed the following proposal reasonable in view of the comparisons made with other JVs which Nora had entered into with other foreign parties:

Permanent experts' monthly salary ranges to be paid by the JV company were as follows:

- (1) Senior expert (seven to 10 years experience)
RM24,300–RM27,900
- (2) Expert (four to six years experience)
RM22,500–RM25,200
- (3) Junior expert (two to three years experience)
RM20,700–RM23,400
- (4) Any Malaysian income taxes payable would be added to the salaries.
- (5) A car for personal use.
- (6) Annual paid vacation of five weeks.

- (7) Return flight tickets to home country once a year for the whole family of married persons and twice a year for singles according to Sakari's general scheme.
- (8) Any expenses incurred during official travelling.

Temporary experts are persons invited by the JV company for various technical assistance tasks and would not be granted residence status. They would be paid the following fees:

- (1) Senior expert RM1,350 per working day
- (2) Expert RM1,170 per working day
- (3) The JV company would not reimburse the following:
 - Flight tickets between Finland (or any other country) and Malaysia.
 - Hotel or any other form of accommodation.
 - Local transportation.

In defense of their proposed rates, Sakari's negotiators argued that the rates presented by Nora were too low. Sakari suggested that Nora's negotiators take into consideration the fact that Sakari would have to subsidize the difference between the experts' present salaries and the amount paid by the JV company. A large difference would require that large amounts of subsidy payments be made to the affected employees.

5. Arbitration

Another major issue discussed in the negotiation was related to arbitration. While both parties agreed to an arbitration process in the event of future disputes, they disagreed on the location for dispute resolution. Because Nora would be the majority stakeholder in the JV company, Nora insisted that any arbitration should take place in KL. Sakari, however, insisted on Helsinki, following the norm commonly practised by the company.

At the end of the five-day negotiation, many issues could not be resolved. While Nora could agree on certain matters after consulting Zainal, the Sakari team, representing a large private company, had to refer contentious items to the company board before it could make any decision that went beyond the limits authorized by the board.

THE DECISION

Zainal sat down at his desk, read through the minutes of the negotiation thoroughly, and was disappointed that an agreement had not yet been reached. He was concerned about the commitment Nora had made to TMB when Nora was awarded the switching contract. Nora would be expected to fulfil the contract soon but had yet to find a partner to provide the switching technology. It was foreseeable that companies such as Siemens, Samsung and Lucent, which had failed in the bid, could still be potential partners. However, Zainal had also not rejected the possibility of a reconciliation with Sakari. He could start by contacting Kuusisto in Helsinki. But should he?

NOTES

1. Sdn Bhd is an abbreviation for Sendirian Berhad, which means private limited company in Malaysia.
2. Oy is an abbreviation for Osakeyhtiö, which means private limited company in Finland.
3. The first name is used because the Malay name does not carry a family name. The first and/or middle names belong to the individual and the last name is his/her father's name.
4. RM is Ringgit Malaysia, the Malaysian currency. As at December 31, 2002, US\$1 = RM3.80.
5. FIM is Finnish Markka, the Finnish currency until January 1, 1999. Markka coins and notes were not withdrawn from circulation until January 1, 2002, when Finland fully converted to the Euro. As at December 31, 2000, US\$1 = FIM6.31, and € 1 = FIM5.95.
6. IMD & World Economic Forum. 2001. The World Competitiveness Report.

MAJESTICA HOTEL IN SHANGHAI?

Prepared by Jane Lu under the supervision of Professor Paul W. Beamish

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On March 20, 2005, Richard Roy, executive vice-president of Majestica Hotels Inc., was in China, for negotiations with Commercial Properties of Shanghai Limited (CPS). They were discussing a possible management contract under which Majestica would be the operator of a new luxury hotel there owned by Shanghai Industrial Holdings.

Majestica Hotels Inc. was one of the world's leading operators of luxury hotels. The expansion into mainland China had been on management's agenda since 1999. The opportunity emerged in late 2003 when a close friend of Majestica's chief executive officer (CEO) revealed that CPS was looking for an operator for its new luxury hotel under construction in Shanghai. Majestica immediately sent representatives to Shanghai to explore the possibility of becoming the operator. Majestica's proposal was welcomed by CPS, and a letter of intent was signed on August 20, 2004.

However, in discussions regarding the management contract, the two parties had reached a deadlock. The key issues to be resolved were the contract term, and the responsibilities and rights of Majestica as the operator, and CPS as the owner, of the hotel.

This Shanghai deal was important for Majestica's global expansion. It would not only provide Majestica with the opportunity to enter the China market but could also set a precedent for Majestica's future expansion in other emerging markets.

MAJESTICA HOTELS INC.

Majestica was founded in 1970 in western Europe. It focused exclusively on its niche of developing and operating luxury hotels with 200

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to 450 rooms. In 1977, Majestica expanded to the United Kingdom. In 1984, Majestica entered the U.S. market via acquisition. Majestica's expansion in the U.S. market continued with properties in seven other major cities. By the end of the 1990s, Majestica had secured a strong position in the luxury hotel industry in North America, competing with such established chains as Four Seasons, Ritz-Carlton, Hilton, Hyatt, Marriott and Westin.

While Majestica expanded quickly in North America, it adopted a gradual expansion strategy in Asia. This gradual expansion strategy shifted when the opportunity arose to acquire a major competitor in Asia in 1998. This acquisition made Majestica one of the world's largest operators of luxury hotels and resort properties. More importantly, it provided Majestica with a much expanded position in Pacific Asia and an immediate presence in the greater China area. Majestica continued its international expansion by amassing a select portfolio of medium-sized luxury hotels in the world's commercial and financial centres. By the end of 2004, Majestica managed 40 properties in 15 countries with approximately 20,000 employees. The contribution of Majestica's properties in North America, Asia and Europe to its consolidated revenue was 54 per cent, 14 per cent and 32 per cent, respectively. Exhibit 1 provides a five-year review of the occupancy rate, average daily room rate (ADR) and average room revenue per available room (REVPAR) of Majestica hotels in these three regions and worldwide.

In 2004, Majestica had a market capitalization of \$1.7 billion¹ and generated revenue of more than \$2.3 billion (see Exhibit 2). Majestica earned revenue both from hotel management and hotel ownership operations. In the past five years, Majestica shifted away from owning hotels and focused on managing hotels. In 2004, 80 per cent of Majestica's earnings before other operating items were generated by its hotel management business.

Majestica followed a business strategy that offered business and leisure travellers excellent hotel and resort accommodation in each

destination it served. Following this strategy, Majestica developed into a luxury hotel chain with service standards among the best in the industry. Majestica hotels and resorts were widely recognized for the exceptional quality of their guest facilities, service and atmosphere. The Majestica brand was generally considered one of the top luxury hotel chain brands in the world, and its hotels and resorts were named frequently among the world's best hotels and travel experiences by Institutional Investor, Condé Nast Traveler, AAA Five Diamond and others. Majestica's success was also reflected in consistently achieving above-market operating results for the properties under its management. During 2003, REVPAR (revenue per available room) for Majestica core hotels worldwide and in North America was 60 per cent higher than that of its competitors in the luxury segments worldwide and in North America. The room rate for a Majestica hotel in Chicago, for example, averaged \$50 higher than those of Hyatt Regency, Hilton, Sheraton and Marriott (see Exhibit 3).

Majestica's superior hotel management results attracted the owners and developers of luxury hotels worldwide. By the end of 2004, in addition to the 40 hotels under its management, Majestica had 16 new hotels and resorts under construction or development, and it was evaluating dozens of additional management opportunities around the world. In summarizing the key success factors, the Majestica management pointed to a service culture that they had fostered for decades.

It emphasized anticipating travellers' needs and meeting those needs with superior hotel structures and a deeply instilled ethic of personal service. This service culture was built into every property, going beyond elegant hotel designs and finishes to the small, thoughtful touches that would add value for the guests. Every detail was deliberate, from mechanical systems that were as quiet as they were efficient to providing a disposable bathing suit in case hotel guests forgot to bring one. In addition, the design of the hotel rooms highlighted a use of space that enhanced the sense of luxury. On average, standard guest

	2004	2003	2002	2001	2000
Worldwide					
Occupancy	75.44%	74.50%	70.30%	69.50%	68.00%
ADR ¹	\$380.18	\$354.22	\$312.24	\$286.53	\$239.85
REVPAR ²	\$280.38	\$265.16	\$223.93	\$203.20	\$162.15
Gross operating margin ³	32.50%	33.10%	29.10%	26.70%	22.00%
North America					
Occupancy	76.40%	77.50%	78.00%	71.20%	68.90%
ADR	\$413.69	\$368.73	\$328.87	\$303.62	\$251.84
REVPAR	\$311.02	\$277.72	\$233.04	\$211.71	\$172.48
Gross operating margin	32.10%	33.10%	31.20%	25.40%	23.80%
Asia-Pacific					
Occupancy	69.90%	74.50%	73.80%	74.10%	67.80%
ADR	\$288.44	\$299.56	\$267.36	\$240.39	\$195.80
REVPAR	\$204.20	\$220.02	\$193.93	\$175.69	\$129.27
Gross operating margin	32.30%	34.50%	31.20%	29.60%	25.80%
Europe					
Occupancy	80.10%	82.30%	77.90%	70.10%	64.50%
ADR	\$669.40	\$637.95	\$576.92	\$428.95	\$515.70
REVPAR	\$530.01	\$519.36	\$455.44	\$296.84	\$331.49
Gross operating margin	42.10%	41.30%	39.80%	31.70%	34.10%

Exhibit 1 Hotel Occupancy, ADR and REVPAR (in US\$ millions)

1. ADR is defined as average daily room rate per room occupied.
2. REVPAR is average room revenue per available room. It is a commonly used indicator of market performance for hotels and represents the combination of the average occupancy rate achieved during the period.
3. Gross operating margin represents gross operating profit as a percentage of gross revenues.

rooms in Majestica hotels were 25 per cent larger than those in Hyatt Regency, Hilton, Sheraton and Marriott.

More importantly, the service culture emphasized the depth of personal service. Majestica deemed ultimate luxury as not derived from furnishings but from personal service. The services at Majestica hotels were comprehensive and highly personalized. Guided by the service

culture, Majestica's employees treated every interaction with guests as an opportunity to anticipate and satisfy a need. They provided services ranging from room service that felt like a fine dining experience to replacing worn shoelaces. The strong service culture ensured highly reliable services. For example, room service always arrived on time and conference arrangements were in place as promised.

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	2004	2003	2002	2001	2000
Statements of Operations Data					
Consolidated revenues	268.80	135.18	151.87	143.92	113.23
Hotel Management Operations					
Fee revenues	118.72	106.06	99.12	89.49	67.54
Hotel management earnings before other operating items	71.34	62.38	58.02	51.41	31.25
Hotel Ownership Operations					
Revenues	151.54	19.71	47.60	48.27	42.56
Distribution from hotel investments	6.72	10.30	6.72	7.62	4.37
Hotel ownership earnings before other operating items	16.91	9.74	16.69	15.90	8.06
Earnings before other operating items	88.14	72.02	74.70	67.20	39.31
Net earnings (loss)	45.70	33.49	(83.55)	7.62	(135.30)
Earnings (loss) per share					
Basic and fully diluted	1.86	1.56	(3.92)	0.36	(6.49)
Weighted average number of shares (millions)	24.6	21.5	21.3	20.9	20.9
Balance Sheet Data					
Total assets	507.58	431.54	427.39	550.48	580.27
Total debt	157.02	268.80	299.71	345.63	400.40
Shareholders' equity	285.04	98.67	64.06	153.66	139.66
Other Data					
Total revenues of all managed hotels	2,373.73	2,129.68	2,058.45	1,901.98	1,514.13
Fee revenues as a % of consolidated revenues	44.20%	78.50%	65.30%	62.20%	59.60%
Percentage of Fee revenues derived outside North America	31.20%	38.30%	40.90%	38.80%	35.90%
Hotel management operating margin	60.10%	58.80%	58.50%	57.40%	46.30%
Hotel management earnings before other operating items as a % of earnings before other operating items	80.90%	86.60%	77.70%	76.50%	79.50%
EBITDA	88.14	72.02	74.70	67.20	39.31
Debt, net of cash	128.69	251.55	258.61	335.10	387.07
Market price per share at year-end	50.40	31.08	21.28	18.20	14.56
Shares outstanding (millions)	25.28	21.53	21.38	21.30	20.85
Market capitalization at year-end	1,699.49	892.86	606.26	517.33	404.43
Employees	24,640	23,520	24,080	24,080	22,456

Exhibit 2 Five-Year Financial Review (in US\$ millions except per share amounts)

Name of Hotel	Affiliation	"Number of Guest rooms"	Room rate*
Four Seasons Hotel Chicago	Four Seasons Hotels & Resorts	343	435-535
The Ritz-Carlton Hotel Chicago	Four Seasons Hotels & Resorts	435	395-535
Park Hyatt Chicago	Hyatt International	203	375-425
Renaissance Chicago Hotel	Marriott International	513	204
The Drake	Hilton International	535	255-295
The Peninsula Chicago	Peninsula Hotel Group	339	445-455
Le Meridien	Le Meridien Group	311	249
Majestica Miracle Mile	Majestica Hotels	435	455

Exhibit 3 Major Luxury Hotels in Chicago (2005) (in US\$)

Source: Company files.

*Ratings and pricing were obtained from Frommer's Hotel Guide online as of March 2005.

The service culture encouraged surpassing each guest's highest levels of expectation. Majestica employees would do everything possible to accomplish the guests' purpose of the trip. The stories of Majestica employees' responses to unusual requests were legendary.

It took Majestica decades to foster this unique service culture and to achieve the widely recognized outstanding service standards. The challenge Majestica faced in its global expansion was how to replicate the exceptional Majestica guest experience from hotel to hotel, no matter where it operated in the world. Maintaining consistency in the quality of guest experience across its portfolio was regarded as essential to Majestica's continuing success. Decades of experience in the luxury hotel market had taught Majestica that constancy built trust and loyalty. The challenge in Majestica's global expansion was how to export its service culture to new locations. Majestica successfully handled this challenge with the following two policies.

First, Majestica was careful about the pace of adding new hotels and resorts in the portfolio. Whether there was a compatible service culture in the new location was an important criterion in

deciding the direction and pace of Majestica's international expansion. In fact, the perceived lack of service culture in Asia was one of the major reasons that Majestica adopted a gradual expansion strategy in Asia in the mid-1990s. This second mover strategy allowed Majestica to profit from the development of a service culture in Asia brought about by the earlier entrants, the major American hotels.

Second, it was Majestica's operating philosophy to have full control of the hotels under its management in order to cultivate its service culture and to maintain service consistency in new markets. Majestica's operating philosophy requested the owners of the Majestica hotels to adopt a hands-off approach, from the planning and designing of the hotels to the daily operating of the hotel such as purchasing hotel equipment, marketing and staffing. The non-interference from the hotel owners was important to the smooth fostering of Majestica's service culture in new markets. For example, the full authority in staffing enabled Majestica to carefully select the right people and imbue them with Majestica's service culture through various training programs and through leadership by

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example. Following this operating philosophy, Majestica's service culture was passed from one Majestica hotel to another so as to succeed in maintaining consistent service throughout its global expansion.

MAJESTICA IN THE ASIA-PACIFIC REGION

Asia was one of the fastest growing tourism destinations in the world. However, Asia's importance as a travel destination was not recognized by the major hotel companies in the world until the rising of Asia's tigers in the 1980s. Attracted by the unprecedented economic and construction boom in the region, a growing middle class, increases in passenger miles and an expanding economy, major hotel companies rapidly opened new properties in the Asia-Pacific region in an attempt to ensure a strong presence.

Among the major international luxury hotel chains, Hilton was the earliest entrant to the region. After its initial entry in 1948 with the 450-room Nagoya Hilton, Hilton International had 45 properties spreading across the region by 2000.

Through its 1995 acquisition of Westin Hotels & Resorts and ITT Sheraton Corp, Starwood Hotels & Resorts Worldwide gained a strong presence in the Asia-Pacific region. Prior to being acquired, both Westin and ITT Sheraton had been active in the Asia-Pacific region and were managing numerous properties.

Marriott and Hyatt were two of the later entrants to the Asia-Pacific region. Hyatt International managed 56 hotels and 18 resorts in 34 countries. In the Asia-Pacific region, it had 18 hotels in operation and 19 properties under development. Marriott entered the Asia-Pacific region in 1990 with its opening of the JW Marriott Hotel Hong Kong. Four more entries over the next seven years brought Marriott's total to five hotels, with a total of 1,941 rooms. Marriott had also secured management contracts for four additional hotels. The company was looking to add more hotels in the four- and five-star categories.

Another competitor, The Four Seasons, had 15 Asian-Pacific properties, with a total of 4,950

rooms. This total represented one-third of its rooms worldwide. In addition to these hotels, two more were scheduled to open in 2005. The company's Asian-Pacific portfolio was heavily concentrated in India, Indonesia, Singapore and Thailand.

The Ritz-Carlton Hotel Company was another upscale hotel firm that had targeted the region. In 1997, the company opened hotels in Osaka and Kuala Lumpur to complement its existing properties in Singapore, Hong Kong, Seoul and Sydney. The company also opened a resort in Bali, Indonesia, situated near one of Four Seasons' premier properties.

In addition to these competitors, Asian hotel companies such as Mandarin Oriental, Dusit Thani, CDL, Regal Hotels, Marco Polo, New World Hotels International and the Peninsula Group had been exploring opportunities for expansion in and around their bases in Asia. Hong Kong-based Shangri-La Hotels and Resorts was the most active Asian hotel company. It operated 32 hotels and resorts in China and Southeast Asia with plans for more.

Compared with the rapid expansion of these companies, Majestica had kept a low profile in the region. It had not entered Asia in the late 1980s because Majestica was not convinced that the political situation was stable and that a service culture existed there.

However, the 1990s brought a change in Majestica's strategy. In 1994, after two years of negotiation, Majestica acquired two Tokyo hotels, for its first properties in the region. In August 1996, with a solid capital base that had been built on the company's outstanding financial performance, Majestica acquired 100 per cent ownership of Le Roi Resorts, including its management contracts, trade names and trademarks. This transaction provided Majestica with a much expanded position in the Asia-Pacific region.

As 2005 approached, China was becoming the centre of Asia's fiercest competition in the hotel industry. With an annual Gross Domestic Product (GDP) growth rate of nine per cent for the past 20 years, China was the seventh largest economy and the 10th largest trading nation in the world. China's booming economy, coupled

with its huge potential market comprising more than 1.2 billion people, had attracted many foreign investors. By the end of 2001, China ranked second to the United States as the largest foreign direct investment recipient in the world.

China's economic development and open door policy also attracted many foreign visitors. With over seven million foreign visitors (including people from Hong Kong, Macao and Taiwan) in 2000, China was the sixth most popular destination for business and leisure travel in the world. The World Tourism Organization predicted that China would become the No. 1 travel destination by 2020.

The hotel industry in China prospered with the boom in tourism. At the end of 2002, China had approximately 5,201 hotels, a growth rate of nearly 20 per cent since 1996. This represented a total of 701,700 available rooms in China. In 2000, the hotels sector recorded growth of over 10 per cent. Over half the hotels in China were categorized as tourist hotels.² Of the 1,669 hotels rated by the government, the majority were at the two- and three-star level, while just three per cent had been awarded five-star ratings. Most five-star hotels were operated by international luxury hotel chains such as Shangri-la Hotels & Resorts, ITT Sheraton Asia Pacific Group, Hilton International and Ritz-Carlton Hotels & Resorts.

COMMERCIAL PROPERTIES OF SHANGHAI LIMITED

Commercial Properties of Shanghai Limited (CPS), was a subsidiary of Commercial Properties Shanghai Investment (Holdings) Co., Ltd. (CPSIH), one of several overseas investment arms of the Shanghai municipal government. Incorporated in Hong Kong in October 1985, CPSIH expanded its businesses quickly and became a diversified conglomerate active in a wide range of businesses including international investment, manufacturing, real estate development and investment, banking and finance, trading and cultural activities. By the end of 2001, it was the largest overseas conglomerate wholly

owned by the Shanghai municipal government with interests in more than 200 companies in Shanghai, Hong Kong, other parts of China and in cities spanning the Americas, Europe, Australia, Africa and Asia.

Hotel development and management was one of the businesses in which CPSIH was engaged. It owned and managed three hotels: the Oceania Hotel situated on Hong Kong Island, Mandarin United Hotel situated in Pudong, Shanghai, and Peace Garden Hotel located near the Yuyuan Gardens in Shanghai. In addition, it also organized mainland China and Hong Kong tours from its properties. Although hotel development and management was a comparatively small business in the company's 2001 business portfolio, it was one of the focuses of the company's future business development. Development of the hotel industry fit well in the company's mission to promote Shanghai and served the need of the Shanghai municipal government for foreign currency. To strengthen its position in the hotel industry and enter the luxury hotel segment, CPSIH had invested \$220 million in building the Oceania Hotel in Hong Kong.

CPS was listed on the Stock Exchange of Hong Kong in May 2000, and subsequently selected as a Hang Seng Index constituent stock in January 2002. At the time of the listing, the market capitalization of CPS was approximately \$700 million. A majority of its shares were held by its parent, CPSIH.

Within the first year after the listing, CPS conducted several successful acquisitions. As well, the parent company also injected assets into CPS. These acquisitions and asset injections together were worth approximately \$1.3 billion, making CPS one of the largest "red-chip" stocks listed on the Hong Kong stock market.

For the year ended 31st December, 2001, the company's turnover reached approximately HK\$4,978 million (about \$795 million), an increase of approximately 60 per cent over that in 2001. Profit for the year amounted to approximately HK\$1,421 million (about \$227 million), and earnings per share HK\$1.79 (about \$0.29), representing substantial increases over the results of 2000.

THE HOTEL INDUSTRY IN SHANGHAI

Situated in the middle of China's east coastline, Shanghai was China's economic and trade centre. In 2000, Shanghai had a population of 16.74 million and the highest per capita income in China. Shanghai and the surrounding provinces of Jiangsu and Zhejiang (Shanghai's manufacturing hinterland) formed the Yangtze River delta region. This region had a comprehensive industrial base and accounted for nearly one-third of China's industrial output. Moreover, it was home to one-quarter of all foreign investment in China. For these reasons, Shanghai was regarded not only as one of the main engines of China's economic growth but also as one of the leading markets in China. Given its strategic importance in China's economic development, its huge market potential and its popularity among tourists, Shanghai had long been recognized as a key site for companies that operated in the luxury hotel business.

According to the Shanghai Tourism Administrative Commission, Shanghai had 423 hotels at the end of 2004, with 68,000 rooms. By the end

of 2005, the number of hotels was expected to rise to around 470 with the number of guest rooms rising to 75,000. The commission expected more than four million overseas tourists to stay at least one night in the city in 2005, an increase of 11 per cent from 2004. The commission also expected the number of domestic tourists visiting Shanghai to rise by five per cent, hitting 90 million. However, only a handful had a top rating of five-stars (see Exhibit 4). Portman Ritz-Carlton had been originally managed by Shangri-la Hotels & Resorts. However, at the end of 1997, the management contract expired and Ritz-Carlton took over the management of Portman. It was then renamed Portman Ritz-Carlton, and was Ritz-Carlton's first hotel in China.

In 1992, the Chinese government announced its initiative to develop Shanghai's Pudong District into Asia's finance centre. Local government offices, the Shanghai Stock Exchange, the Shanghai Cereal & Oil Exchange, and the Shanghai Real Estate Trading Market were all to move their offices across the Huangpu River to the Pudong District. Hotel developers quickly seized

Name of Hotel	Affiliation	"Number of Guest rooms"	Room rate*
St. Regis Shanghai	St. Regis Hotels International	318	320-340
Portman Ritz-Carlton Shanghai	Ritz-Carlton Hotels & Resorts	564	250
Westin Shanghai	Westin Hotels	301	320
Sheraton (fka Westin) Tai Ping Yang, Shanghai	Sheraton Hotels & Resorts	578	230-280
Grand Hyatt Shanghai	Hyatt International	555	320-335
Pudong Shangri-la	Shangri-la Hotels & Resorts	606	330-350
Hilton Shanghai	Hilton Hotels International	720	264
Four Seasons Shanghai	Four Seasons Hotels	439	312-362

Exhibit 4 Major Luxury Hotels in Shanghai (2005) (in US\$)

Source: Company files.

*Ratings and pricing were obtained from Frommer's Hotel Guide online as of March 2005.

the opportunity created by this initiative and invested in the Pudong area. International luxury hotel chains soon followed and by mid-1998 Shangri-la opened the first five-star hotel in Pudong. Several months later, in the fall of 1998, Hyatt International opened its first Chinese Grand Hyatt in Pudong. This luxury hotel occupied the top 36 floors of Pudong's 88-story Jin Mao Tower, making it the tallest hotel in the world. Quickly, other luxury hotels followed these entries, and there was some thought among industry observers that the Shanghai luxury hotel market was saturated, even before Majestica's proposed entry.

MAJESTICA—CPS NEGOTIATION

Shanghai was an ideal location for Majestica's expansion into mainland China. First, the Shanghai location met Majestica's preference for locating in major commercial and financial centres. In fact, Shanghai ranked second to Paris on the company's list of attractive international location choices. Shanghai was also attractive for its investment infrastructure, especially in terms of the service mentality of the Shanghai people. The quality of people was important for the development of a service culture.

In addition to being an ideal location, Majestica was interested in the partner. The partner was seen as having both the appetite and resources and could provide the potential to enter into multiple cities in China in the future. Such an owner not only reduced Majestica's concern about the political risk in China but also ensured a long-term commitment to the city and the support of the Shanghai municipal government to the project. The fact that CPS was publicly listed in Hong Kong gave Majestica more confidence about business transparency and independence from government influence. Further, the fact that the hotel was under construction made the opportunity more attractive to Majestica.

Majestica's proposal to operate the luxury hotel satisfied CPS's ambition to build a pre-eminent hotel in Shanghai. Majestica's outstanding financial performance and reputation in

the luxury hotel industry convinced CPS that Majestica had the capability to provide the expected rate of return to its investment in the Hotel. CPS's confidence in Majestica was reflected in changing the original hotel design from 600 to 700 rooms (the Sheraton standard) to 375 to 450 rooms to meet the high standard of Majestica.

Majestica and CPS signed a letter of intent on August 20, 2004. After the signing of the letter of intent, the two parties started negotiation on the management contract. With respect to the fee structure, CPS was impressed by Majestica's above-market results for existing properties and was confident that the same could be achieved for the hotel. CPS agreed that Majestica would receive a base fee of three per cent of gross revenues of the hotel, as per its standard arrangement. In addition, Majestica would receive incentive fees based on the hotel's operating performance. Such incentives were in place for 90 per cent of the properties that Majestica managed.

The key issues in the negotiation that required resolution in March 2005 were the length of contract term and the control that Majestica could have over the management of the hotel.

Length of Contract Term

Most of the negotiation time was spent on the issue of the length of contract term. The length of the term of management contract was very important to Majestica. Majestica did not sign short-term management contracts. Based on its typical management contract term of 50 to 60 years elsewhere in the world, Majestica asked for a contract term of 55 years in its negotiation with CPS. CPS was shocked by this request; it had been prepared to offer only 12 years. In China, there were two levels of licensing in hotel development and management. The first level of licensing was from the government to the owner for the use of the land on which the hotel was built. The maximum length of land lease was 50 years. The second level of licensing was from the owner of the hotel to the operator who would

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manage the hotel on behalf of the owner. The normal hotel management term in China was only 10 years, since one of the objectives of the licensors was to learn hotel management and eventually manage the hotel themselves.

The big gap between the two parties on the contract length was a very difficult issue in the negotiation. After consultation with its parent company and presumably the Shanghai municipal government, CPS countered with an offer of 30 years. Majestica insisted that the hotel management contract term should be at least 50 years, the same as the land use right certificate term that CPS had received from the government. CPS argued that the hotel industry belonged to a sector which limited foreign investment, and government regulations would not allow the duration of hotel operation by foreign investors to be over 30 years. It further suggested that Majestica could enjoy a 30-year operation period, and the operation period could be extended when it expired, if both parties agreed to extend.

Pre-opening Assistance

Majestica assumed a substantial pre-opening role by sending senior people, such as its senior vice-president of design and construction, to help CPS in the design and constructing of the hotel. CPS welcomed Majestica's help but couldn't accept Majestica's request for retaining the approval right over all design aspects relating to the hotel, including the furniture, fixtures and equipment. Majestica argued that it requested this right to keep chain consistency, to make sure that the hotel would be developed and constructed as a world-class luxury hotel and to allow effective functioning of the hotel in operation.

Name of the Hotel

CPS suggested that the hotel be named "Shanghai Oceania—Majestica Hotel." Majestica insisted that the Hotel should be under the name "Majestica Hotel, Shanghai." This was essential to and consistent with Majestica's international strategic expansion program. Majestica believed

that the Majestica brand was critical to the successful operation of the hotel as an international luxury hotel. Majestica would not agree to operate the hotel under any other name.

General Manager

Another major issue under debate was staffing the different levels of the hotel management (Exhibit 5). The hotel's general manager was responsible for the overall operation. In general, the two parties agreed that the general manager, upon the opening of the hotel, would be an expatriate. CPS, however, expressed the wish that in the near future, a Chinese general manager would be used. Majestica told CPS that in the selection of a general manager for the hotel, the competence of the general manager was a more important issue than their ethnic background and that while they could make every effort to locate a suitable person with Chinese background, they could not guarantee such an appointment. There was simply no history of Chinese nationals managing world class hotels at or near this level.

Expatriates

In discussions about the number of expatriates to be employed, the localization issue was raised again and was expressed more strongly. CPS could accept the use of any number of expatriates that Majestica considered necessary to get the hotel up and running. But they insisted that the number of the expatriate managers should be gradually reduced and local managers trained to replace them. The reasons were two-fold. First, such a move would cut down the overall operating costs, as it was very expensive to use expatriates. Second, learning how to operate a world class luxury hotel was one of CPS's objectives, and CPS expected Majestica to train the local employees and eventually use them to replace the expatriates.

Specifically, CPS requested that Majestica use a deputy general manager and a deputy financial controller sent by CPS. Majestica told CPS that Majestica would like to fill the positions of senior hotel personnel with local people, both from a cost

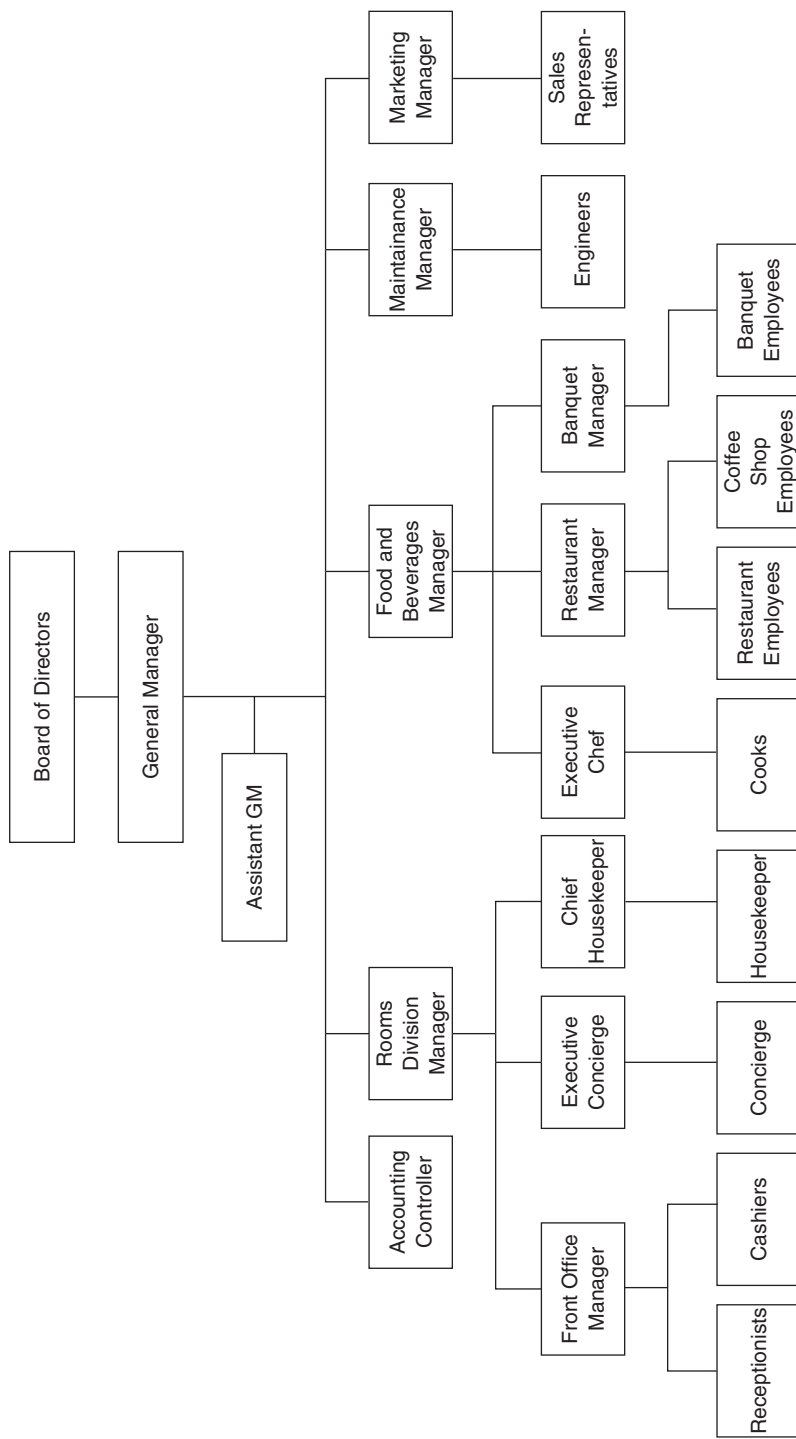


Exhibit 5 Hotel Management Chain in Majestica

Source: Company files.

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and a cultural perspective. However, at this time, Majestica did not believe that local people would have the prerequisite experience (i.e. having held an equivalent position successfully in a world class luxury hotel) to perform their duties at the hotel on a basis consistent with its operation as an international world class luxury hotel. In addition, hotel management was a service business, and it took a long time to build a service culture. On average, it took 12 to 15 years for the culture to be absorbed by hotel professionals. Therefore, it was difficult to reduce the number of expatriates in the foreseeable future. In fact, staffing key positions in the new hotels with experienced hotel operations personnel was one of the secrets to Majestica's success. Richard Roy noted: "Exporting the Majestica work ethic does not depend on manuals, but on seeding new markets with those skilled at finding similar people in new places."

General Staffing

Closely related to the issues of the general manager and expatriates was the responsibility and authority of general staffing. Majestica insisted that it must have the exclusive responsibility and authority on the hiring, paying, supervising, relocating and discharging of all personnel of the hotel, and that CPS should unconditionally employ all the personnel selected and pay all the employment expenses. Majestica emphasized that selecting the appropriate employees and developing their attitudes and job performance in the context of Majestica's operating philosophy was critical to maintaining consistently high-quality performance. Therefore, Majestica should have exclusive authority in staffing to achieve a consistency of staff attitude and service standards. CPS argued that it was entitled to share the responsibility and authority in staffing as the ultimate employer of the hotel staff.

Purchasing

Majestica insisted that, commencing on the opening date, the hotel should participate in Majestica's centralized purchasing system for

furniture, fixtures, operating equipment and supplies, and CPS should pay Majestica a modest fee relating to such centralized purchasing. Majestica argued that central purchasing could ensure standardized products, economies of scale and control over quality and design. CPS was concerned about the purchase prices and insisted that domestic purchasing should be a first priority.

With regard to personal property, other than the operating equipment and supplies, Majestica agreed that CPS could be responsible for the purchasing, subject to Majestica's approval right over the design of the personal property, as well as the firm used to purchase and install the personal property.

Owners' Access to Hotel Rooms

As the owner of the hotel, CPS requested access to hotel rooms or the use of some hotel rooms as offices. Majestica, however, insisted that the owner should not have any privileges over the use of hotel rooms as such an arrangement would cause confusion for the hotel management.

Arbitration

Another major issue discussed in the negotiation was related to arbitration. While both parties agreed to an arbitration process in the event of future disputes, they disagreed on the location for dispute resolution. Majestica insisted on a third country, following the norm commonly practised by the company. CPS, however, insisted that any arbitration should take place in China.

On top of the various issues in the negotiation of the management contract, CPS asked Majestica to take a minority equity position in the hotel. Generally, Majestica made only minority investments in properties where it was necessary and justified. It sought to limit its total capital exposure to no more than 20 per cent of the total equity required for the new property. The Foreign Investment Law in China, however, had stipulated until recently that the equity holdings by foreign investor(s) in an equity joint venture should be no less than 25 per cent. Thus,

the request by CPS exceeded Majestica's upper limit on minority investment policy.

After many rounds of negotiation in the past three months, several issues remained unresolved. While CPS showed its flexibility and made concessions with a counter offer of 30-year contract term, it was clear that Majestica was expected to reciprocate CPS's flexibility and make some concessions in the next round of negotiations. However, Majestica found it difficult to make any concessions. Any requests made in the management contract were based on its operating philosophy for building a service culture, the key success factor in the luxury hotel industry.

THE DECISION

Thinking of the prolonged negotiation, Richard Roy felt disappointed because a lot of management time had been invested in this Shanghai project, but no decision had been reached. Reading through the minutes of the negotiation

again, it was clear to Roy that many of the issues under dispute reflected the conflict between Majestica's operating philosophy and CPS's hands-on approach as the owner of the hotel. The Shanghai deal was a great opportunity, particularly if the management contract could be settled quickly. Roy was unsure what position Majestica should take. Given the importance of the China market, should Majestica adopt a contingency approach and relax its operating philosophy at this time, or should it stick with its original philosophy, even if this meant not entering the Shanghai market?

NOTES

1. All amounts in US\$ unless otherwise specified.
2. In China, there are two basic categories of hotels. Tourist hotels are licensed to receive foreigners. The rest are open only to domestic visitors. Tourist hotels are usually better built and better equipped than domestic hotels.

ELI LILLY IN INDIA: RETHINKING THE JOINT VENTURE STRATEGY

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of Professors Charles Dhanaraj and Paul W. Beamish*

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In August 2001, Dr. Lorenzo Tallarigo, president of Intercontinental Operations, Eli Lilly and Company (Lilly), a leading pharmaceutical firm based in the United States, was getting ready for a meeting in New York, with D. S. Brar, chairman and chief executive officer (CEO) of Ranbaxy Laboratories Limited (Ranbaxy), India. Lilly and Ranbaxy had started a joint venture (JV) in India, Eli Lilly-Ranbaxy Private Limited (ELR), that was incorporated in March 1993. The JV had steadily grown to a full-fledged organization employing more than 500 people in 2001.

However, in recent months Lilly was re-evaluating the directions for the JV, with Ranbaxy signaling an intention to sell its stake. Tallarigo was scheduled to meet with Brar to decide on the next steps.

THE GLOBAL PHARMACEUTICAL INDUSTRY IN THE 1990s

The pharmaceutical industry had come about through both forward integration from the manufacture of organic chemicals and a backward

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integration from druggist-supply houses. The industry's rapid growth was aided by increasing worldwide incomes and a universal demand for better health care; however, most of the world market for pharmaceuticals was concentrated in North America, Europe and Japan. Typically, the largest four firms claimed 20 per cent of sales, the top 20 firms 50 per cent to 60 per cent and the 50 largest companies accounted for 65 per cent to 75 per cent of sales (see Exhibit 1). Drug discovery was an expensive process, with leading firms spending more than 20 per cent of their sales on research and development (R&D). Developing a drug, from discovery to launch in a major market, took 10 to 12 years and typically cost US\$500 million to US\$800 million (in 1992). Bulk production of active ingredients was the norm, along with the ability to decentralize manufacturing and packaging to adapt to particular market needs. Marketing was usually equally targeted to physicians and the paying customers. Increasingly, government agencies, such as Medicare, and health management organizations (HMOs) in the United States were gaining influence in the buying processes. In most countries, all activities related to drug research and manufacturing were strictly controlled by government agencies, such as the Food and Drug Administration (FDA) in the United States, the Committee on Proprietary Medicinal Products (CPMP) in Europe, and the Ministry of Health and Welfare (MHW) in Japan.

Patents were the essential means by which a firm protected its proprietary knowledge. The safety provided by the patents allowed firms to price their products appropriately in order to accumulate funds for future research. The basic reason to patent a new drug was to guarantee the exclusive legal right to profit from its innovation for a certain number of years, typically 20 years for a product patent. There was usually a time lag of about eight to 10 years from the time the patent was obtained and the time of regulatory approval to first launch in the United States or Europe. Time lags for emerging markets and in Japan were longer. The "product patent" covered the chemical substance itself, while a "process

patent" covered the method of processing or manufacture. Both patents guaranteed the inventor a 20-year monopoly on the innovation, but the process patent offered much less protection, since it was fairly easy to modify a chemical process. It was also very difficult to legally prove that a process patent had been created to manufacture a product identical to that of a competitor. Most countries relied solely on process patents until the mid-1950s, although many countries had since recognized the product patent in law. While companies used the global market to amortize the huge investments required to produce a new drug, they were hesitant to invest in countries where the intellectual property regime was weak.

As health-care costs soared in the 1990s, the pharmaceutical industry in developed countries began coming under increased scrutiny. Although patent protection was strong in developed countries, there were various types of price controls. Prices for the same drugs varied between the United States and Canada by a factor of 1.2 to 2.5.¹ Parallel trade or trade by independent firms taking advantage of such differentials represented a serious threat to pharmaceutical suppliers, especially in Europe. Also, the rise of generics, unbranded drugs of comparable efficacy in treating the disease but available at a fraction of the cost of the branded drugs, were challenging the pricing power of the pharmaceutical companies. Manufacturers of generic drugs had no expense for drug research and development of new compounds and only had limited budgets for popularizing the compound with the medical community. The generic companies made their money by copying what other pharmaceutical companies discovered, developed and created a market for. Health management organizations (HMOs) were growing and consolidating their drug purchases. In the United States, the administration under President Clinton, which took office in 1992, investigated the possibility of a comprehensive health plan, which, among other things, would have allowed an increased use of generics and laid down some form of regulatory pressure on pharmaceutical profits.

Company	Origin	1992 Sales*	Company	Origin	2001 Sales**
Glaxo	US	8,704	Pfizer	USA	25,500
Merck	UK	8,214	GlaxoSmithKline	UK	24,800
Bristol-Myers Squibb	US	6,313	Merck & Co	USA	21,350
Hoechst	GER	6,042	AstraZeneca	UK	16,480
Ciba-Geigy	SWI	5,192	Bristol-Myers Squibb	USA	15,600
SmithKline Beecham	US	5,100	Aventis	FRA	15,350
Roche	SWI	4,897	Johnson & Johnson	USA	14,900
Sandoz	SWI	4,886	Novartis	SWI	14,500
Bayer	GER	4,670	Pharmacia Corp	USA	11,970
American Home	US	4,589	Eli Lilly	USA	11,540
Pfizer	US	4,558	Wyeth	USA	11,710
Eli Lilly	US	4,537	Roche	SWI	8,530
Johnson & Johnson	US	4,340	Schering-Plough	USA	8,360
Rhone Poulenc Rorer	US	4,096	Abbot Laboratories	USA	8,170
Abbot	US	4,025	Takeda	JAP	7,770
			Sanofi-Synthelabo	FRA	5,700
			Boehringer Ingelheim	GER	5,600
			Bayer	GER	5,040
			Schering AG	GER	3,900
			Akzo Nobel	NTH	3,550

Exhibit 1 World Pharmaceutical Suppliers 1992 and 2001 (US\$ millions)

*Market Share Reporter, 1993.

**Pharmaceutical Executive, May 2002.

THE INDIAN PHARMACEUTICAL INDUSTRY IN THE 1990S

Developing countries, such as India, although large by population, were characterized by low per capita gross domestic product (GDP). Typically, healthcare expenditures accounted for a very small share of GDP, and health insurance was not commonly available. The 1990 figures for per

capita annual expenditure on drugs in India were estimated at US\$3, compared to US\$412 in Japan, US\$222 in Germany and US\$191 in the United Kingdom.² Governments and large corporations extended health coverage, including prescription drug coverage, to their workers.

In the years before and following India's independence in 1947, the country had no indigenous capability to produce pharmaceuticals, and was

dependent on imports. The Patent and Designs Act of 1911, an extension of the British colonial rule, enforced adherence to the international patent law, and gave rise to a number of multinational firms' subsidiaries in India, that wanted to import drugs from their respective countries of origin. Post-independence, the first public sector drug company, Hindustan Antibiotics Limited (HAL), was established in 1954, with the help of the World Health Organization, and Indian Drugs and Pharmaceutical Limited (IDPL) was established in 1961 with the help of the then Soviet Union.

The 1970s saw several changes that would dramatically change the intellectual property regime and give rise to the emergence of local manufacturing companies. Two such key changes were the passage of the Patents Act 1970 (effective April 1972) and the Drug Price Control Order (DPCO). The Patents Act in essence abolished the product patents for all pharmaceutical and agricultural products, and permitted process patents for five to seven years. The DPCO instituted price controls, by which a government body stipulated prices for all drugs. Subsequently, this list was revised in 1987 to 142 drugs (which accounted for 72 per cent of the turnover of the industry). Indian drug prices were estimated to be five per cent to 20 per cent of the U.S. prices and among the lowest in the world.³ The DPCO also limited profits pharmaceutical companies could earn to approximately six per cent of sales turnover. Also, the post-manufacturing expenses were limited to 100 per cent of the production costs. At the World Health Assembly in 1982 Indira Gandhi, then Prime Minister of India, aptly captured the national sentiment on the issue in an often-quoted statement:

The idea of a better-ordered world is one in which medical discoveries will be free of patents and there will be no profiteering from life and death.

With the institution of both the DPCO and the 1970 Patent Act, drugs became available more cheaply, and local firms were encouraged to make copies of drugs by developing their own processes, leading to bulk drug production. The

profitability was sharply reduced for multinational companies, many of which began opting out of the Indian market due to the disadvantages they faced from the local competition. Market share of multinational companies dropped from 80 per cent in 1970 to 35 per cent in the mid-1990s as those companies exited the market due to the lack of patent protection in India.

In November 1984, there were changes in the government leadership following Gandhi's assassination. The dawn of the 1990s saw India initiating economic reform and embracing globalization. Under the leadership of Dr. Manmohan Singh, then finance minister, the government began the process of liberalization and moving the economy away from import substitution to an export-driven economy. Foreign direct investment was encouraged by increasing the maximum limit of foreign ownership to 51 per cent (from 40 per cent) in the drugs and pharmaceutical industry (see Exhibit 2). It was in this environment that Eli Lilly was considering getting involved.

ELI LILLY AND COMPANY

Colonel Eli Lilly founded Eli Lilly and Company in 1876. The company would become one of the largest pharmaceutical companies in the United States from the early 1940s until 1985 but it began with just \$1,400 and four employees, including Lilly's 14-year-old son. This was accomplished with a company philosophy grounded in a commitment to scientific and managerial excellence. Over the years, Eli Lilly discovered, developed, manufactured and sold a broad line of human health and agricultural products. Research and development was crucial to Lilly's long-term success.

Before 1950, most OUS (a company term for "Outside the United States") activities were export focused. Beginning in the 1950s, Lilly undertook systematic expansion of its OUS activities, setting up several affiliates overseas. In the mid-1980s, under the leadership of then chairman, Dick Wood, Lilly began a significant

	1992	1994	1996	1998	2000
Gross domestic product (GDP) at current market prices in US\$	244	323	386	414	481
Consumer price index (June 1982 = 100) in local currency, period average	77.4	90.7	108.9	132.2	149.3
Recorded official unemployment as a percentage of total labor force	9.7	9.3	9.1	9.2	9.2
Stock of foreign reserves plus gold (national valuation), end-period	8,665	23,054	23,784	29,833	48,200
"Foreign direct investment inflow (in US\$ millions)" ¹	252	974	2,525	2,633	2,319
Total exports	19,563	25,075	33,055	33,052	43,085
Total imports	23,580	26,846	37,376	42,318	49,907

Year ²	Population*
1991	846
2001	1,027

Exhibit 2 India Economy at a Glance

Source: The Economist Intelligence Unit.

1. United Nations Commission on Trade and Development
2. 1991, 2001 Census of India

*In millions.

move toward global markets. A separate division within the company, Eli Lilly International Corporation, with responsibility for worldwide marketing of all its products, took an active role in expanding the OUS operations. By 1992, Lilly's products were manufactured and distributed through 25 countries and sold in more than 130 countries. The company had emerged as a world leader in oral and injectable antibiotics and in supplying insulin and related diabetic care products. In 1992, Lilly International was headed by Sidney Taurel, an MBA from Columbia University, with work experience in South America and Europe, and Gerhard Mayr, an MBA from Stanford, with extensive experience in Europe. Mayr wanted to expand Lilly's operations in Asia, where several countries including India were opening up their markets for foreign investment. Lilly also saw opportunities to use

the world for clinical testing, which would enable it to move forward faster, as well as shape opinion with leaders in the medical field around the world; something that would help in Lilly's marketing stage.

RANBAXY LABORATORIES

Ranbaxy began in the 1960s as a family business, but with a visionary management grew rapidly to emerge as the leading domestic pharmaceutical firm in India. Under the leadership of Dr. Parvinder Singh, who held a doctoral degree from the University of Michigan, the firm evolved into a serious research-oriented firm. Singh, who joined Ranbaxy to assist his father in 1967, rose to become the joint managing director in 1977, managing director in 1982,

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and vice-chairman and managing director in 1987. Singh's visionary management, along with the operational leadership provided by Brar, who joined the firm in 1977, was instrumental in turning the family business into a global corporation. In the early 1990s, when almost the entire domestic pharmaceutical industry was opposing a tough patent regime, Ranbaxy was accepting it as given. Singh's argument was unique within the industry in India:

The global marketplace calls for a single set of rules; you cannot have one for the Indian market and the other for the export market. Tomorrow's global battles will be won by product leaders, not operationally excellent companies. Tomorrow's leaders must be visionaries, whether they belong to the family or not. Our mission at Ranbaxy is to become a research based international pharmaceutical company.⁴

By the early 1990s, Ranbaxy grew to become India's largest manufacturer of bulk drugs⁵ and generic drugs, with a domestic market share of 15 per cent (see Exhibit 3).

One of Ranbaxy's core competencies was its chemical synthesis capability, but the company had begun to outsource some bulk drugs in limited quantities. The company produced pharmaceuticals in four locations in India. The company's capital costs were typically 50 per cent to 75 per cent lower than those of comparable U.S. plants and were meant to serve foreign markets in addition to the Indian market. Foreign markets, especially those in more developed countries, often had stricter quality control requirements, and such a difference meant that the manufacturing practices required to compete in those markets appeared to be costlier from the perspective of less developed markets. Higher prices in other countries provided the impetus for Ranbaxy to pursue international

Company	1996*	Company	2000
Glaxo-Wellcome	4.97	Ranbaxy	20.00
Cipla	2.98	Cipla	12.00
Ranbaxy	2.67	Dr. Reddy's Labs	11.30
Hoechts-Roussel	2.60	Glaxo (India)	7.90
Knoll Pharmaceutical	1.76	Lupin Labs	7.80
Pfizer	1.73	Aurobindo Pharma	7.60
Alembic	1.68	Novartis	7.20
Torrent Pharma	1.60	Wockhardt Ltd.	6.80
Lupin Labs	1.56	Sun Pharma	6.70
Zydus-Cadila	1.51	Cadilla Healthcare	5.80
Ambalal Sarabhai	1.38	Nicholas Piramal	5.70
Smithkline Beecham	1.20	Aventis Pharma	5.30
Aristo Pharma	1.17	Alembic Ltd.	4.80
Parke Davis	1.15	Morepen Labs	4.70
Cadila Pharma	1.12	Torrent Pharma	4.40
E. Merck	1.11	IPCA Labs	4.20
Wockhardt	1.08	Knoll Pharma	3.70
John Wyeth	1.04	Orchid Chemicals	3.60
Alkem Laboratories	1.04	E Merck	3.50
Hindustan Ciba Geigy	1.03	Pfizer	3.40

Exhibit 3 Top 20 Pharmaceutical Companies in India by Sales, 1996 to 2000 (Rs billions)

Source: "Report on Pharmaceutical Sector in India," *Scope Magazine*, September 2001, p.14.

*1996 figures are from ORG, Bombay as reported in Lanjouw, J.O., www.oiprc.ox.ac.uk/EJWP0799.html, NBER working paper No. 6366.

markets; the company had a presence in 47 markets outside India, mainly through exports handled through an international division. Ranbaxy's R&D efforts began at the end of the 1970s; in 1979, the company still had only 12 scientists. As Ranbaxy entered the international market in the 1980s, R&D was responsible for registering its products in foreign markets, most of which was directed to process R&D; R&D expenditures ranged from two per cent to five per cent of the annual sales with future targets of seven per cent to eight per cent.

THE LILLY RANBAXY JV

Ranbaxy approached Lilly in 1992 to investigate the possibility of supplying certain active ingredients or sourcing of intermediate products to Lilly in order to provide low-cost sources of intermediate pharmaceutical ingredients. Lilly had had earlier relationships with manufacturers in India to produce human or animal insulin and then export the products to the Soviet Union using the Russia/India trade route, but those had never developed into on-the-ground relationships within the Indian market. Ranbaxy was the second largest exporter of all products in India and the second largest pharmaceutical company in India after Glaxo (a subsidiary of the U.K.-based firm).

Rajiv Gulati, at that time a general manager of business development and marketing controller at Ranbaxy, who was instrumental in developing the strategy for Ranbaxy, recalled:

In the 1980s, many multinational pharmaceutical companies had a presence in India. Lilly did not. As a result of both the sourcing of intermediate products as well as the fact that Lilly was one of the only players not yet in India, we felt that we could use Ranbaxy's knowledge of the market to get our feet on the ground in India. Ranbaxy would supply certain products to the joint venture from its own portfolio that were currently being manufactured in India and then formulate and finish some of Lilly's products locally. The joint venture would buy the active ingredients and Lilly would have Ranbaxy finish the package and allow the joint venture to sell and distribute those products.

The first meeting was held at Lilly's corporate center in Indianapolis in late 1990. Present were Ranbaxy's senior executives, Dr. Singh, vice-chairman, and D.S. Brar, chief operating officer (COO), and Lilly's senior executives including Gene Step and Richard Wood, the CEO of Lilly. Rickey Pate, a corporate attorney at Eli Lilly who was present at the meeting, recalled:

It was a very smooth meeting. We had a lot in common. We both believed in high ethical standards, in technology and innovation, as well as in the future of patented products in India. Ranbaxy executives emphasized their desire to be a responsible corporate citizen and expressed their concerns for their employees. It was quite obvious Ranbaxy would be a compatible partner in India.

Lilly decided to form the joint venture in India to focus on marketing of Lilly's drugs there, and a formal JV agreement was signed in November 1992. The newly created JV was to have an authorized capital of Rs200 million (equivalent of US\$7.1 million), and an initial subscribed equity capital of Rs84 million (US\$3 million), with equal contribution from Lilly and Ranbaxy, leading to an equity ownership of 50 per cent each. The board of directors for the JV would comprise six directors, three from each company. A management committee was also created comprising two directors, one from each company, and Lilly retained the right to appoint the CEO who would be responsible for the day-to-day operations. The agreement also provided for transfer of shares, in the event any one of the partners desired to dispose some or its entire share in the company.

In the mid-1990s, Lilly was investigating the possibility of extending its operations to include generics. Following the launch of the Indian JV, Lilly and Ranbaxy, entered into two other agreements related to generics, one in India to focus on manufacturing generics, and the other in the United States to focus on the marketing of generics. However, within less than a year, Lilly made a strategic decision not to enter the generics market and the two parties agreed to terminate the JV agreements related to the generics. Mayr recalled:

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At that time we were looking at the Indian market although we did not have any particular time frame for entry. We particularly liked Ranbaxy, as we saw an alignment of the broad values. Dr. Singh had a clear vision of leading Ranbaxy to become an innovation driven company. And we liked what we saw in them. Of course, for a time we were looking at the generic business and wondering if this was something we should be engaged in. Other companies had separate division for generics and we were evaluating such an idea. However, we had a pilot program in Holland and that taught us what it took to be competitive in generics and decided that business wasn't for us, and so we decided to get out of generics.

The Start-up

By March 1993, Andrew Mascarenhas, an American citizen of Indian origin, who at the time was the general manager for Lilly's Caribbean basin, based in San Juan, Puerto Rico, was selected to become the managing director of the joint venture. Rajiv Gulati, who at the time spearheaded the business development and marketing efforts at Ranbaxy, was chosen as the director of marketing and sales at the JV. Mascarenhas recalled:

Lilly saw the joint venture as an investment the company needed to make. At the time India was a country of 800 million people: 200 million to 300 million of them were considered to be within the country's middle class that represented the future of India. The concept of globalization was just taking hold at Lilly. India, along with China and Russia were seen as markets where Lilly needed to build a greater presence. Some resistance was met due to the recognition that a lot of Lilly's products were already being sold by Indian manufacturers due to the lack of patent protection and intellectual property rights so the question was what products should we put in there that could be competitive. The products that were already being manufactured had sufficient capacity; so it was an issue of trying to leverage the markets in which those products were sold into.

Lilly was a name that most physicians in India did not recognize despite its leadership position in the United States, it did not have any recognition in India. Ranbaxy was the leader within India. When

I was informed that the name of the joint venture was to be Lilly Ranbaxy, first thing I did was to make sure that the name of the joint venture was Eli Lilly Ranbaxy and not just Lilly Ranbaxy. The reason for this was based on my earlier experience in India, where "good quality" rightly or wrongly, was associated with foreign imported goods. Eli Lilly Ranbaxy sounded foreign enough!

Early on, Mascarenhas and Gulati worked getting the venture up and running with office space and an employee base. Mascarenhas recalled:

I got a small space within Ranbaxy's set-up. We had two tables, one for Rajiv and the other for me. We had to start from that infrastructure and move towards building up the organization from scratch. Rajiv was great to work with and we both were able to see eye-to-eye on most issues. Dr. Singh was a strong supporter and the whole of Ranbaxy senior management tried to assist us whenever we asked for help.

The duo immediately hired a financial analyst, and the team grew from there. Early on, they hired a medical director, a sales manager and a human resources manager. The initial team was a good one, but there was enormous pressure and the group worked seven days a week. Ranbaxy's help was used for getting government approvals, licenses, distribution and supplies. Recalled Gulati:

We used Ranbaxy's name for everything. We were new and it was very difficult for us. We used their distribution network as we did not have one and Lilly did not want to invest heavily in setting up a distribution network. We paid Ranbaxy for the service. Ranbaxy was very helpful.

By the end of 1993, the venture moved to an independent place, began launching products and employed more than 200 people. Within another year, Mascarenhas had hired a significant sales force and had recruited medical doctors and financial people for the regulatory group with assistance from Lilly's Geneva office. Mascarenhas recalled:

Our recruiting theme was ‘Opportunity of a Lifetime’ i.e., joining a new company, and to be part of its very foundation. Many who joined us, especially at senior level, were experienced executives. By entering this new and untested company, they were really taking a huge risk with their careers and the lives of their families.

However, the employee turnover in the Indian pharmaceutical industry was very high. Sandeep Gupta, director of marketing recalled:

Our biggest problem was our high turnover rate. A sales job in the pharmaceutical industry was not the most sought-after position. Any university graduate could be employed. The pharmaceutical industry in India is very unionized. Ranbaxy’s HR practices were designed to work with unionized employees. From the very beginning, we did not want our recruits to join unions. Instead, we chose to show recruits that they had a career in ELR. When they joined us as sales graduates they did not just remain at that level. We took a conscious decision to promote from within the company. The venture began investing in training and used Lilly’s training programs. The programs were customized for Indian conditions, but retained Lilly’s values (see Exhibit 4).

Within a year, the venture team began gaining the trust and respect of doctors, due to the strong values adhered to by Lilly. Mascarenhas described how the venture fought the Indian stigma:

Lilly has a code of ethical conduct called the Red Book, and the company did not want to go down the path where it might be associated with unethical behavior. But Lilly felt Ranbaxy knew how to do things the right way and that they respected their employees, which was a very important attribute. So following Lilly’s Red Book values, the group told doctors the truth; both the positive and negative aspects of their drugs. If a salesperson didn’t know the answer to something, they didn’t lie or make up something; they told the doctor they didn’t know. No bribes were given or taken, and it was found that honesty and integrity could actually be a competitive advantage. Sales people were trained to offer product information to doctors. The group gradually became distinguished by this “strange” behavior.

Recalled Sudhanshu Kamat, controller of finance at ELR:

Lilly from the start treated us as its employees, like all its other affiliates worldwide. We followed the same systems and processes that any Lilly affiliate would worldwide.

Much of the success of the joint venture is attributed to the strong and cohesive working relationship of Mascarenhas and Gulati. Mascarenhas recalled:

We both wanted the venture to be successful. We both had our identities to the JV, and there was no Ranbaxy versus Lilly politics. From the very start when we had our office at Ranbaxy premises, I was invited to dine with their senior management. Even after moving to our own office, I continued the practice of having lunch at Ranbaxy HQ on a weekly basis. I think it helped a lot to be accessible at all times and to build on the personal relationship.

The two companies had very different business focuses. Ranbaxy was a company driven by the generics business. Lilly, on the other hand, was driven by innovation and discovery.

Mascarenhas focused his effort on communicating Eli Lilly’s values to the new joint venture:

I spent a lot of time communicating Lilly’s values to newly hired employees. In the early days, I interviewed our senior applicants personally. I was present in the two-day training sessions that we offered for the new employees, where I shared the values of the company. That was a critical task for me to make sure that the right foundations were laid down for growth.

The first products that came out of the joint venture were human insulin from Lilly and several Ranbaxy products; but the team faced constant challenges in dealing with government regulations on the one hand and financing the affiliate on the other. There were also cash flow constraints.

The ministry of health provided limitations on Lilly’s pricing, and even with the margin the Indian government allowed, most of it went to the wholesalers and the pharmacies, pursuant to formulas in the Indian ministry of health. Once those were factored out of the gross margin, achieving profitability was a real challenge, as some of the biggest obstacles faced were duties imposed by the Indian government on imports

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PEOPLE

"The people who make up this company are its most valuable assets"

- Respect for the individual
 - Courtesy and politeness at all times
 - Sensitivity to other people's views
 - Respect for ALL people regardless of case, religion, sex or age
- Careers NOT jobs
 - Emphasis on individual's growth, personal and professional
 - Broaden experience via cross-functional moves

"The first responsibility of our supervisors is **to build men, then medicines**"

ATTITUDE

"There is very little difference between people. But that difference makes a BIG difference. The little difference is attitude. The BIG difference is . . . Whether it is POSITIVE or NEGATIVE"

"Are we part of the PROBLEM or part of the SOLUTION?"

TEAM

"None of us is as smart as all of us"

INTEGRITY

- Integrity outside the company
 - a. "We should not do anything or be expected to take any action that we would be ashamed to explain to our family or close friends"
 - b. "The red-faced test"
 - c. "Integrity can be our biggest competitive advantage"
- Integrity inside the company
 - With one another: openness, honesty

EXCELLENCE

- Serving our customers

"In whatever we do, we must ask ourselves: how does this serve my customer better?"
- Continuous improvement

"Nothing is being done today that cannot be done better tomorrow"

- Become the Industry Standard

"In whatever we do, we will do it so well that we become the Industry Standard"

Exhibit 4 Values at Eli Lilly Ranbaxy Limited

and other regulatory issues. Considering the weak intellectual property rights regime, Lilly did not want to launch some of its products, such as its top-seller, Prozac.⁶ Gulati recalled:

We focused only on those therapeutic areas where Lilly had a niche. We did not adopt a localization

strategy such as the ones adopted by Pfizer and Glaxo⁷ that manufactured locally and sold at local prices. India is a high-volume, low price, low profit market, but it was a conscious decision by us to operate the way we did. We wanted to be in the global price band. So, we did not launch several patented products because generics were selling at 1/60th the price.

Product and marketing strategies had to be adopted to suit the market conditions. ELR's strategy evolved over the years to focus on two groups of products: one was off-patent drugs, where Lilly could add substantial value (e.g. Ceclor), and two, patented drugs, where there existed a significant barrier to entry (e.g. Reopro and Gemzar). ELR marketed Ceclor, a Ranbaxy manufactured product, but attempted to add significant value by providing medical information to the physicians and other unique marketing activities. By the end of 1996, the venture had reached the break-even and was becoming profitable.

The Mid-Term Organizational Changes

Mascarenhas was promoted in 1996 to managing director of Eli Lilly Italy, and Chris Shaw, a British national, who was then managing the operations in Taiwan, was assigned to the JV as the new managing director. Also, Gulati, who was formally a Ranbaxy employee, decided to join Eli Lilly as its employee, and was assigned to Lilly's corporate office in Indianapolis in the Business Development—Infectious Diseases therapeutic division. Chris Shaw recalled:

When I went to India as a British national, I was not sure what sort of reception I would get, knowing its history. But my family and I were received very warmly. I found a dynamic team with a strong sense of values.

Shaw focused on building systems and processes to bring stability to the fast-growing organization; his own expertise in operations made a significant contribution during this phase. He hired a senior level manager and created a team to develop standard operating procedures (SOPs) for ensuring smooth operations. The product line also expanded. The JV continued to maintain a 50-50 distribution of products from Lilly and Ranbaxy, although there was no stipulation to maintain such a ratio. The clinical organization in India was received top-ratings in internal audits by Lilly, making it suitable for a wider range of clinical trials. Shaw also streamlined the sales and marketing activities around therapeutic areas to emphasize and enrich the

knowledge capabilities of the company's sales force. Seeing the rapid change in the environment in India, ELR, with the support of Mayr, hired the management-consulting firm, McKinsey, to recommend growth options in India. ELR continued its steady performance with an annualized growth rate of about eight per cent during the late 1990s.

In 1999, Chris Shaw was assigned to Eli Lilly's Polish subsidiary, and Gulati returned to the ELR as its managing director, following his three-year tenure at Lilly's U.S. operations. Recalled Gulati:

When I joined as MD in 1999, we were growing at eight per cent and had not added any new employees. I hired 150 people over the next two years and went about putting systems and processes in place. When we started in 1993 and during Andrew's time, we were like a grocery shop. Now we needed to be a company. We had to be a large durable organization and prepare ourselves to go from sales of US\$10 million to sales of US\$100 million.

ELR created a medical and regulatory unit, which handled the product approval processes with government. Das, the chief financial officer (CFO), commented:

We worked together with the government on the regulatory part. Actually, we did not take shelter under the Ranbaxy name but built a strong regulatory (medical and corporate affairs) foundation.

By early 2001, the venture was recording an excellent growth rate (see Exhibit 5), surpassing the average growth rate in the Indian pharmaceutical industry. ELR had already become the 46th largest pharmaceutical company in India out of 10,000 companies. Several of the multinational subsidiaries, which were started at the same time as ELR, had either closed down or were in serious trouble. Das summarized the achievements:

The JV did add some prestige to Ranbaxy's efforts as a global player as the Lilly name had enormous credibility while Lilly gained the toehold in India. In 10 years we did not have any cannibalization of each other's employees, quite a rare event if you compare with the other JVs. This helped us build a unique culture in India.

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	1998-1999	1999-2000	2000-2001
Sales	559,766	632,188	876,266
Marketing Expenses	37,302	61,366	96,854
Other Expenses	157,907	180,364	254,822
Profit after Tax	5,898	12,301	11,999
Current Assets	272,635	353,077	466,738
Current Liabilities	239,664	297,140	471,635
Total Assets	303,254	386,832	516,241
No. of Employees	358	419	460
Exchange Rate (Rupees/US\$)	42.6	43.5	46.8

Exhibit 5 Eli Lilly-Ranbaxy India Financials 1998 to 2001 (Rs'000s)

Source: Company Reports.

Note: Financial year runs from April 1 to March 31.

THE NEW WORLD, 2001

The pharmaceutical industry continued to grow through the 1990s. In 2001, worldwide retail sales were expected to increase 10 per cent to about US\$350 billion. The United States was expected to remain the largest and fastest growing country among the world's major drug markets over the next three years. There was a consolidation trend in the industry with ongoing mergers and acquisitions reshaping the industry. In 1990, the world's top 10 players accounted for just 28 per cent of the market, while in 2000, the number had risen to 45 per cent and continued to grow. There was also a trend among leading global pharmaceutical companies to get back to basics and concentrate on core high-margined prescription preparations and divest non-core businesses. In addition, the partnerships between pharmaceutical and biotechnology companies were growing rapidly. There were a number of challenges, such as escalating R&D costs, lengthening development and approval times for new products, growing competition from generics and follow-on products, and rising cost-containment pressures, particularly with the growing clout of managed care organizations.

By 1995, Lilly had moved up to become the 12th leading pharmaceutical supplier in the world, sixth in the U.S. market, 17th in Europe and 77th in Japan. Much of Lilly's sales success through the mid-1990s came from its antidepressant drug, Prozac. But with the wonder drug due to go off patent in 2001, Lilly was aggressively working on a number of high-potential products. By the beginning of 2001, Lilly was doing business in 151 countries, with its international sales playing a significant role in the company's success (see Exhibits 6 and 7). Dr. Lorenzo Tallarigo recalled:

When I started as the president of the inter-continental operations, I realized that the world was very different in the 2000s from the world of 1990s. Particularly there were phenomenal changes in the markets in India and China. While I firmly believed that the partnership we had with Ranbaxy was really an excellent one, the fact that we were facing such a different market in the 21st century was reason enough to carefully evaluate our strategies in these markets.

Ranbaxy, too, had witnessed changes through the 1990s. Dr. Singh became the new CEO in 1993 and formulated a new mission for

	1992	1994	1996	1998	2000
Net sales	4,963	5,711	6,998	9,236	10,862
Foreign sales	2,207	2,710	3,587	3,401	3,858
Research and development expenses	731	839	1,190	1,739	2,019
Income from continuing operations before taxes and extraordinary items	1,194	1,699	2,131	2,665	3,859
Net income	709	1,286	1,524	2,097	3,058
Dividends per share*	1.128	1.260	0.694	0.830	1.060
Current assets	3,006	3,962	3,891	5,407	7,943
Current liabilities	2,399	5,670	4,222	4,607	4,961
Property and equipment	4,072	4,412	4,307	4,096	4,177
Total assets	8,673	14,507	14,307	12,596	14,691
Long-term debt	582	2,126	2,517	2,186	2,634
Shareholder equity	4,892	5,356	6,100	4,430	6,047
Number of employees*	24,500	24,900	27,400	29,800	35,700

Exhibit 6 Lilly Financials, 1992 to 2000 (US\$ millions)

Source: Company files.

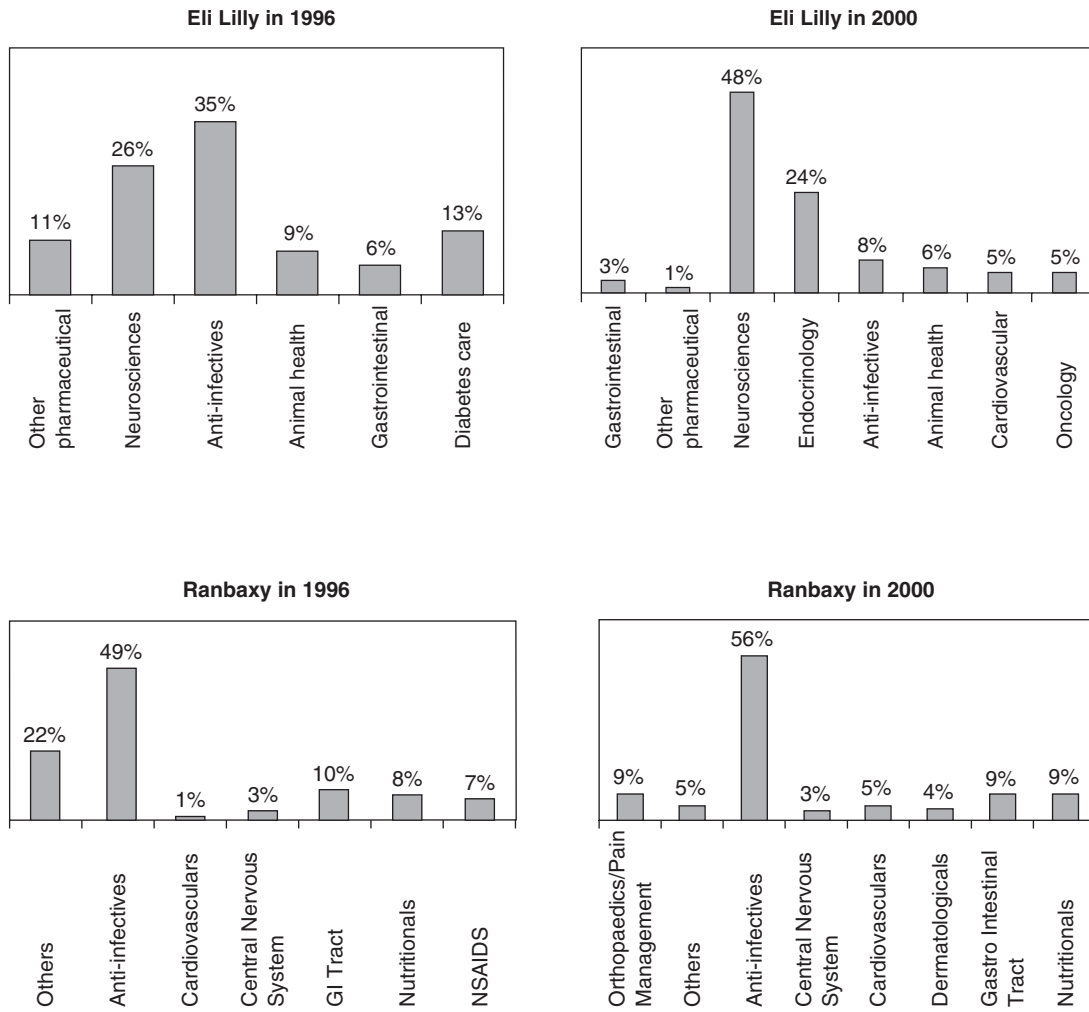
*Actual value

the company: to become a research-based international pharmaceutical company with \$1 billion in sales by 2003. This vision saw Ranbaxy developing new drugs through basic research, earmarking 20 per cent of the R&D budget for such work. In addition to its joint venture with Lilly, Ranbaxy made three other manufacturing/marketing investments in developed markets: a joint venture with Genpharm in Canada (\$1.1 million), and the acquisitions of Ohm Labs in the United States (\$13.5 million) and Rima Pharmaceuticals (\$8 million) in Ireland. With these deals, Ranbaxy had manufacturing facilities around the globe. While China and Russia were expected to remain key foreign markets, Ranbaxy was looking at the United States and the United Kingdom as its core international markets for the future. In 1999, Dr. Singh handed over the reins of the company to Brar, and later the same year, Ranbaxy lost this visionary leader due to an untimely death. Brar continued Singh's vision to keep Ranbaxy in a leadership position.

However, the vast network of international sales that Ranbaxy had developed created a large financial burden, depressing the company's 2000 results, and was expected to significantly affect its cash flow in 2001 (see Exhibit 8). Vinay Kaul, vice-chairman of Ranbaxy in 2001 and chairman of the board of ELR since 2000, noted:

We have come a long way from where we started. Our role in the present JV is very limited. We had a smooth relationship and we have been of significant help to Lilly to establish a foothold in the market here in India. Also, we have opened up a number of opportunities for them to expand their network. However, we have also grown, and we are a global company with presence in a number of international markets including the United States. We had to really think if this JV is central to our operations, given that we have closed down the other two JV agreements that we had with Lilly on the generics manufacturing. It is common knowledge that whether we continue as a JV or not, we have created a substantial value for Lilly.

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**Exhibit 7** Product Segment Information, Lilly and Ranbaxy, 1996 and 2000

There were also significant changes in the Indian business environment. India signed the General Agreement on Tariffs and Trade (GATT) in April 1994 and became a World Trade Organization (WTO) member in 1995. As per the WTO, from the year 2005, India would grant product patent recognition to all new chemical entities (NCEs), i.e., bulk drugs developed then onward. Also, the Indian government had made

the decision to allow 100 per cent foreign direct investment into the drugs and pharmaceutical industry in 2001.⁸ The Indian pharmaceutical market had grown at an average of 15 per cent through the 1990s, but the trends indicated a slowdown in growth, partly due to intense price competition, a shift toward chronic therapies and the entry of large players into the generic market. India was seeing its own internal consolidation

	1992-93	1994-95	1996-97	1998*	2000
Sales	4,607	7,122	11,482	10,641	17,459
Foreign sales	1,408	3,019	5,224	4,414	8,112
Profit before tax	358	1,304	1,869	1,240	1,945
Profit after tax	353	1,104	1,604	1,170	1,824
Equity dividend	66.50	199.80	379.10	560.10	869.20
Earnings per share (Rs)	16.21	25.59	32.47	13.46	15.74
Net current assets	1,737	5,790	9,335	8,321	8,258
Share capital	217.90	430.50	494.00	1,159.00	1,159.00
Reserves and surplus	1,028	6,000	11,056	12,849	16,448
Book value per share (Rs)	57.16	149.08	233.70	120.90	136.60
No. of employees	4,575	4,703	6,131	5,469	5,784
Exchange rate (US\$1 = Rs)	29.00	31.40	35.90	42.60	46.80

Exhibit 8 Ranbaxy Financials 1992 to 2000 (Rs Millions)

Source: Company files.

*The financial year for Ranbaxy changed from April 1 to March 31 to calendar year in 1998. Also, the company issued a 1:2 bonus issue (see the changes in share capital and book value per share). The 1998 figures are based on nine months April to December 1998.

of major companies that were trying to bring in synergies through economies of scale. The industry would see more mergers and alliances. And with India's entry into the WTO and its agreement to begin patent protection in 2004-2005, competition on existing and new products was expected to intensify. Government guidelines were expected to include rationalization of price controls and the encouragement of more research and development. Recalled Gulati:

The change of institutional environment brought a great promise for Lilly. India was emerging into a market that had patent protection and with tremendous potential for adding value in the clinical trials, an important component in the pharmaceutical industry. In Ranbaxy, we had a partner with whom we could work very well, and one which greatly respected Lilly. However, there were considerable signals from both sides, which were forcing us to evaluate the strategy.

Dr. Vinod Mattoo, medical director of ELR commented:

We have been able to achieve penetration in key therapeutic areas of diabetes and oncology. We have created a high caliber, and non-unionized sales force with world-class sales processes. We have medical infrastructure and expertise to run clinical trials to international standards. We have been able to provide clinical trial data to support global registrations, and an organization in place to maximize returns post-2005.

EVALUATING STRATEGIC OPTIONS

Considering these several developments, Tallarigo suggested a joint task force comprising senior executives from both companies:

Soon after assuming this role, I visited India in early 2000, and had the pleasure of meeting Dr. Brar and the senior executives. It was clear to me that both Brar and I were in agreement that we needed to think carefully how we approached the future. It was there that I suggested that we create a joint task force to come up with some options that would help us make a final decision.

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A task force was set up with two senior executives from Lilly's Asia-Pacific regional office (based in Singapore) and two senior executives from Ranbaxy. The task force did not include senior executives of the ELR so as to not distract the running of the day-to-day operations. Suman Das, the chief financial officer of ELR, was assigned to support the task force with the needed financial data. The task force developed several scenarios and presented different options for the board to consider.

There were rumors within the industry that Ranbaxy expected to divest the JV, and invest the cash in its growing portfolio of generics manufacturing business in international markets. There were also several other Indian companies that offered to buy Ranbaxy's stake in the JV. With India recognizing patent protection in 2005, several Indian pharmaceutical companies were keen to align with multinationals to ensure a pipeline of drugs. Although there were no formal offers from Ranbaxy, the company was expected to price its stakes as high as US\$70 million. One of the industry observers in India commented:

I think it is fair for Ranbaxy to expect a reasonable return for its investment in the JV, not only the initial capital, but also so much of its intangibles in the JV. Ranbaxy's stock has grown significantly. Given the critical losses that Ranbaxy has had in some of its investments abroad, the revenue from this sale may be a significant boost for Ranbaxy's cash flow this year.

Gerhard Mayr, who in 2001 was the executive vice-president and was responsible for Lilly's demand realization around the world, continued to emphasize the emerging markets in India, China and Eastern Europe. Mayr commented on Ranbaxy:

India is an important market for us and especially after patent protection in 2005. Ranbaxy was a wonderful partner and our relationship with them was outstanding. The other two joint ventures we initiated with them in the generics did not make sense to us once we decided to get out of the generics business. We see India as a good market for Lilly. If a partner is what it takes to succeed, we should go with a partner. If it does not, we should have the flexibility to reconsider.

Tallarigo hoped that Brar would be able to provide a clear direction as to the venture's future. As he prepared for the meeting, he knew the decision was not an easy one, although he felt confident that the JV was in a good shape. While the new regulations allowed Lilly to operate as a wholly owned subsidiary in India, the partnership has been a very positive element in its strategy. Ranbaxy provided manufacturing and logistics support to the JV, and breaking up the partnership would require a significant amount of renegotiations. Also, it was not clear what the financial implications of such a move would be. Although Ranbaxy seemed to favor a sell-out, Tallarigo thought the price expectations might be beyond what Lilly was ready to accept. This meeting with Brar should provide clarity on all these issues.

NOTES

1. Estimates of industry average wholesale price levels in Europe (with Spanish levels indexed at 100 in 1989) were: Spain 100; Portugal 107; France 113; Italy 118; Belgium 131; United Kingdom 201; The Netherlands 229; West Germany 251. Source: T. Malnight, *Globalization of an Ethnocentric Firm: An Evolutionary Perspective*, Strategic Management Journal, 1995, Vol. 16 p.128.

2. Organization of Pharmaceutical Producers of India Report.

3. According to a study from Yale University, Ranitidine (300 tabs/10 pack) was priced at Rs18.53, whereas the U.S. price was 57 times more, and Ciprofloxacin (500 mg/4 pack) was at Rs28.40 in India, whereas the U.S. price was about 15 times more.

4. Quoted in *Times of India*, June 9, 1999.

5. A bulk drug is an intermediate product that goes into manufacturing of pharmaceutical products.

6. Used as an antidepressant medication.

7. An industry study by McKinsey found that Glaxo sold 50 per cent of its volume, received three per cent of revenues and one per cent of profit in India.

8. In order to regulate the parallel activities of a foreign company, which had an ongoing joint venture in India, the regulations stipulated that the foreign partner must get a "No objection letter" from its Indian partner, before setting up a wholly owned subsidiary.