
Organizational Status Change of Joint Venture: The Buyout by One Parent

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Abstract:

Purpose: This study aims to discuss the buyout of joint ventures by one parent.

Design/Methodology/Approach: Focusing on termination through acquisition by one parent, the paper suggests the testable proposition that explains a possible inverted U-shaped relationship between the likelihood of a focal parent acquiring a JV and the similarity of the JV to the focal parent.

Findings: We propose that the likelihood of a focal parent acquiring a JV is likely to increase and then decrease as the JV similarity to the focal parent increases.

Practical implication: This study can provide practical implications for firms from a more neutral standpoint. Firms that want to keep long-term relationships and operate JVs with their partners should be concerned about how JVs turn out over time.

Originality/Value: This study can provide some normative implications for successfully maintaining JV relationships. Particularly in the case of international JVs, local companies that shake hands with aggressive foreign companies (often eager to obtain local market knowledge) face the situation in which they are forced to sell their stake to the foreign partner. Frequently, local companies are satisfied with a bit of advanced technology transfer from their partners and thus, foreign partners easily own the JVs. However, once the companies in JV relationships understand the dynamics of evolving JVs and the tendency of acquisition based on similarity, companies can make more careful strategies in raising their JVs.

Keywords: Organizational status change, joint ventures, buyout, JV termination, JV relationships.

JEL classification: M10.

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1. Introduction

On March 10th, 2003, Reuter News reported that Virgin Mobile, a 50:50 joint venture between Richard Branson's Virgin Group and Deutsche Telecom's T-Mobile, had disintegrated into a fight between the two shareholders--the Virgin Group and Germany's T-Mobile to gain control of the business. Virgin was planning to use another clause in the agreement to try to force T-Mobile to sell its stake.

Virgin Mobile was set up in November 1999 as a joint venture between Virgin and Deutsche Telekom's T-Mobile unit. The group benefited from a lower-cost base by piggybacking on T-Mobile's network rather than running its own. However, the Virgin Group had started legal proceedings against the German company T-Mobile for what it describes as "material breaches" of their joint-venture agreement. The newspaper cited industry sources as saying that for months, T-Mobile (which had carried all of Virgin Mobile's calls) had wanted either to seize complete control of the venture or close it down. The article added that T-Mobile executives had sought to reduce a series of payments that their firm had made to Virgin as part of the joint venture's contract. Observers suspected that these executives wanted to use the cuts to trigger what is known as a "default termination process" aimed at wresting control of the joint venture. There were suggestions that the German company's executives were unhappy with the terms of the original agreement, drawn up by the previous management. Virgin representatives claimed that the situation between the two sides was "incapable of remedy."

On March 19th, 2003, the Virgin Group moved a step closer to gaining complete control of its mobile phone alliance with T-Mobile after a judge said that the German group deserved "moral condemnation" for attempting to break up Virgin Mobile after a contractual dispute. Finally, nine months later, the Virgin Group controlled Virgin Mobile by buying out its joint venture partner, T-Mobile. In return, T-Mobile received a value equivalent to its stake through a "materially enhanced telecoms agreement."

The account above clearly shows how eager the partners of joint ventures try to seize complete control of ventures and how difficult it is to become the sole owner of such a venture. There are two interesting observations in this case. Although T-Mobile was the supplier of the critical resource (i.e., the network) to the venture, it was forced to sell its stake to its partner. Additionally, both initial desires of T-Mobile--either to seize complete control of the venture or to close it down--were not accomplished.

Virgin Mobile was an international equity joint venture. An equity JV is one form of various strategic alliances that combines resources from more than one organization to create a new organizational entity (a "child") distinct from its parents (Inkpen and Curral, 2004). An equity JV is typically used when the required task integration between partners is high, and the alliance business is characterized by uncertainty

and decision-making urgency (Doz and Hamel, 1998). Many studies have shown that there is a high chance that JVs can terminate for many reasons such as conflict of interest, inefficiencies, or enduring losses (e.g., Kogut 1988; Nemeth and Nippa, 2013).

Although legal proceedings resolved Virgin Mobile's case, firms engaged in equity JVs often handle similar situations without a third party, such as the court system. If it is not a legal battle, then one partner of the venture should agree on the sales of its equity for the other party to buy out (i.e., mutual content). Given that both partners were interested in their joint venture when they entered their contract at the outset, which partner would end up fully acquiring the equity of its joint-venture partner? Based on JVs and JVs termination literature, we seek to address this question in this paper.

2. Literature Review

Joint ventures are legally independent organizational entities partially held by parent organizations (Pfeffer and Nowak, 1976). Although firms found and ran JVs to pursue strategic objectives, many terminated unintendedly or intendedly (Yan and Zeng, 1999). JVs tend to be unstable organizations because of conflicts between parents, governance issues, parents' changing goals, industry fluctuation, etc. (Barkema and Vermeulen, 1997).

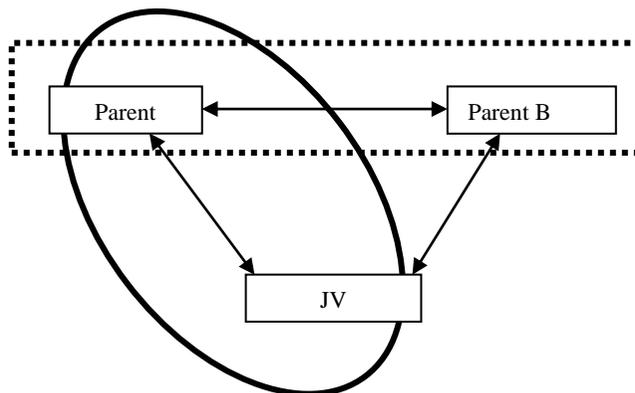
However, most previous studies on the termination of joint ventures have not made any distinction in the ways that joint ventures cease to operate. Very few studies consider different types of JV termination: termination through acquisition by one of the partners; a spin-off to third parties; and liquidation (e.g., Hennart and Zeng, 2002; Makino *et al.*, 2007). Since prior JV research has mostly treated alternative JV ownership changes indifferently and has regarded JV termination as merely an indicator of failure, there have been many inconsistent results regarding the factors causing JV terminations. Ignoring a distinctive type of termination and the difference between unintended and intended ends leads to biases (Cui and Kumar, 2012; Nemeth and Nippa, 2013; Mata and Portugal, 2015; Nippa and Reuer, 2019). To handle this inconsistency, we need to distinguish among the various types of termination. We can guess that one of the partners' termination through acquisition is generated via different decision routes from termination through a spin-off to third parties and liquidation. The former is chosen when at least one parent wants to keep the JV, while the two latter options are chosen when both parents no longer want the JV.

In this study, we specifically focus on one type of JV termination-termination through acquisition by one parent. By doing so, we set out a scope to clarify the purpose of the current research. Narrowing the scope would help resolve previous studies on JV terminations, and we suggest a factor that enables a focal parent to acquire the JV.

Acquisition of a JV refers to a parent's internalization of the JV through buying out the remaining equity of the JV that its partner owns. The buyout option's attractiveness comes from the fact that such an option gives a parent complete control of the JV. From a transaction cost economics perspective, a JV is chosen as a first-best strategy because, alternatively, the cost of organizing mode is higher than in JV (Robson, Leonidou, and Katsikeas, 2002). Over time, the transaction cost of intermediate assets, which hinders the parents from taking complete control at the beginning, changes, and thus firms' willingness to take complete control of JV might change as well (Park and Russo, 1996). Therefore, once those barriers (or risks) initially preventing firms from acquiring the partner are removed through fully assimilating the partner's assets, those firms are willing to take complete control. Reuer and Miller (1997) show that JVs are often used as stepping-stones to more outstanding market commitment through a partner's buyout of the venture.

Previous research on JV terminations have investigated a few factors to determine JV termination, such as JV performance (e.g., Cui, Calantone and Griffith, 2011), partner characteristics such as nationality and size (e.g., Delios and Beamish 2004), and experience/learning between partners (e.g., Barkema, Bell and Pennings, 1996). While such factors can address the question "under which conditions does JV terminate," they cannot answer "which partner owns JV" because factors used to explain JV terminations are mainly related to characteristics of partners or JV and relationship between partners (dotted-lined box in Figure 1). However, we should not overlook the fact that the joint venture's minimal structure is composed of three players - rather than two partners and their joint venture - and thus, it comprises three relationships. Previous studies on JV termination have not fully considered a relationship between JV and parents. To answer our question, we should consider the relationship between the parent and the JV, drawn as an ellipse in Figure 1. Since JV internalization is a specific investment decision (Reuer and Miller, 1997), consideration of the target (JV) is necessary when the parent decides whether or not it will own the target.

Figure 1. Simplified structure of a joint venture



Source: Own creation.

3. Research Proposition

Unlike a non-equity alliance, the partners in a JV relationship interact with and learn from each other through the distinct organism, the "JV." While the parent firms are jointly involved in the investment, production, marketing, and other management activities of their joint venture (Nakamura, Shaver and Yeung, 1996), and while significant information generation and exchanges occur between the parents and the JV under this process, the JV itself grows and evolves. Therefore, the acquirer (one of the parents) and the target (the JV) are embedded in each other, explaining why JV acquisition by one of the parents requires distinct consideration from other mergers and acquisitions in which the acquirer and the target are usually independent entities.

Since a JV is not an inanimate object, and thus, necessarily evolve, it has a particular development path (Cui and Kumar, 2012). We can think of two interaction scenarios between a focal parent and a JV.

During the process of a JV's evolution, one parent may lose its interest for certain reasons while the other parent keeps it. On the other hand, both partners may lose interest and may become detached from their JV or keep their interests and may want to be committed to the JV continuously. This change of interest may be induced not only from the JV but also from the change occurring on the parent's side. Depending on the interaction between each parent and the JV, a JV can show a convergent development process with a focal parent, which may be a divergent development process to the other parent.

According to homophily theory (Lazarsfeld and Merton, 1954), people associate and bond with similar others. Individuals in homophilic relationships share common characteristics (e.g., beliefs, values, education, etc.) that make communication and relationship formation easier. Homophily often leads to homogamy (i.e., marriage to people with similar characteristics). If we apply this theory to firms, which are organisms, we suggest that firms sharing similar characteristics (e.g., management style, industry, culture, etc.) may communicate and form a relationship more quickly. As a result, similar entities are more inclined to bond together and become one entity by nature.

The similarity of a JV to its parent is analogous to a child's resemblance to his/her parents. A child resembles his/her parents from birth by receiving genes from the parents and interacting with them during the child's growth period. Likewise, a JV becomes similar to its parents through the parents' initial commitment and interactions with them during the developmental process. Just as a child often resembles one of the parents a JV has an unbalanced similarity to each parent.

Even though they did not draw on homophily theory, Morck, Schleifer, and Vishny (1989) report that bidders' abnormal returns are higher for "related" acquisitions than

they are for "unrelated" acquisitions. "Relatedness" in this context suggests that the bidder possesses intangible assets helpful in managing the target firm. Such findings are consistent with previous research showing that related JV is less likely to terminate than unrelated JV (Hennart, Kim, and Zeng, 1998).

Therefore, the parent firm that acquires the JV, sharing a similarity with it, can expect abnormally higher returns in the stock market. Beyond the reasons addressed here, the fear of a parent losing its core competence by giving up the second self may give the parent an incentive to own the JV. Based on this argument so far, we can infer that the more similar the JV is to a parent, the more likely it is that the focal parent will acquire the JV. However, it is necessary to remember that one of the motivations of forming a JV involves organizational learning (Yoon and Song, 2010; Khan, Shenkar, and Lew, 2015). Since tacit knowledge (i.e., technology, market knowledge, management skills, etc.) is often embedded in an organization (Yoon, Lee, and Song, 2015), firms use a JV to transfer such knowledge different firms. Therefore, the organizational learning explanation for a JV implies that parent firms at the outset possess different yet complementary intangible competitive capabilities. Therefore, if a JV resembles the partner firm more, it becomes divergent from the focal parent. Given the situation in which the partner relationship will indeed be terminated, the focal parent may have much interest in the JV, as it can serve as a substitute for the partner. Weitzman (1982) supports this view that acquisition is used for learning, arguing that acquiring a controlling stake may offer further learning advantages to investors, who internalize the target to facilitate technology transfer. In this sense, a parent will be more willing to acquire a different JV (but complementary).

Which one, then, will lead to the acquisition of a JV by the focal parent? This question can be answered if we also consider the "dark side" of similarity and dissimilarity. Van de Ven (1976) argues that organizations have nothing in common at the extreme low end of domain similarity and are thus not likely to have mutually desired resources. As a result, an inter-organizational relationship will be impossible. From the learning perspective, we can argue that at the high end of domain similarity, a similar joint venture makes the focal parent firm lose interest in buying it, as there is not much to learn. Instead, the joint venture has capabilities redundant to the focal parent firm. Perhaps, then, the wisest answer could be that both facilitative and inhibitive processes are probably at play in different degrees over the range from low to high similarity. In short, the polar ends of similarity--either the low or high extreme ends of similarity will not stimulate the focal parent's appetite for the JV. Instead, an inverted U-shaped relationship between similarity and the likelihood of JV acquisition by the focal parent is proposed.

Proposition:

The likelihood of a focal parent's acquiring a JV is likely to increase and then decrease as the similarity of the JV to the focal parent increases.

This model is illustrated in Figure 2.

Figure 2. *Conceptual Model*



Source: Own creation.

4. Discussions

In this study, we assume that there is an asymmetry in partners' interests in internalizing JV. If both partners have equal interests in the JV, then merely having an interest in the JV would not necessarily lead to owning it. In such a case, we might need to consider the party's relative ability over its partner to acquire the JV. Although factors such as bargaining power, equity share, or financial conditions affect the parent's ability to acquire the JV and are meant for consideration, our specific setting characterized as unequal interest in the JV, but a terminated relationship between the partners - compel us to focus more on the motivational factors rather than on the factors affecting the ability to buy. For one partner to win the battle over another partner, one party should have more bargaining power over the other party. We intentionally exclude the case of equal interests from both parents for argument simplicity. We focused on how the interest itself can purely decide whether the focal parent will buy the JV.

Our study makes contributions to the JV literature in two ways. First, we consider a different mode of termination. Previous studies which neglect distinctive types made mistakes by regarding JV terminations as a failure. However, for example, the buyout of JV is the internalization of the venture into the parent firm, and it requires JV parent's extended commitments (Reuer, 2002). Nemeth and Nippa (2013) state that research that clearly distinguishes different international JV exit modes is needed when investigating the JV exit factor. By explicitly focusing on a single type of termination, our study helps better understanding this phenomenon. Second, we include a tie between JV and its parent firm in understanding the dynamics of JV termination. Most studies on this topic have shed light on the relationship between parent firms (dotted-lined box in Figure 1) or individual parent firm's characteristics and JV. In their review piece about international JV exit, Nemeth and Nippa (2013) found that there has been neglect of specific perspectives in joint venture relationships and called for approaches that include "the perspectives of all organizations and management directly involved in IJV" (p.467). By considering the similarity between a parent firm and JV, we advance our understanding of JV termination with a more balanced view of these dynamics.

5. Conclusions

For more than 50 years, JVs have been used as a popular way of conducting business for many firms—from entrepreneurial entities to conglomerates—nevertheless, they are still poorly understood by practicing firms. This study can provide some normative implications for successfully maintaining JV relationships. Particularly in the case of international JVs, local companies that shake hands with aggressive foreign companies (often eager to obtain local market knowledge) face the situation in which they are forced to sell their stake to the foreign partner. Frequently, local companies are satisfied with a bit of advanced technology transfer from their partners and easily own the JVs. However, once the companies in JV relationships understand the dynamics of evolving JVs and the tendency of acquisition based on similarity, companies can make more careful strategies in breeding their JVs. Moreover, the study can provide practical implications to firms from a more neutral standpoint. Firms that want to keep long-term relationships and operate JVs with their partners should be concerned about how JVs turn out over time.

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