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The formation and evolution of non-equity strategic alliances in China

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Abstract Contractual joint ventures (CJVs) are a major form of non-equity strategic alliance in China, employed mainly by Hong Kong firms in the south China province of Guangdong. Due to their ambiguous legal status and the lack of conceptualisation and of their contractual nature, there has been little empirical research on CJVs. By theorising CJVs as a relational subcontracting arrangement and drawing on data from structured interviews with managers from both sides, this paper reveals the managerial decisions pertaining to the formation and evolution of the CJV non-equity alliances in Guangdong.

Keywords China · Contractual joint ventures · Non-equity alliance formation · Non-equity alliance evolution

Strategic alliances comprise both equity and non-equity collaborative arrangements between firms where pooled or complementary resources are leveraged for competitive advantage (Arino, 2003). Compared to equity alliances, the formation of non-equity alliances are under-researched (Narula & Dunning, 1998). Further, relatively little attention has been paid to the evolution of non-equity alliances (Ireland, Hitt, & Vaidyanath, 2002; Kumar & Nti, 1998; Reuer & Arino, 2002). This paper takes up these challenges to study the formation and evolution of an important but neglected type of non-equity alliance in China, namely contractual joint ventures (CJVs).

Contractual joint ventures, also called cooperative joint ventures, are a major form of non-equity strategic alliance during China's reform era. In CJVs, the Chinese and foreign firms work together in a separate organization on a wide range of projects, which are often

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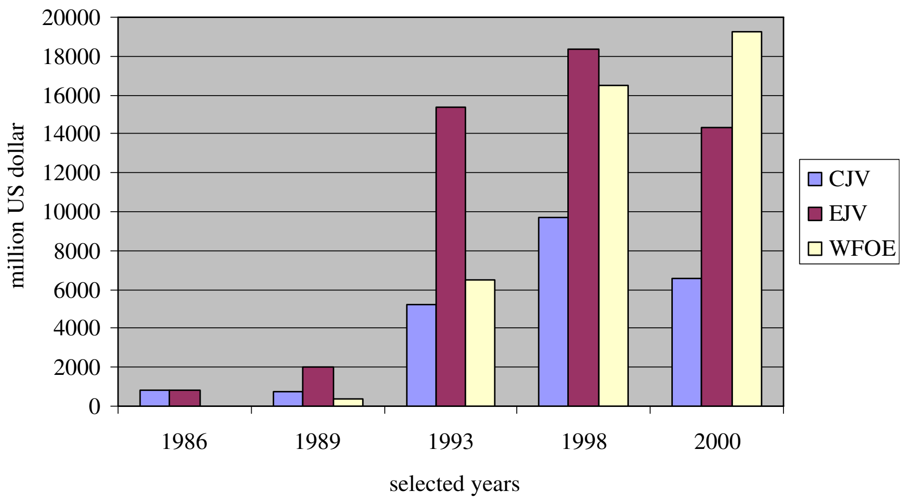
vaguely specified in the formal contract and involve no equity stake (Casson & Zheng, 1992). Among the three major forms of foreign direct investment (FDI) prescribed by Chinese government, CJVs generated more realized value than equity joint ventures (EJVs) and wholly foreign owned enterprises (WFOEs) until the mid 1980s. Since the late 1980s, Figures 1 and 2 show CJVs' importance have declined relative to EJVs and WFOEs at the national level. But in the south China province of Guangdong bordering Hong Kong, CJVs remained more important than EJVs throughout the 1990s and accounted for about one third of the province's realized FDI in 2000, compared with 16% for China. CJVs were mainly formed by small-to-medium sized Hong Kong manufacturing firms and township and village enterprises (TVEs) in Guangdong. Formerly known as 'commune and brigade enterprises,' TVEs are individual or joint-capital rural enterprises overseen by local governments to achieve industrialisation in China's rural areas (Flynn & Xu, 2001). The CJV's geographic concentration in Guangdong built on the strong cultural, kinship and family ties that Guangdong TVEs have with small Hong Kong manufacturing firms (Wang & Nicholas, 2005).

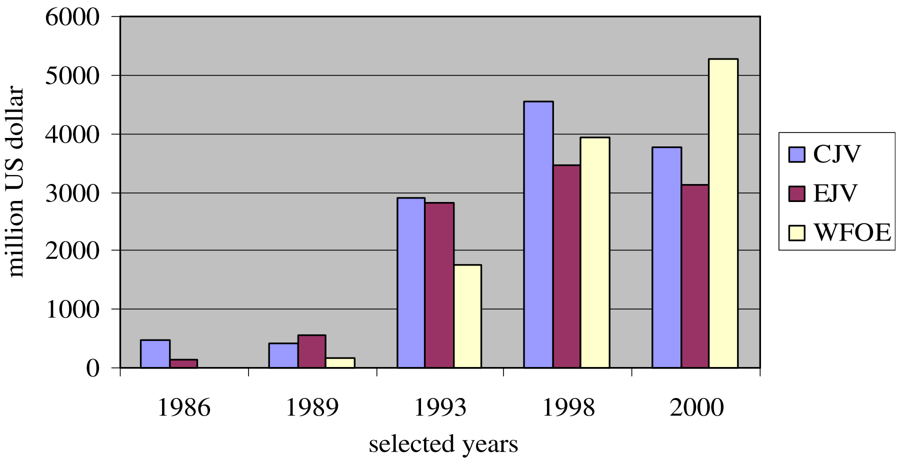
Compared with EJVs and WFOEs, CJVs have been largely ignored by the central government, partly because most CJVs were engaged in low-tech labour intensive consumer goods industries and not conducive to the import of advanced technologies. While the Law on EJVs was passed in 1979 and the Law on WFOEs was passed in 1986, the Law on CJVs was passed only in 1988, almost 10 years after China initiated its economic reform. Despite some improvement, the CJV Law remains vague on critical issues such as the limited liability status.

Given an ambiguous legal status and unspecified theoretical basis, little previous empirical research has focused on Sino-foreign CJVs (Pan & Tse, 1996; Pan & Chi, 1999). Theorising CJVs as a type of non-equity alliance between Hong Kong and Guangdong firms, and using data from structured interviews and case studies, the



Source: State Statistics Bureau (1985-2001)

Figure 1 FDI in China by investment forms: realised value



Source: Guangdong Statistics Bureau (1985-2001)

Figure 2 FDI in Guangdong by investment forms: realised value

paper addresses two research questions: (1) What motivated the formation of CJV non-equity alliances? (2) How did CJV non-equity alliances evolve over time?

Theoretical and conceptual underpinnings: CJV alliance formation and evolution

The contractual nature of CJVs in China

Chinese official terminology of CJVs deviates from global norms and often confuses researchers. A JV is, by definition, equity-based (Hennart, 1988); CJVs are not. Rather than based on each partner's equity investment, the terms and conditions regarding each CJV partners' contribution, profit distribution and management control are negotiated between the partners (De Keijzer, 1992). Unlike conventional JVs or WFOEs, CJVs may or may not have an independent legal status separate from their parent firms (Pomfret, 1991). In contrast to hierarchical approaches that bypass the incompleteness of market contracts (Hennart, 1988; Macneil, 1974), CJVs incorporate the openness and flexibility of alliance contracts, allowing terms and conditions to be continuously negotiated between partners, but without being unified under common ownership. In Williamson's (1979, 1985) terminology, JVs and WFOE are relational contracts with unified governance structures while CJVs are relational contracts with bi-lateral governance.

CJVs' bi-lateral governance structures are quasi-hierarchical non-equity alliances, with the creation of a joint operation that has its own board of directors or so-called 'management committee.' Recently, Inkpen (2000) differentiated between two types of non-equity alliances: one form in which there is no separate organization and the alliance boundaries are very loose; the other with a clear alliance organization and a discrete task structure. Fitting Inkpen's latter type of non-equity partnership, CJVs typically had the chair of the management committee concurrently serving both as the general manager of the CJV and the chair and general manager of the Hong Kong parent company. The deputy chair was normally the head of a local TVE. Other senior managerial positions, such as sales and financial managers, were also held by Hong Kong expatriates. Guangdong parents usually appointed the plant manager and several junior level managers to cooperate with the Hong Kong managers (Wang & Nicholas, 2005). Such a quasi-hierarchical organizational structure allowed Hong Kong parents to exercise control similar to that in hierarchical WFOEs or EJVs, but without incurring substantial equity investment (Thoburn, Leung, Chau, & Tang, 1990).

CJV non-equity alliances were also different from processing & assembling contracts (P&As), a popular form of arm's-length subcontracting arrangement between Hong Kong small manufacturing firms and Chinese suppliers in Guangdong. It is distinguished in Chinese statistics from FDI as 'other foreign investment.' In P&As, foreign companies played a central role in both the procurement of raw material and the overseas sale of products, with P&A factories focusing on vertically shallow and 'single-phase' functions, such as single component assembly (Fung, 1997). The Chinese manager retains legal control of the manufacturing operation and the Hong Kong party pays a processing fee. In contrast, CJV non-equity alliances require closer collaboration between Hong Kong and Guangdong managers on higher value-added subcontracting activities, sharing the control of the operation. Both sides commit to on-going exchange, construct a more complex internal architecture and invest in machines and specific assets (Wang, 2002). Table 1 outlines the main contractual differences between CJVs and alternative investment forms available for foreign investors, including P&As, EJVs and WFOEs.

Table 1 Major foreign investment forms in China: contract attributes and theoretical nature.

Chinese official terminology	Contract attributes	Theoretical nature
Processing and assembling contracts (P&As)	Contracting arrangements between foreign companies and manufacturing entities in China, where foreign companies contract all or part of their production processes to the Chinese firms	arm's-length contracts
Contractual joint ventures (CJVs)	Foreign companies work together with Chinese firms on a range of projects sharing the management and control which are negotiated between the partners but not based on their respective equity investment; may not create a separate legal entity independent from parent firms	Non-equity alliances; relational contracting with bi-lateral governance
Equity joint ventures (EJVs)	A limited liability company with equity capital and management control shared by the foreign and Chinese partners. The Chinese and foreign partners share the profits and losses proportionally according to their equity contribution.	Equity-based alliances; relational contracting with unified governance
Wholly foreign owned enterprises (WFOEs)	An enterprise established by a foreign company that uses its own capital and assumes sole responsibility for the venture risks, gains and losses	Vertical integration; relational contracting with unified governance

The formation of CJV non-equity alliances

Transaction cost-contracting approaches are fundamentally about organising inde-pendencies between firms (Hennart, 2006), a perspective enriched and extended by resource-based theory (Barney, 1991; Grant, 1991; Peteraf, 1993). These inter-dependencies arise through the need of each party to negotiate the terms and conditions for cooperation and from the transfer of resources, especially knowledge, between the parties. CJV non-equity alliances share common theoretical ground with the reasons JVs are formed (Hennart, 1988). JVs use common ownership and profit distribution, related to equity share, as an incentive for non-opportunistic collaboration and to facilitate the transfer of resources between partners. CJV non-equity alliances replicate many of these JV attributes, but rely on more flexible contracting arrangements. For example, the distribution of profit is negotiated and renegotiated between the partners rather than based on the partners' equity investment. This flexibility in negotiating profit was also reflected in CJV non-equity alliances' quasi-hierarchical arrangements for complex decision-making and control. In addition, there are no limits on the duration of the contract or prohibitions for withdrawal of registered capital during the contractual term. Therefore, the transaction costs of entering and exiting the partnership are attenuated, particularly for small to medium Hong Kong subcontractors (Wang, 2002). CJVs can be established quickly to take advantage of short-term business opportunities and dissolved when they complete their assigned task (Luo, 1998). In comparison, EJVs lack strategic flexibility (Harrigan, 1985). With requirements of minimum investment and restrictions on the withdrawal of registered capital, EJV partnerships are more difficult to establish and terminate. Thus we suggest:

Proposition 1 Hong Kong and Chinese managers form CJV non-equity alliances to economise on transaction costs related to entering, negotiating and exiting CJV contracts

Recently there has been increasing studies on alliance formation using resource-based theory (Contractor & Ra, 2002; Das & Teng, 1998, 2000; Eisenhardt & Schoonhoven, 1996). From a resource-based view, alliances are essentially the outcome of resource integration among firms which allow access to each other's valuable resources (Das & Teng, 2000). Alliances are a mechanism through which knowledge, competence or technologies are transferred while working with partners, and particularly suitable for the transfer of tacit knowledge (Jolly, 2005). To transfer resources, including knowledge, JVs structure formal dispute settling and monitoring mechanisms. Using quasi-hierarchical contracts to incentivise and monitor partners, CJV non-equity alliances encourage knowledge transfer, but are less costly to form and maintain than JVs (Hennart, 2006). Foreign firms entering China need to access location-bound resources such as distribution channels, supply networks and local bureaucratic ties. On the other hand, Chinese firms need foreign partners to bring their advanced technologies and management skills into the country. The interdependencies in pooled tangible and intangible resources between foreign and Chinese firms give rise to alliances. Previous studies (Mathur & Chen, 1987; Sung, 1991) have shown that foreign firms normally contribute technology, equipment, managerial know-how, and so on, while the Chinese firms provide land, building, and labour in CJV non-equity alliances. We therefore suggest that apart from transaction costs saving rationale, access to complementary assets and resources also motivated the CJV alliance formation.

Proposition 2 Hong Kong and Chinese managers establish CJV non-equity alliances to pool their complementary resources and assets

The evolution of CJV non-equity alliances

CJV non-equity alliances are dynamic economic organizations. The first dynamic aspect involves 'transitioning' through sequential forms of economic organizations (Nicholas & Maitland, 2002; Teece, 1985). Factors impacting on such transitioning decision include the level of transaction-specific investment, uncertainty and the frequency of transacting (Williamson, 1985). For Hong Kong firms producing complex products for the high-end market and competing on product differentiation, arm's-length P&A organisations are inefficient, failing to provide mixed co-specialised assets or to transfer tacit knowledge. Transitioning to CJV non-equity alliances allow the P&A contracts to be replaced to ensure investment in mixed-specific assets, without the need to transition to either EJVs or WOFEs. By the same token, changes in asset-specificity may trigger contract renegotiation or CJV termination. CJV alliances may evolve into hierarchical EJVs or WFOEs, induced by the significant increase in the level of asset-specificity. Of course, when there was no significant increase in the level of asset-specificity, we should expect a stable CJV non-equity alliance partnership rather than transitioning to EJVs or WFOEs. Therefore we develop two alternative propositions:

Proposition 3 CJV non-equity alliances evolve into EJVs or WFOEs when there is a significant increase in the level of investments in specific assets

Proposition 4 Hong Kong and Chinese managers maintain CJV non-equity alliance partnerships when the level of investments in specific assets remains mixed

The second dynamic aspect is manifested by CJV alliances' evolutionary path, which involves gradual shift of the value chain overseas (Brookfield & Liu, 2005; Chang, 1995) rather than transitioning from one contracting form to another as predicted by the stages model (Johanson & Vahlne, 1977). The resource-based view suggests that the increase in the diversity of experience in a host country may contribute to a more extensive knowledge base (Huber, 1991) and more opportunities in a host country (March, 1991). MNEs therefore accumulate diverse experience through active participation in a broader range of business activities over time (Luo & Peng, 1999). Empirical studies on Asian MNEs show a pattern of evolution different from the stages model, focusing on capability-building through diversification and by the mode of alliance or network (Chang, 1995; Ernst, 1998; Erramilli, Srivastava, & Kim, 1999; Li, 2003). In the case of Sino-foreign CJV non-equity alliances, managers may learn to grow their firms by operating in a wider range of subcontracting activities across the value chain. Given the level of mixed asset-specificity, diversification opportunities may contribute significantly to firm growth in a dynamic environment such as China (Peng, 1997, 2000). We therefore suggest:

Proposition 5 Given mixed asset-specificity, the diversification of subcontracting activities allows the CJV non-equity alliance to evolve over time

Overall, Propositions 1 and 2 tackle the formation issue (research question one) and Propositions 3, 4 and 5 deal with the evolutionary aspects (research question two).

Survey design and sample characteristics

Data sources

In a review of 840 articles from 30 journals in management research in the Asian context, White (2002) complained about the singular reliance on quantitative and correlational analytic methods. Parkhe (1993) also criticised the bias toward large sample multivariate statistical studies misses the 'test of realism.' Qualitative data from interviews or case studies offer one advantage over quantitative data in enabling us to understand the shared meanings of managerial decision-making and draw insights that cannot be gained with 'hard' data alone (Minzberg, 1979; Numagami, 1998). They are particularly suitable for in-depth study of MNE evolution (Li, 2003). Following White's (2002) recommendation to incorporate multiple methods (including ethnographic, interpretive, process-oriented) and answering Parkhe's (1993) call for 'joint research', this paper uses both quantitative and qualitative data to investigate antecedents of CJV non-equity alliance formation and examine dynamic and endogenous processes in CJV alliance evolution. Fieldwork was conducted at 65 Hong Kong-Guangdong manufacturing CJVs in 2000, involving 73 structured interviews with 43 Hong Kong and 30 Guangdong managers and eight in-depth case studies in which both Hong Kong and Guangdong managers were interviewed. All interviews used the same questionnaire and were conducted mainly in Cantonese by the same researcher (the first author) to control the data quality.

The target firms were randomly selected using a three-stage cluster sampling method (De Vaus, 1990; Foreman, 1991), in which larger cities in Guangdong were first sampled and progressively scaled down to towns and villages where CJV non-equity alliances were most numerous for second-stage sampling. Given the larger and earlier presence of Hong Kong investment in Shenzhen and Dongguan, the municipalities closest to Hong Kong, these were divided into urban districts and rural counties in the third-stage sampling. Since most CJV non-equity alliances are located in Guangdong and concentrated in manufacturing industries (Pomfret, 1991), the sample firms reflected the general features of CJV non-equity alliances in China.

Questionnaire and measures

Considering the potential variety of reasons for entering CJV non-equity alliances, open-ended questions were used to capture the full range of possible factors in the selection of CJV non-equity alliances over internalised EJVs and quasi-market P&A contracts. Similar answers with different expressions were put in the same category for analysis. We ensured data reliability by following the same sequence of questions for all interviews (Wang, Tong, & Koh, 2004). Appendix lists key interview questions. Tables 2 and 3 summarise the most frequent answers by the managers to the reasons for forming CJV non-equity alliances.

Two variables were used to measure the transaction-specific features of CJVs: the perceived technology level and the types of actual subcontracting activities undertaken. The firms' technology level is commonly used as an indicator for asset specificity (Agarwal & Ramaswami, 1992; Erramilli & Rao, 1993; Kim & Hwang, 1992). The types of subcontracting activities are also used because the particular value-added activities that are subcontracted define the degree of asset specificity in a subcontracting arrangement (Nishiguchi, 1994). This measure also allowed us to examine the evolutionary path of CJV alliances given the asset-specificity. Tables 4, 5 and 6 summarise information on these two measures.

Given the unknown population distribution, non-parametric Wilcoxon tests were used to determine whether the CJV non-equity alliances' contractual nature and cooperative relationships changed over time as a result of changing asset-specific features, and Mann-Whitney *U* tests were used to determine when there were differences in CJV non-equity alliances behaviour and partnership character due to size, age and industry type.

Sample characteristics

Most of the sample firms has a history of over three years by 2000 when interview were conducted: twenty-five firms (39%) were established between 1994 and 1998, twenty-three firms (35%) set up 1991–1993 and another 16 (nearly 25%) 1986–1990. Measured by the number of employees, 49% were small firms with fewer than 500 employees and 20% were classified as large with more than 1,000 workers. The industry distribution of the sample reflected the strength of Hong Kong manufacturing firms in international subcontracting in low-tech labour-intensive industries. About 68% were engaged in the production of consumer goods such as textiles, clothing, footwear, toys and household electrical appliances. Another 27% were component suppliers, producing for industrial buyers a diverse array of parts and components, such as machinery parts and tools, building materials, and computer peripherals.

CJV non-equity alliances formation: results for Propositions 1 and 2

The first research question investigated the motivation of managers to form CJV non-equity alliances. The open-ended responses revealed that Hong Kong and Guangdong managers viewed the CJV non-equity alliance as a more dynamic and effective arrangement to grow their business than EJVs. Flexible contracting, which economised on the cost of negotiating, was not only the most important reason quoted by Hong Kong managers, but also for 15 Guangdong partners (see Table 2).

Most terms and conditions of CJV alliance contract can be negotiated both before the contract was signed and after the partnership was established to respond to contingencies. Items subject to negotiation and amendments included profit distribution, production rates and areas of management control. Rather than being constrained by each side's equity investment, the CJV alliance parties negotiated profit distribution based on net profit, sales or physical output. 'When the profit prospect was good, the Hong Kong managers tended to negotiate a net profit distribution method with a favourable profit share. During the early stages of the operation, they preferred returns based on the allocation of products, because the profit prospect was uncertain and financial capital was crucial for the continuous investment in the company's production facilities,' a similar statement like this was made by many Guangdong managers.

In Table 2, low exit cost was the second-most frequently cited reason Hong Kong managers preferred CJV non-equity alliances. EJVs incur high sunk capital investments, which are at risk in a quick exit. In contrast, CJV non-equity alliances allowed small-to-medium sized Hong Kong manufacturers to switch products or production locations at low cost by compensating their local counterparts with products, machinery and equipment. Guangdong managers also valued low exit costs. As stated by a CJV plant manager from Guangdong, 'a major goal of many local TVEs is to make quick money, and quick exit is attractive when the project did not meet (profit) expectations.' Although both parties highly valued low exit costs at formation, few CJV partners took advantage of this attribute, as the low costs of contract re-negotiation costs discouraged 'quick exit' opportunism.

Eleven Guangdong firms and 12 Hong Kong managers gave 'quick return on investment' as their reason for a CJV non-equity alliance. 'The 1988 CJV Law allowed foreign investors to take their return on investment before making a profit and paying income tax,' quoted from an interview with a Guangdong deputy manager, 'Hong Kong managers usually recouped their investment by securing all the profits or products in the first years of the CJV cooperation, and then a new profit distribution scheme was negotiated. Sometimes the partners negotiated a fixed proportion of profit or product (for profit distribution). Or the partners use accelerated depreciation on the fixed assets to compensate the Hong Kong partner's

Table 2 The most important reasons for choosing a CJV over an EJV form.

Reasons	Hong Kong firms		Guangdong firms	
	Rank order	Cases	Rank order	Cases
Flexible contract	**1**	17	**3**	15
Low exit cost	**2**	15	**4**	12
Full control like WOS	3	13	–	–
Quick return on investment	**4**	12	**5**	11
Low transitioning cost from P&A contract	**5**	12	**2**	16
Lack of capital	–	–	1	19

Source: Authors' survey (2000)

'–' indicates the reason was not considered by the partner; Rank order in **bold** indicates the reason is given by both partners investment, but this method requires local government approval. In practice, these arrangements were often combined.' The Guangdong side was similarly advantaged. According to many interviewees from both sides, besides a negotiated share of net profit or products, Guangdong partners are paid an annual fixed return in the name of a 'rent' or a 'management fee' which is not taxable income. 'Local partners thus gained a quick cash return at the expense of government taxation' quoted from an interview with a Hong Kong manager. Engaging in long-term contracting to maximise their financial returns, CJV non-equity alliances attenuated short-term 'quick return' opportunism and fostered a win-win scenario.

For Hong Kong managers, the third most important motivation for forming CJV alliances was to enjoy wholly owned subsidiary-like management structures (see Table 2). In contrast to split control in EJVs, the 1988 CJV Law allowed the Hong Kong managers full management control. 'Because of the lacking of the managerial and technical capability, most Guangdong managers are willing to accept a secondary role on the CJV board, as they believe the CJVs would perform better under the Hong Kong managers' control,' a similar quote from many interviews with managers from both sides. Dominated by the Hong Kong managers, the CJV board oversaw the daily operation of the CJV. This differed from the practice in EJVs where the board's main role was monitoring management (Beamish, 1993). Exercising control over both operational and strategic issues aligned the objectives of CJV non-equity alliances, avoiding the trade-off in EJVs between the parents' need to control and the EJVs' need for autonomy (Harrigan, 1985).

Twelve Hong Kong and 16 Guangdong managers preferred CJV non-equity alliances to EJVs when they 'transitioned' from short-term P&A contracts to a government-recognised FDI-type arrangement. The CJV non-equity alliance allowed Hong Kong firms to economise on costs of transferring codified knowledge, embodied in specialised physical and technological resources, through upgrading existing facilities in the P&A factories. The assignment of expatriate Hong Kong managers facilitated the transfer tacit know-how related to quality control, plant management and logistics. The cost of adapting management structures were also low, with the partners' previous involvement in P&A contracts facilitating a transition to co-management, but avoiding the overheads of a more complex shift to the unified governance structure of an EJV.

The most important reason that Guangdong managers gave for entering CJVs was the lack of capital and the inability to access bank loans to enter an EJV. Unlike state owned enterprises (SOEs), TVEs did not have access to bank loans and government subsidies, CJV non-equity alliances provided an efficient alternative to accessing Hong Kong capital, replacing failed loan markets in China.

The CJV non-equity alliances' attributes also explained the choice of CJVs over P&As. Table 3 shows that 16 Hong Kong firms chose CJV non-equity alliances over P&As to reduce the costs of continuously searching for qualified suppliers and controlling product quality, and to economize on market outsourcing, which was ranked number two. Similarly, by relying on the Hong Kong partner's expertise, the Guangdong managers avoided the transaction costs related to uncertainty in sales, products and markets, and attenuated the failure of Chinese financial markets to provide capital.

Table 3 The most important reasons for choosing a CJV over a P&A contract.

Reasons	Hong Kong firms		Guangdong firms	
	Rank order	Cases	Rank order	Cases
Costs of finding qualified local suppliers and costs of monitoring local suppliers' product quality	1	16	–	–
Cost of market outsourcing greater than cost of establishing and running a supply base	2	13	–	–
Access to FDI policy advantages	**3**	12	**5**	11
Complementary assets	**4**	11	**2**	15
Right of sales in China's domestic market	5	11	–	–
Avoid uncertainty in sales and markets	–	–	1	17
Lack of capital for independent production	–	–	3	14
Lack of capability for independent production	–	–	4	12

Source: Authors' survey (2000)
'–' indicates the reason was not considered by the partner; Rank order in **bold** indicates the reason is given by both partners

Table 3 also shows both parties accessed the complementary assets of their partners, without the costs of acquisition. Hong Kong managers gained cheap labor, existing facilities and bureaucratic connections from their local suppliers. Guangdong managers' bureaucratic connections were ambiguous and difficult to transfer through P&A quasi-market contracts but were transferred within CJV non-equity alliances. Similarly, Guangdong firms (15 cases) frequently quoted Hong Kong side's knowledge about market conditions and consumer tastes as key complementary assets, which were equally difficult to articulate through P&A contracts.

Rights specified under Chinese law were important factors for both Hong Kong and Guangdong firms. For Hong Kong managers (11 cases), the P&A products were sold exclusively in Hong Kong or abroad, but as CJVs enjoyed the right of sales in China without equity investment. CJV non-equity alliances also have independent customs clearing rights, which avoided the reliance on special government agents or another company with this right, allowing Hong Kong firms to economize on tangible (agent fees) and intangible (time delays) costs. Entering CJV alliances allowed local partners (11 cases) the right to access FDI policy advantages like government funding and loans, without committing substantial equity investment. The data provide strong support to Proposition 1 that managers chose to form CJV non-equity alliances to save on transaction costs (especially in entering, negotiating and exiting CJV alliance contracts) and reasonable credence to Proposition 2 that managers use CJV alliance form to access complementary assets.

CJV non-equity alliances evolution: results for Propositions 3, 4 and 5

The second research question asks how the CJV non-equity alliance evolved over time. Previous research has emphasized the impact of changes in transaction-specific investments on alliance governance structures (Dyer, 1997; Dyer & Singh, 1998;

Reuer & Arino, 2002). Our survey data showed CJV non-equity alliances were a dynamic form of contracting, adapting to changes in the level of mixed specific investments rather than transitioning to other forms of contracting. As the first measure of asset-specificity, the technology level of the CJV refers to the product and process technology of the CJV compared with the industry standard in South China. Two-thirds of the CJV managers saw themselves as possessing a basic or intermediate level of technology at formation (see Table 4). By 1999, 62% of CJV non-equity alliances considered their technology as advanced within the industry. Among the 65 firms surveyed, Wilcoxon tests showed a significant technological catch-up by 34 firms over time. Mann-Whitney tests revealed that the firm size was a significant variable, with larger firms more technologically advanced, whether at the formation or in 1999. They were financially stronger than smaller firms and able to install more sophisticated plant.

Over time the higher technology level was achieved by Hong Kong managers transferring more advanced machinery to their CJV plants, which required their local partners to make additional investments in co-specialized physical and human assets. To ensure the efficient operation and proper maintenance of the more sophisticated machinery, the Hong Kong managers provided additional on-going technical and managerial assistance to their local partners. 'Many Hong Kong firms dispatched special technical staff for training local employees and overseeing the operation of the new machinery,' quoted from an interview with a local plant manager, 'depending on the sophistication of the technology and the absorptive capacity of local partners, these Hong Kong technical staff stayed in the CJV plants for a few months or a number of years.' But, the more advanced machinery still had multiple uses, and could be switched to other users, retaining its mixed asset specificity status.

The second measure of asset specificity in CJV non-equity alliances is the range of subcontracting activities undertaken, which were classified into eight categories according to their functions. Four categories were relevant to the CJVs' production and the others were non-production logistics and service activities, as shown in the two matrices in Tables 5 and 6. The number of firms engaged in single production and non-production activities are indicated in bold italics on the diagonal in Tables 5 and 6, while firms engaged in any two activities simultaneously are show in the off-diagonal. Arrows indicate the changes of the number of CJVs engaged in these value-added activities between formation and 1999.

Table 4 CJVs' technology level relative to the industry standard.

Perceived technology level	Formation Percent	1999 Percent	Change Percent
Basic	16.9	0	−16.9%
Intermediate	50.8	33.8	−17.0%
Advanced	27.7	61.6	33.9%
Leading edge	4.6	4.6	0
Total	100.0	100.0	
Wilcoxon (Significant at 0.05)		−2.388 (Z score)	

Source: Authors' survey (2000)

Table 5 The number of CJVs engaged in production activities between formation and 1999.

	Assembling components	Manufacturing components	Assembling a complete product	Assembling multiple complete products
Assembling components	***33→30***	13→17	0→1	15→16
Manufacturing components	13→17	***23→27***	0→0	10→13
Assembling a complete product	0→1	0→0	***3→4***	0→0
Assembling multiple complete products	15→16	10→13	0→0	***40→43***

Source: Authors' survey (2000)
(1) bold italics on the diagonal indicates the number of firms engaged in any single production activities (2) the number of firms engaged in any two production activities simultaneously are shown in the off-diagonal (3) arrows denote the changes of the number of firms engaged in production activities between formation and 1999

Table 5 shows the number of CJVs engaged in main production activities that were essential for carrying out subcontracting operations in Guangdong. Assembly of complete products required more transaction specific investments than the assembly of components. Since only four firms in 1999 and three firms at formation assembled a complete product and 40 at formation and 43 in 1999 assembled multiple complete products, there was no significant change towards more specific assets. CJVs engaged in two production activities simultaneously require more asset specificity than those engaged in single activities. Table 5 also shows no significant shift towards undertaking two types of activities. Consequently, mixed asset specificity continued to characterise the CJV non-equity alliances' main production activities.

Mixed asset specificity was also indicated by the frequent shifts between different production activities, made possible both by the multi-uses of machinery and the flexible nature of CJV non-equity alliances' on-going negotiation between the partners. For example, 'many electronics companies not only produce sophisticated audio-visual products, but also manufacture components for these products,' quoted from an interview with a local village chief in Dongguan, a city famous of its concentration of electronics companies from Hong Kong and Taiwan. 'It is very common that toy companies producing digital controlled toy cars are also engaged in the assembling of miscellaneous parts for cloth dolls,' stated by a Hong Kong general manager. In garment-making industry, 'firms often receive orders for sewing and brand knitting from other clothing manufacturers,' revealed by many Hong Kong and Guangdong CJV managers, 'depending on the orders received, one activity overwhelmed the other at a particular time, the aim is to smooth the impact of seasonal demands and diversify their business risks.' The result of adopting such a diversification strategy was mixed asset specificity for production activities.

Unlike production, the number of firms engaged in single non-production activities is not a good measure of asset specificity. The degree to which CJV non-equity alliances invested in co-specialised assets depended on the nature of the activity. Although packaging was undertaken by most CJVs (60 at formation to 62 in 1999), only medium level of investments in specific assets were required. As explained by many interviewees, 'packaging was mainly for transporting products to

Table 6 The number of CJVs engaged in non-production activities between formation and 1999.

	Packaging	Shipping	Marketing	After-sale service
Packaging	***60→62***	23→34	10→23	33→40
Shipping	23→34	***23→31***	9→18	14→25
Marketing	10→23	9→18	***10→23***	8→21
After-sale service	33→40	14→25	8→21	***35→42***

Source: Authors' survey (2000)
(1) bold italics on the diagonal indicates the number of firms engaged in any single non-production activities (2) the number of firms engaged in any two non-production activities simultaneously are shown in the off-diagonal (3) arrows denote the changes of the number of firms engaged in non-production activities between formation and 1999

Hong Kong, normally Hong Kong parents need to re-package the products to meet the different requirements and tastes of US and European markets'.

Similarly, the number of CJVs engaged in after-sale service (35 at formation to 42 in 1999) was second only to those engaged in packaging. But the investments in co-specialised assets remained small because after-sale services were provided for the Hong Kong managers, not for end customers in overseas markets. CJV non-equity alliances did not need (nor were they given) proprietary information about end customers or final markets.

Mann-Whitney tests show that there was a significant increase in the CJV non-equity alliance' engagement in marketing over time, as the number of CJVs selling their products to the Chinese domestic market increased. This required the Guangdong managers' specialised knowledge about the local market and local distribution system. But as western countries were still the main markets for most CJVs (including those that increased their sales to China), most Hong Kong firms retained their marketing and distribution capability in-house to exploit Hong Kong's superior information infrastructure and to protect their proprietary know-how in international marketing. Consequently, CJV marketing activities continued to be characterised by mixed co-specialised assets.

The above discussion shows that over time CJV alliance managers increased their involvement in a wider range of subcontracting activities but maintained medium level of investments in co-specialised assets. Among the 65 firms surveyed, only one transformed their CJV arrangements into an EJV and one into a WFOE. In both these cases, high value-added activity, such as product design and outbound logistics, were relocated to Guangdong, requiring significant increases in asset-specific investment from both sides. Given these high levels of asset specificity, frequent re-negotiation and adaptation of the contract was costly. Locking the local party into an EJV or taking over the local factory as a wholly owned subsidiary became a viable solution. In both cases, a significant increase in transaction specific investments triggered the transition, confirming proposition 3. These two exceptional cases also indicate that CJV non-equity alliances may be stepping-stones for EJVs and WFOEs. The more important manifestation of the dynamic contracting of CJV non-equity alliances was their greater participation in both production and non-production subcontracting activities over time. Supporting Proposition 4, the data shows most Hong Kong and

Chinese managers chose to maintain CJV non-equity alliance partnerships because the level of investments in specific assets remained mixed. Given the mixed asset-specificity, their increased experience in a diversified range of subcontracting activities contributed to the stable growth of CJV non-equity alliances after their formation. Proposition 5 is therefore supported.

Discussions

Discussion of main results

Contractual joint ventures (CJVs) in China were conceptualised as a non-equity subcontracting alliance, with elements of both arm's-length market and firm governance. The data from structured interviews showed that Hong Kong and Guangdong managers selected CJV non-equity alliances over alternatives for saving on transaction costs related to negotiating, entering and exiting CJV alliance contracts. The study also found that both Hong Kong and Guangdong managers viewed CJV alliances as a vehicle to gain access to each other's idiosyncratic resources and assets.

The survey data show that there were changes in both technology and the types and the nature of subcontracting activities between formation and 1999, but the changes were not significant enough in most cases to trigger the transition into other forms of organization. Instead, given the mixed asset-specificity, managers developed their diverse experience through engaging in a broader range of value-added activities over time, which led to the stable growth of CJV alliance ventures.

Discussion of main contributions

The paper contributes to the literature on strategic alliances in following areas. Firstly, it answers Inkpen's (2000) call for studying specific types of alliances rather than talking about strategic alliances in general. Secondly, the study fills a gap in empirical research on alliance formation strategies in China, which have focused on the equity joint ventures and almost ignored non-equity alliances (Pan, 1997; Pan & Li, 1998). Thirdly, previous research on MNE evolution concentrated on either the transition of contracting forms from a transaction cost perspective or the accumulation of experience and knowledge through diversification from a resource-based view. Our paper examined both dimensions of CJV non-equity alliance evolution and explained why some CJV alliances evolved into EJVs and WFOEs while others maintained their stable growth over time.

Finally, the paper addresses some of the problems common in Asian management research identified by White (2002). For example, White complains about the lack of questions that are important both theoretically and empirically. Our study has provided both empirical and theoretical insights into a major but understudied foreign investment form in China. By examining why managers chose to form CJV non-equity alliances and how this type of cooperation evolve over time, the paper also answers White's (2002) call to pursue conceptually interesting and managerially relevant 'how' and 'why' questions instead of being satisfied with documenting differences and correlations among pre-set variables. In addition, White (2002) critiques the restrictive and dysfunctional trend in Asian management research towards singular reliance on quantitative methods. In this paper, we follow his recommendation to purposefully incorporate multiple methods (interpretive, quantitative and qualitative) in order to uncover the managerial decision-making process and dynamics in CJV non-equity alliances. Last but not least, most existing research on international cooperative strategies in China relies on data collected with western managers and creates a bias (Jolly, 2005). By collecting data from Hong Kong and Chinese managers, this study reflects more accurately the phenomena of Sino-Foreign joint ventures, most of which are between mainland Chinese firms and overseas Chinese investors particularly from Hong Kong.

Limitations and future research

The paper has some limitations. Firstly, the paper aims to unveil the managerial motivations for CJV alliance formation. It did not attempt to compare the efficiency of CJV non-equity alliances with EJVs or P&As, where data would be required on all three types of investment forms. Future research should survey why Hong Kong and Guangdong EJV managers selected EJVs over CJV non-equity alliances, allowing a direct comparison between the contracting choices of the two joint venture forms in China. Secondly, following Yan and Duan (2003), we focused on manufacturing CJVs to minimize extraneous variation resulting from differences between service and manufacturing sectors. Future research should investigate the antecedents of the formation and the evolution of CJV non-equity alliance in service sectors. Thirdly, although Mann-Whitney tests show no significant difference between the perceptions of Hong Kong and Guangdong managers, the findings may still be biased towards Hong Kong side as 43 interviews were conducted with Hong Kong managers and only 30 with Guangdong managers. A related weakness is that although more than 90% of the interviewees were in the same position at the CJV formation as in 2000 when interviews were conducted, memory errors could occur during the recall of information (Taris, 2000). Finally, this research tackles a particular type of strategic alliances in South China province of Guangdong. The results, though representative in Guangdong, may not be generalized across China. Such a context-specific study adds valuable and novel insight to the stock of management knowledge (Tsui, 2006), but it shares the problem of the limited theoretical contribution common in Asian management research (Lau, 2002). Future research should test the results of the paper using data from other regions and compare the findings with alliance phenomena elsewhere in the world, making the China-specific study more globally relevant (Peng, 2005).

Conclusion

Among the major forms of foreign investment in China, contractual joint ventures (CJVs) are the least understood. Within China itself, they are not widely used outside the south China province of Guangdong. Due to a possible lack of self-confidence and pressure for publishing theory-driven context-free research (Cheng, 1994; Tsui, 2004), Asian management scholars frequently avoid studying highly context-specific topics such as CJVs. However, given the need to study more indigenous management phenomenon in Asia, this paper responds to Meyer's (2006) recent call for Asian management researchers to push locally-relevant research agendas by presenting the first systematic and comprehensive study of the formation and evolution of an important form of non-equity strategic alliance in China and Guangdong.

Appendix

Key interview questions

(1) Why did you choose CJV over EJV?
(2) Why did you choose CJV rather than through buying or selling products using P&A contracts?
(3) What operations are/were undertaken by the CJV? (Tick the appropriate box)

	Beginning	Now		Beginning	Now
Assembling components	□	□	Packaging	□	□
Manufacturing components	□	□	Shipping	□	□
Assembling a complete product	□	□	Marketing	□	□
Assembling multiple complete products	□	□	After-sale service	□	□
Other____________________________	□	□	Other__________	□	□

Beginning=The year the interviewee began to work for the CJV
Now=The year the interview was conducted

(4) What is/was the CJV's technology level relative to the industry concerned? (Tick the appropriate box)

	Beginning	Now
Very basic	□	□
Basic	□	□
Intermediate	□	□
Advanced	□	□
Ledging edge	□	□

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