Case 3
The New China Hotel in Beijing
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Spring 1987 in Beijing, China was unusually cold, ironically appropriate considering the icy state of relations between Peter Morris and his company, the Asian Development Corporation (ADC), and its Chinese joint venture partner, the Yellow River Tourist Service (YRTS) for the New China Hotel (NCH) project. After years of futile attempts to salvage the alliance, Morris, vice-chairman of the board of directors of the New China Hotel in Beijing, had just settled an agreement with his Chinese counterparts to withdraw ADC's equity investment in the hotel.

Close to a decade later, he still vividly recalled the day the Foreign Investment Commission in the People's Republic of China broke the news of the venture to the Asian Wall Street Journal. In December of 1979, the commission announced its informal approval of the New China Hotel alliance between ADC and YRTS.

Ecstatic upon receiving permission to pursue the project, Morris considered this a major success, because it was one of a rare handful of large joint ventures allowed in the early days of China's “open-door policy.” By 1985, however, soon after the hotel unofficially opened, ADC reluctantly opted to relinquish its interest in the project. Two years later in 1987, the company finally ended a series of long, bitter negotiations with YRTS and reduced its investment to a mere 10% from its original share of 51%.

Stealing a last glance at the glittering glass facade of the hotel before departing for Los Angeles, Morris remained convinced that the joint venture had been a sound strategic decision for ADC, one in line with the company's desire to enter the Chinese market. He was at present, however, reevaluating the decision-making and negotiation process to identify any miscalculations and false expectations that may have contributed to the grave problems ADC encountered, particularly those related to the deeply implanted Chinese bureaucracy.

China's Open Door Policy

The end of the 1970s marked a significant change in China's economic strategy with the government's implementation of a new "open-door" policy. Prior to this, the nation adhered to a strict program of import-substitution. Few goods and services were imported, and international trade was severely curtailed, except limited trade activity with Western Europe. Trade between the U.S. and China was, for the most part, non-existent. Foreign investment was discouraged, the economy was centrally planned, and little, if any, private ownership was allowed.
In the late 1970s, China announced a new open-door policy that welcomed and actively sought foreign capital to finance modernization projects. Foreign investments were evaluated and approved based upon their ability to attract the foreign currency, Western technology, and management skills the Chinese needed to revamp the economy.

In the early stages of this relatively liberal policy, joint ventures emerged as the most common structure of foreign investment projects, because this form allowed Chinese partners to gain management skills and access to new technology. However, the Chinese government severely restricted long-term and permanent foreign ownership. Generally, joint venture agreements ranged in duration from ten to twenty-five years, and foreign investors were prohibited from holding a majority interest.

Hotel Industry in China

Tourism ranked as an important sector of the open door policy due to its ability to generate foreign currency earnings to finance development of other industries. Existing hotel and tourism facilities, however, were underdeveloped and incapable of meeting the demands of growing numbers of tourists and business people. In response to the need for more and better hotels, several hotel chains rushed to China to propose projects.

New China Hotel

The New China Hotel, among the first world-class hotels in Beijing, the Chinese capital, opened in 1984. Prior to this, many guest houses and inns were available to local travelers; however, relatively few were equipped with facilities capable of accommodating foreign visitors according to Chinese government standards. Beijing Hotel, despite its poor amenities and limited services, was the best available. The Diaoyutai Hotel, which surpassed the level of comfort and service offered by other lodges, was reserved for government and foreign officials.

To be jointly constructed and managed by ADC and YRTS, the NCH project was designed as a 1,000-room luxury hotel with seven restaurants and delicatessens. Located within a ten-minute drive to the city center and situated on the road to the airport, the hotel was built to attract both tourists and business travelers.

The Asian Development Company

The Asian Development Company (ADC) was owned by the Asian Investment Corporation (AIC) and Webb International Corporation, both U.S.-based companies. AIC, formed in April 1979 and owned by the Bergel Group of Companies and Eastern Construction Company, specialized in consortium joint ventures and compensation deals in China. The Bergel Group, a pioneer with more than thirty years of experience in project development in the former Soviet Union and Eastern Europe, extended its business into China in 1978. When the deal with YRTS to construct the New China Hotel came to fruition in 1979, AIC engineered a consortium to establish ADC, the entity that eventually entered into the 49% equity joint venture with YRTS for the New China Hotel.
Peter Morris, executive vice-chairman and general manager of ADC, participated as a member of the negotiation team involved in the initial meetings with YRTS. Reflecting later upon ADC's enthusiasm in the early stages, Morris noted the company's expectations of an excellent return on its investment due to considerably lower construction costs, cheaper labor, and forecasted inflows of hard currency immediately upon the hotel's opening.

The company was confident that it could draw on its previous success in similar hotel projects in such socialist countries as Hungary, Rumania, Cuba, and the former Soviet Union. In fact, its experience, acquired through years of dealing with the business practices and mentalities ingrained in planned economies, constituted the company's greatest competitive advantage in the bidding process.

**Project Negotiations**

The Bergel Group, neither large nor an international hotel chain, won the right to pursue the project amid strong competition from several competitors, including Hilton and Inter-Continental. According to the Foreign Investment Commission, which approved the YRTS-ADC joint venture, size factored only nominally in the decision; instead, the terms a foreign partner set forth were crucial.

**Project Team**

In late 1978, ADC assembled a project team comprising several members with expertise in diverse areas related to the venture. The crew consisted of Peter Morris, several experienced negotiators, a project manager, a construction manager, several design experts, a project finance expert, and, most importantly, two China experts. Most team members possessed extensive experience in project management in Eastern Europe, and many spoke Chinese and were familiar with Chinese culture. Of the two experts, both overseas Chinese-Americans, K.C. Tung, chairman of the Eastern Construction Company, was born in China and educated in the U.S. The other, David Chen, born and educated in the U.S., lived in China for several years prior to liberation.

Morris later commented on Tung's and Chen's negotiating skills: "We understood that the Chinese regard modesty as a virtue, and that many Americans are often arrogant when conducting international business. They don't realize that aggressive salesmanship does not work in China and, therefore, seem unable to comprehend why negotiations invariably stall. Be a Roman when in Rome; that's why we tried our best to adapt to Chinese customs, regulations, methods and requirements."

The China experts, through excellent connections in the government, soon found themselves acquainted with officials of YRTS, a state organization charged with promoting and regulating travel nationwide. Because of China's dire need for additional, modern hotel facilities to develop its tourism sector, YRTS and the Beijing municipal government aggressively sought foreign investment and participation in hotel construction projects.

By February 1979, a few months after the ADC team initiated preliminary attempts to enter the Chinese hotel market, the company succeeded in securing letters of intent from both YRTS and the municipal government. According to these documents, ADC retained responsibility for administration of the
financing, design, construction management, and foreign procurement activities. The Chinese partners agreed to provide the site, necessary Chinese government approvals, certain project materials, and hotel construction and operations labor.

Morris was thrilled about the letters of intent, until discovering that YRTS and the municipal government had signed similar documents with other hotel groups. In the U.S., these agreements constituted a commitment that both parties would work together until a deal was consummated or abandoned. To ADC's dismay, in China, letters of intent were neither binding nor exclusive. A Chinese ministry might, as it appeared that YRTS and the local government had done, sign a similar letter with several companies.

Slow progress in moving forward to the next stage of the negotiations after the signing of the agreement spurred ADC's realization that both YRTS and the municipal government were continuing to discuss proposals with other prospective partners. At this point, the importance of negotiating directly with the key decision maker and of structuring an extremely appealing offer struck the team. Tung and Chen immediately began delving into the layers of the Chinese bureaucracy and ultimately succeeded in identifying the general secretary of the YRTS as the official who held the true decision-making power.

**Keys to Success**

Acknowledging that a principal weakness in China's attempts at modernization stemmed from an acute shortage of foreign currency, the ADC team focused on its ability to circumvent this problem. By designing its offer to successfully address this issue, ADC believed it would greatly enhance the probability of securing approval of the project.

In most centrally-planned economies, the central bank acts as the prime guarantor for repayment of loans to foreign lenders. However, as elsewhere in the socialist world, China's hard currency reserves were quite limited. Thus, the Bank of China had proven unwilling to offer financial guarantees for joint ventures. In fact, numerous foreign companies had expended significant amounts of capital to develop, bid for, and secure projects in China, only to ultimately fail because they were incapable of gaining approval for foreign loans due to the bank's refusal to act as guarantor.

Morris knew that the key to the project's success involved ensuring ADC's ability to secure financing, a lesson learned through the team's collective experience in the former Soviet Union and Eastern Europe. Based upon previous joint venture proposals accepted by East European governments, the team's initial plan emphasized the point that financing for the project would not involve guarantees from the Bank of China. Under the company's plan, lenders would be assured that the partners would be held jointly liable for repayment of loans and that a steady stream of hard foreign currency earnings would be immediately directed toward debt service upon the hotel's opening. These earnings would be received by customers who would be required to pay in foreign currency or "foreign exchange certificates," a special form of exchange in China.

Furthermore, during an April meeting with the secretary of YRTS, the ADC team presented a unique proposal concerning interest rates to its prospective Chinese partner. To counter YRTS assertions that the prevailing world commercial prime lending rate was too high to attain governmental approval, ADC
offered YRTS a lower fixed interest rate than the prevailing 8 - 8½%. The difference between this fixed rate and the variable global rate would be paid by ADC.

A crucial final decision remained at this point: selecting a partner for the project. In a centrally-planned economy, an influential and powerful partner offers significant advantages to a venture, including facilitating procurement and government approvals. After extensive consideration, ADC selected YRTS based upon the belief that, as a nationwide ministry charged with promoting and regulating travel in China, it would offer greater benefits than the municipal government. This view was later substantiated; YRTS swiftly obtained the required approvals from more than 25 various government departments, bureaus, and ministries.

**The Joint Venture Contract**

ADC's efforts were rewarded in May 1979, at which time it signed a formal joint venture agreement with YRTS. Although binding, the document was subject to the terms of a final contract to be negotiated within five months. The size, class, and site of the hotel, as well as the method of cooperation, division of profits and losses and period of joint operation, were outlined in the agreement. The duration of the project was set at ten years; at the end of this period, ADC would be required to relinquish all rights of ownership to YRTS. The contract also described promises made by YRTS concerning certain guarantees related to the repayment of loans and the repatriation of profits.

In the early stages of the open door policy, China had not yet developed a comprehensive commercial law. Thus, a procedure to be followed in the case of a dispute between the two parties was also set forth in the joint venture agreement. The Chinese partner insisted, and ADC acquiesced, on the exercise of the principle of "mutual discussion and agreement" to resolve future conflicts. This meant that all disagreements would be settled in China under Chinese law.

The absence of an established commercial law fueled foreign skepticism concerning the methods that the Chinese would use to enforce "mutual discussion or agreement." However, ADC, enthusiastic about concluding negotiations and beginning the project, dismissed its reservations about the clause and proceeded to finalize the contract. At the time, Morris never dreamed that one day he would be haunted by the Chinese principle of "mutual discussion" to which he so easily agreed.

In October 1979, the final joint venture contract was signed. YRTS and ADC drafted contracts in both Chinese and English, both of which were binding. ADC employed its own lawyers and translators to ensure that the English contract was identical to the Chinese one. Achieving perfect translations, however, proved nearly impossible, because the two languages differ greatly in syntax and concept. Poor translation quality further complicated the task and resulted in numerous discrepancies between the two versions. Though the ADC team was assisted by its two China experts, they could not be held responsible for flawless translation and a failure to detect subtle errors. Thus, the team relied heavily upon its lawyers, who in turn counted upon their translators. In the end, although each party certified that the agreements carried the same content, numerous discrepancies still existed at the time the contracts were signed.
Financing of the Project

From the outset, ADC intended to avoid contributing its corporate capital to the project. Rather, the company planned to fully finance the project costs, estimated at $72 million, through bank loans. To accomplish this goal, ADC created a financial plan based on two assumptions. First, ADC was confident that the hotel would immediately generate substantial hard currency cash flows upon opening, given expectations of high occupancy and low labor costs. Second, the company predicted that the total debt incurred would be self-liquidating within six to ten years. Sometime later, Peter Morris revealed that ADC initially anticipated earning a $40 to $50 million profit from its 49% share over the project's duration.

To allay the prospective lenders' fears of default, ADC secured the YRTS's commitment to joint liability for 100% of the outstanding debt. Initially, however, YRTS agreed to undertake responsibility for only 51% of the loan in accordance with its share of the hotel. Lacking extensive exposure to, and understanding of, international financing, YRTS failed to comprehend the common international lending practice that required all parties of a joint venture to be jointly and severally liable for the full sum of the debt incurred. After several weeks, ADC eventually convinced its Chinese partners of the necessity of agreeing to the joint liability clause.

Describing the resolution of this conflict, Tung remarked, "At first, they were adamant that they retain responsibility for only 51% of the debt. Later, YRTS realized that it's an international practice and that stubbornness on its part would only hurt the joint venture. But, because the Chinese are proud of their history and culture and hate losing face, we had to take care not to upset our partners. So, we acted as if we, too, were learning about the process, and we worked together to determine the best solution."

Because the bank loan was to be repaid from operating profits, the joint venture established a moratorium on debt service during the construction period. After operations commenced, all revenues would be deposited into a loan amortization account, from which funds would be transferred to another account for operations.

By the fall of 1980, the joint venture secured a $72 million syndicated loan to finance construction. The syndicate was headed by the Nordic Bank Limited of Norway, and, not surprisingly, the Bank of China participated in the financing coalition. Under the terms of the contract, YRTS would pay a fixed interest rate lower than the 8% prime lending rate. ADC assumed responsibility for payment of the difference between the fixed and market rates, a stipulation that proved devastating when the prime lending rate skyrocketed to 20% in 1983.

The Construction Process

In May 1980, the Foreign Investment Commission formally approved the New China Hotel, Ltd. ADC, though contractually responsible for the structure's design, was required to obtain approval by YRTS. The design, a modern structure with a glass wall curtain facade submitted by an American architectural firm hired to provide design and construction expertise, delighted the Chinese.
However, although YRTS quickly agreed to the project's design, several misunderstandings concerning the construction of the hotel occurred. The most serious transpired at a mid-1980 meeting during which the Chinese admitted their lack of expertise in construction management. Interpreting this confession to mean that the Chinese wished for the hotel to be built on a turnkey basis, the American directors arranged to hire a foreign contractor to undertake the entire construction project. To the Americans' surprise during the next directors' meeting. The proposal to invite bids for the job from foreign construction firms was met by an icy response from the Chinese.

At this point, the ADC team realized that a serious communication gap concerning the construction process existed. The Chinese did not want to hire a foreign firm to complete the project entirely; YRTS hoped to absorb the advanced building technology and skills by working on the project together with a foreign firm. Eventually, the architectural company in Los Angeles was assigned responsibility for design and construction management activities, while Beijing's Construction Company would undertake the actual construction work. This misunderstanding concerning management of the construction process constituted the first in a series of obstacles that culminated in the current bitter situation between YRTS and ADC.

Construction of the hotel began at the end of 1980. At that time, the Los Angeles architectural firm provided a set of designs to Beijing's Construction Company. The latter, however, complained that the drawings did not include detailed shop drawings, another problem originating from conflicting cultural norms. In China, architects supply both work and shop drawings, while architects in the U.S. provide work drawings only. The Beijing Construction Company's resentment grew upon discovering that the American engineers on the construction management team could not produce the expected shop drawings, a fact subsequently reported to the Chinese directors.

Unease on the part of the American team was evident as well, especially related to concerns about delays in the construction schedule. At the outset, the project was planned to be completed within 24 to 26 months. Remaining optimistic about its ability to meet the target completion date in January 1983, ADC believed that its Chinese partner was equally committed to finishing the hotel on time. It was also confident of the ability of the Chinese labor to quickly learn to use new construction techniques and advanced equipment. To ADC's disappointment, however, the construction process was poorly managed, and labor was exceptionally unskilled. Thus, progress was slow, and the quality was sub-standard.

These factors, and several others, resulted in numerous construction delays. First, the Chinese construction workers, mostly farmers from the rural areas, experienced great difficulty in delivering an acceptable standard of building quality and learning the new technology. Furthermore, the government-owned Beijing's Construction Company was completely unfamiliar with Western building technology and construction management practices. Though assisted by the American engineers, the company lacked the experience and expertise to ensure adherence to the construction timeline.

Moreover, the BCC's slow and bureaucratic decision-making style hindered the company's ability to make the quick decisions and handle crisis situations necessary to avoid project setbacks. Furthermore,
the Construction Management Team, composed of both American engineers and several YRTS-appointed members, was less effective than expected. The inexperience of the Chinese members in managing large construction projects especially impeded progress.

**Financial Crisis**

Near the end of 1981, the $72 million construction fund reached the point of exhaustion. ADC proposed borrowing more to continue construction, but YRTS refused, knowing that the Chinese government would deny requests for additional funding. A deadlock resulted, and construction halted. Though resolution of the impasse in accordance with the principle of "mutual agreement" clearly failed at this stage, YRTS, fearful of losing face, continued to attempt to solve the problem according to Chinese law. ADC requested, but was not provided with, a copy of the Chinese commercial law to consult in hopes of ending the standstill. In fact, no comprehensive commercial law existed at the time.

YRTS sensed the pressure increasing daily. Failure of the joint venture would lead not only to serious financial losses, but also to a loss of face and negative publicity that would profoundly dampen investors' confidence in China.

In early 1982, YRTS resumed negotiations with ADC in search of a solution. An agreement was finally reached under which YRTS agreed to finance all subsequent costs required to complete the remaining construction work. For its part, ADC agreed to delay the hotel completion date until the end of 1984, two years after the original deadline. Moreover, according to the settlement, if YRTS failed to meet the new project deadline, it would be held responsible and would be required to compensate ADC for losses resulting from the delay.

In December 1984, YRTS unofficially opened the New China Hotel to avoid incurring the damages that it was liable for to ADC as specified in the newest agreement. At the time, only 300 of the 1,000 rooms and one of the seven planned restaurants were ready. Six months later, the hotel was completed and officially began operations in June 1985.

**The Break-Up**

At this point, dissolution of the partnership between YRTS and ADC appeared imminent. The bitterness, initiated during the construction period and never completely overcome, intensified as a result of numerous problems arising from disparate management styles and the ambiguity and discrepancies inherent in the Chinese and English versions of the joint venture contract. A final blow to the relationship occurred in 1986 when ADC was denied the right to repatriate profits to the U.S. as a result of a serious shortage of capital experienced by YRTS. Soon after, ADC demanded to be allowed to extract itself from the partnership, and YRTS contracted with another international hotel group to manage the hotel.
Final Settlement

In 1987, Morris reached an agreement with his Chinese counterparts to end the two-year-long negotiation process. ADC reduced its equity interest in the hotel to 10% and received some financial compensation, leaving YRTS with a controlling share of 90%.

Disappointed and disillusioned, Morris continued to reflect upon the situation during his final drive from the hotel to the airport. As he reviewed the past several years, he wondered if the problems that ultimately caused the project to fail to meet ADC’s expectations could have been avoided, and, if so, how. While he still believed that entering the joint venture to develop the New China Hotel had been a sound decision for ADC, he realized that the risks inherent in conducting business in China may not have been outweighed by the potential returns in the case of the New China Hotel.

1. In your opinion what were the main risks about the new Chinese open door policy for foreign companies (ex. Legislation, timing, money, etc.)?
2. How was China different from other socialist countries where ADC had experience working with?
3. It seemed that ADC had all its bases covered. Why did the venture fail?
4. How can cultural assumptions affect an international venture? List them and discuss at least two assumptions made by each side that went wrong.
5. Why did the Chinese dislike the Americans’ proposition to invite bids to hire a new foreign contractor?
6. In your own words explain what went wrong? Do you think those issues could have been avoided, and if so, how?