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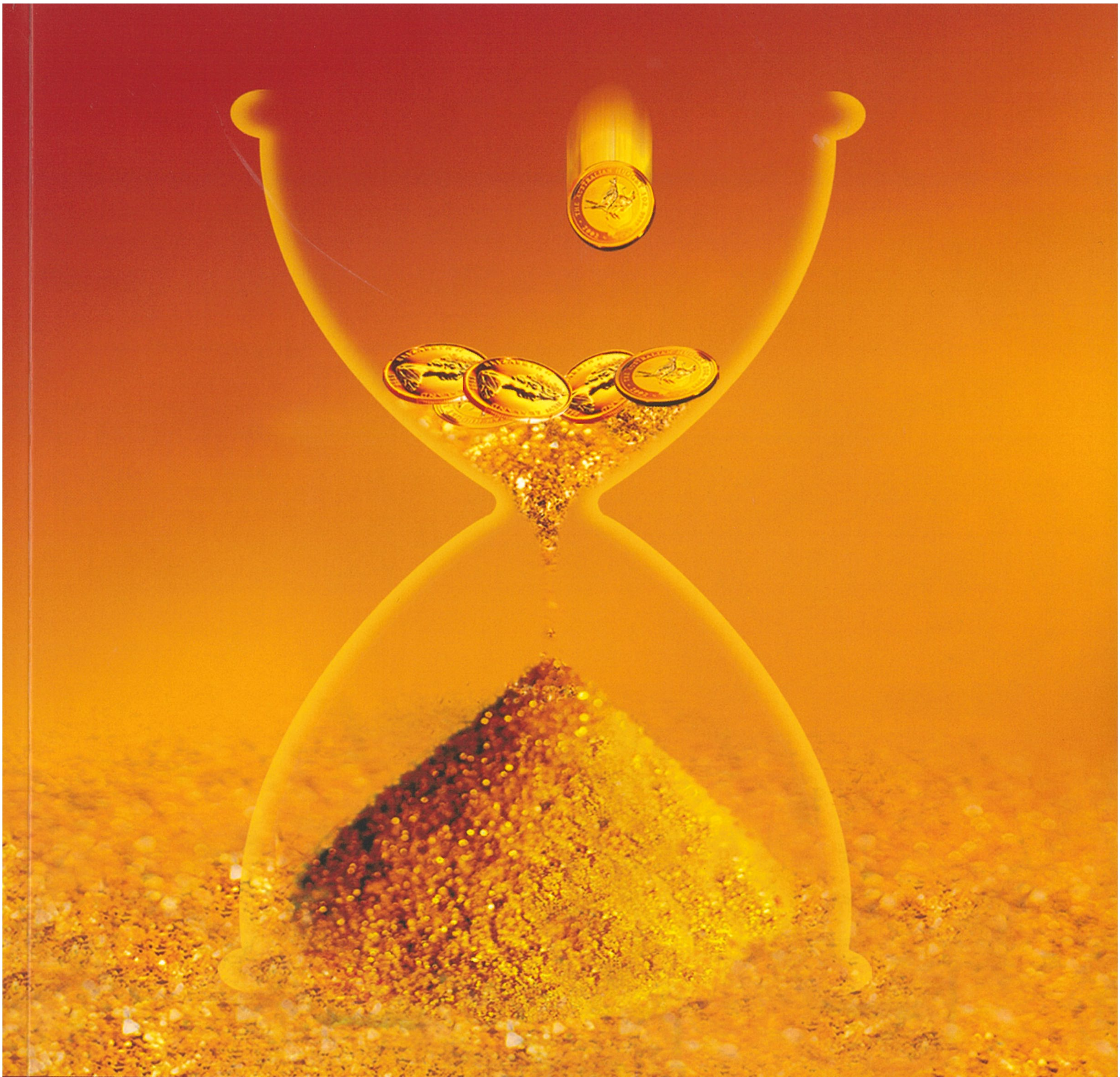

CHINESE ENTREPRENEURS

LESSONS FROM THE NEW WAVE

Juan Antonio Fernandez and Per Villendrup Jenster

China Europe International Business School
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Contents

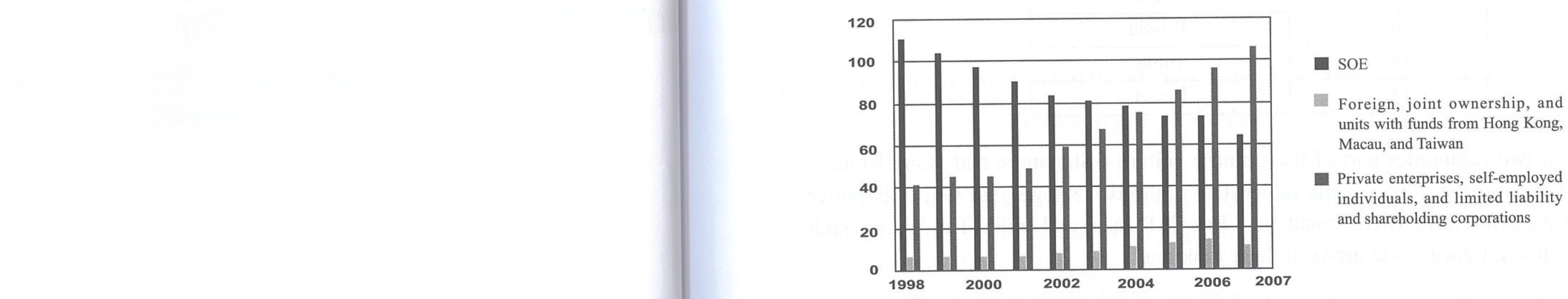
INTRODUCTION

CHINESE ENTREPRENEURS: LESSONS FROM THE NEW WAVE

It is a well-known fact that China is going through rapid social and economic transformation. In the past three decades of reform, the country has been able to reinvent itself and is rapidly bridging the gap with the most advanced economies of the world. However, though the reform process is on the fast track, daunting challenges lie ahead. The widening gap between the rich and the poor, environment concerns, and the demand for political reforms are a few of them. But these challenges are the result of the success of the reforms, not their failure.

The success is attributed in part to the role played by the Chinese private sector. As Professor Wu Jinliang writes in the preface to his book, Chinese Economic Reform,[1] the strategy for facilitating the transition from a centrally planned economy to a market economy is classified into two major types on the basis of the speed of the transition: The "Big Bang" approach, exemplified by the former Soviet Union, and the "Gradual Approach," followed by China. However, according to Professor Wu, "This method is too superficial to reach any significant conclusion." Instead, he favors the Hungarian Professor Janos Kornai's framework that suggests two types of strategies for economies in transition: Strategy A, which tries to create a favorable environment for the development of the private sector, and strategy B, which stresses on the elimination of state ownership as quickly as possible. Strategy A, concludes Professor Wu Jinliang, is the one followed by China, as depicted in the following graph.

Number of Employed Persons in Urban Areas (million)



Source: China Statistical Yearbook 2008

[1] Wu Jinglian, Understanding and Interpreting Chinese Economic Reform, Singapore: Thomson/South West (2005)

The black bars represent the number of persons employed in state-owned enterprises (SOEs) in urban areas between 1998 and 2007. We can clearly see a steady decline in the number of jobs in SOEs. At the same time, the dark grey bar shows a gradual increase in the number of jobs in the private sector. It is in 2006 that the dark grey bar surpasses the black bar. We can say that 2006 was the year when China's transition into a capitalist economy or a social market economy, as the Chinese Communist Party likes to call it, was effected. Of course, things are not as simple as this graph indicates, and there are many other factors that need to be taken into consideration. But we can at least say that China is following a clear path to a modern economy and that the success of the private sector is one of the preconditions to achieve that goal.

However, in China, the environment for private businesses is still not ideal, and there are many areas that require reform. According to the Doing Business 2008 report, published by the World Bank,[2] China ranks 83rd among the 178 economies included in the study. Table 1 compares China's business environment with that of a few select countries.

Table 1: Doing Business for Entrepreneurs, World Bank Ranking

Rank (2008)	Country
1	Singapore
3	United States
4	Hong Kong (China)
12	Japan
15	Thailand
24	Malaysia
30	Korea
44	Mexico
83	China
91	Vietnam
106	Russia
120	India
122	Brazil

Interestingly, two economies part of the Chinese culture—Singapore and Hong Kong—are placed on the top of the list of this table. The table also shows that China is better positioned than the other three BRIC countries—Brazil, Russia, and India. The World Bank study used 11 different indicators to arrive at these rankings.[3]

[2] The report can be accessed at www.doingbusiness.org

[3] Please refer to the China country report at www.doingbusiness.org for a detailed explanation of the indicators included in the ranking.

Table 2: Detailed Ranking by Item

Doing Business in China	Rank (2008)	Rank (2007)	Change
Ease of doing business	83	92	+9
Starting a business	135	128	–7
Dealing with licenses	175	175	0
Employing workers	86	86	0
Registering property	29	28	–1
Getting credit	84	94	+10
Protecting investors	83	81	–2
Paying taxes	168	173	+5
Trading across borders	42	31	–11
Enforcing contracts	20	20	0
Closing a business	57	76	+19

From Table 2, we can see that China has improved its overall position from 2007, but it still ranks quite low in critical parameters, such as starting a business, dealing with licenses, and paying taxes. But this ranking uses aggregated numbers and does not consider individuals who want to start or run their own business in China. Further, it does not take into consideration the type of problems they face. Therefore, the authors of this book felt impelled to offer a perspective on China's dynamic entrepreneurial spirit. Both authors have been directors at the Center of Entrepreneurship, China Europe International School (CEIBS) for a substantial period. The cases included in this book are the result of extensive work at the center. We have selected nine stories or cases on Chinese entrepreneurs that bring some of the challenges and problems faced by entrepreneurs in China to the fore. They attempt to cover the entire gamut of concerns related to conducting business in China—from business creation to growth and maturity.[4]

We provide a short description of each of the case studies below:

Chapter 1: Be Careful What You Wish for—You May Get It！—Planning and Establishing a New Venture

Case Study: From High Technology to Spas: Allen Lee's Risky Switch

After a casual conversation in an airplane, Allen Lee decides to invest in a foot massage business that Zhang Kang, the founder and president of Kanzi Foot Massage Health Center Group (KFHC), plans to develop in Shanghai. The company has 200 centers across China, but

[4] One area that is not covered in our cases is succession, that is, when the first generation passes the business to its heirs. As private ownership of business is a relatively recent phenomenon in China, most of the companies are still being managed by the first generation.

none in Shanghai. A few of these centers are owned by KFHC, while others are franchised to different owners.

Zhang is on a visit Shanghai to find a location for a luxury massage center, his first in the city. Allen sees an opportunity to invest in what sounds like a promising business opportunity, though he knows nothing about the massage industry. The case details the process of investment in the center and attempts to develop it. However, it brings into focus how dreams can, at times, turn into nightmares, as things turn out to be quite different from what they seemed at the outset.

Chapter 2: Accidental Ventures and Sustainability

Case Study: Wanbo Technology Co., Ltd.

Headquartered in Beijing, Wanbo is a distributor of computer components in northern China. It supplies a variety of products to computer assemblers and retailers in small- and medium-size cities, and grew rapidly—from annual sales of RMB 3 million in 2001 to RMB 100 million in 2006. The company projected a 50% growth rate for 2007. However, the pressures of posting a high growth rate gave little time to management to properly develop the organization and formulate policies. The incapability of the finance and HR departments thus poses a major hindrance to Wanbo's long-term growth. The case poses questions pertaining to the strategy and the financial viability of Wanbo's growth plans.

Chapter 3: When the Dream Vanishes: Financial Component of a Successful Venture

Case Study: Gao Weidong: A Milestone in an Entrepreneur's Life

This case presents the problems facing a Chinese entrepreneur after the first year of operations of his vine-importing business. Gao faces an extremely difficult financial situation because of an investment decision. The very survival of his company is at stake. To help him to overcome this crisis, he hires a consultant.

Chapter 4: Where is the Money?—Sources of Financing

Case Study: Envisioning the Future: Shanghai Venture Capital (SHVC)

After five years of successful operations, SHVC needs to make a strategic decision about its

future growth. The company was created by the Shanghai municipal government to promote high-tech start-ups and the VC industry in Shanghai.

Gao Jin, vice president of SHVC, wants to reformulate the earlier strategy and explore other possibilities. Among these is the expansion of activities to provinces around Shanghai and participation in international funds. This case explores these issues and the evolution of the VC industry in China.

Chapter 5: When Success is Looking for a Strategy

Case Study: Shanghai Red Star Engineering

Shanghai Red Star Engineering is a family-owned manufacturing company with 300 employees. Ever since its inception in 2000, the company has been growing rapidly at an average rate of 20%, with profits before tax varying from 8% to 10%. Rapid expansion in production, however, gives little time to the management team to formulate personnel policies, make plans, and update computer systems. A new order that seeks to account for 40% of its production triggers heated discussion among the top brass on the company's future course of action.

Chapter 6: The Dangers of Rapid Expansion: The Road of Franchising

Case Study: Ahua: The Franchising Dilemma

Chen Renhua, the owner and general manager of Ahua, a leading mother-baby care company in China, is pondering about the future of his organization. Since its inception in 1993, Ahua has grown into a company offering products such as baby hair pins, pictures, and albums, as well as services including prenatal education for pregnant women, preschool education, and nursing services for babies. Having followed the franchise model since 1994, Ahua has been successful in quickly expanding its business all around China, but suffers from limited management control. Thus, Chen needs to take a call whether to terminate the franchise system or continue with it.

Chapter 7: Leadership Crisis: When 24 Hours is not Enough

Case Study: Fuqima Washing Machine Corporation

After years of successful operations and rapid expansion, Fuqima Washing Machine

Corporation (FWM), established in 1987, found itself grappling with major challenges in 2000. These included fierce competition from both domestic and foreign companies, failure of its new product—HDT-2000, and internal conflict. To make matters worse, Wang, CEO of FWM, was hospitalized for three months, which paralyzed the company's decision-making system. This case provides an insight into the typical problems facing Chinese companies in a growing competitive market environment and the changes in management styles that these organizations had to introduce to continue with their growth plans.

Chapter 8: Strategic Leadership and Execution

Case Study: WWRC Shanghai: The Threat to the Middleman[5]

Worldwide Resins and Chemicals (WWRC) Shanghai was one of the leading distributors of special chemicals in east China, and connected local customers with producers of special chemicals outside China. It performed well during 1997–2006 because of its prudence in selecting and executing the right business strategies. With changing market dynamics, however, the company faced challenges such as sluggish growth in construction-related coating, ink, and plastic industries; fierce competition from local producers; and demanding customers. Although the company's performance in terms of revenue, profit, and productivity was positive, Wang Huitao, the main founder of the company, was aware of his company's limited growth in the current industries, and knew that the company would not sustain its profitability if strategic changes were not introduced. Wang listed four options—new business, own brand, new application, and new products—to help the company combat changes in the Chinese market. This case encourages students to analyze and evaluate the options that Wang presented.

Chapter 9: Building an International Business

Case Study: The "Fruitful" Journey of China Haisheng Juice

In barely 10 years of its existence, China Haisheng Juice Holding Co. Ltd captured 20% of the export market for apple juice concentrate. This case discusses the evolution of the firm and its founder, who recalls his experiences while establishing the company. In its early years, Haisheng survived fierce competition from other domestic juice producers and two major

[5] A middleman, also called reseller, is a company or individual that purchases goods or services with the intention of reselling them rather than consuming or using them. Available at: Wikipedia, the free encyclopedia, http://en.wikipedia.org/wiki/Reseller

crises—US FDA charges of pesticide residue in products and the anti-dumping case slapped by the US Apple Association. With the help of Goldman Sachs, Haisheng floated an IPO in 2005. The firm is now considering new avenues of growth.

We hope that this collection of cases will help those not familiar with the Chinese market better understand entrepreneurship as it exists in the country. And for those planning to set up a business of their own, we hope that the experiences discussed here will help avoid the mistakes committed by the companies described here.

CHAPTER 1

Be Careful What You Wish For – You May Get It! Planning and Establishing a New Venture

CASE STUDY

From Technology to Spa: Allen Lee's Risky Switch

Allen Lee,[1] born in the city of Lanzhou, China, was sitting in an airplane, waiting for it to take off. It was the Chinese New Year,[2] and a family reunion had been planned. This was the first time in the past five years that Allen was visiting his hometown. He recalled the time when he had just completed his bachelor's degree at Shanghai's East China University of Science and Technology in 1992 and started his career by joining PetroChina. In 1996, however, Allen had returned to his alma mater, to carry out research on telecommunications software. In 1998, he left the institute and started his own business in Shanghai in software development for telecommunications companies in China.

Today he was no longer the inexperienced young man he was eleven years ago, with a mind brimming with ambitious ideas. As a young entrepreneur owning three IT companies, Allen was undoubtedly successful. However, he was always in pursuit of business opportunities.

At this moment, Allen's flight to the past was abruptly interrupted by a bulky man who took the aisle seat beside him. The man was about 50 years old, dressed simply. Allen greeted his neighbor and introduced himself. A little later, they exchanged business cards. The gentleman's business card read: Zhang Kang, President and Chairman, Kangzi Foot Massage Health Care Center Group (KFHC). Allen also recognized the logo of baby footprints, which he had seen extensively advertised all across Shanghai.

Sitting beside him now was the owner of that company.

"Nice to meet you! I admire people who are computer professionals," Zhang said joyfully after getting acquainted with Allen. "And you are pursuing an IT entrepreneur in Shanghai? That's great!"

"You have a much greater stature than I have," Allen said, pointing to the corner on the visiting card that stated Zhang's designation. Allen could not hide his delight and added, "Your group already has 200 centers. That's quite an achievement!"

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[1] All the names have been changed to maintain confidentiality.

[2] The Chinese New Year falls on a different date every year. It starts with the new moon on the first day of the year and ends on the full moon 15 days later. New Year's Eve and New Year's Day are celebrated as a family affair, they are a time of reunion and thanksgiving.

While talking to Zhang, however, Allen was reflecting on his own situation. Allen owed a large part of his success to China's economic reforms. He had been able to take advantage of both the earlier planned economy and the emerging market economy. He was familiar with his customers, who were not only managers in the corporate sector but also administrators in the public sector. His telecommunications software development business had grown exponentially in the past five years, and had enough cash to invest in new business opportunities. Allen felt that Zhang had appeared just at the right time for him.

"That is luck ... you know, first-mover advantage," Zhang said about his foot massage business, "actually, with the business growing at such a fast pace, I have been under tremendous mental pressure. I want to expand in large cities, such as Beijing and Shanghai. But to do so, I need the help of professional and experienced managers, like you." It was almost as if Zhang had sensed Allen's ideas and concerns.

At his end, Allen became seriously interested in such a completely different line of business because of Zhang's imposing personality. He responded enthusiastically, "Hey, why don't we have a detailed discussion on this? It sounds interesting to me and, perhaps, some other people I know may also be interested in it."

Zhu Introduces Foot Therapy to Allen

Encouraged by Allen's interest, Zhang elaborated the origins and benefits of foot massage therapy. Foot Massage Health Care was born out of China's traditional medical practices. In ancient times, the Chinese considered that the feet represented the entire body in a miniature form. For them, different points on the feet corresponded to different parts or organs of the human body. "Normally, a well-trained foot masseur can identify a person's illness within minutes. Foot therapy can completely relax a person and even cure him/her of certain diseases—it has proven therapeutic effects," explained Zhang (Exhibit 1 and 2).

Gazing outside the window, Allen was weighing the possibilities in entering this unfamiliar territory. He was reflecting over the dramatic changes that China had witnessed during recent years. Since the progress of the "open-door"[3] reforms, China had entered a new era of development and stability. Private entrepreneurs were encouraged, protected, and respected more than ever before. The state's long-term development policy was improving the living standards of the population. Further, income levels had been steadily increasing. All these factors convinced Allen that people would pay greater attention to their health and well-being in the coming years.

As far as the labor market was concerned, China had an estimated population of 1.3 billion, of which 900 million continued to live in rural areas. This enormous figure provided a huge pool of unskilled labor and presented the Foot Massage Health Care enterprise as

[3] The Third Plenary Session of the Eleventh Central Committee of the CPC in 1978 marked the start of China's "Reform and Open-Door" policy. Economic development zones were set up in southern China to attract overseas investment, foreign technology, and advanced management methods; and ultimately introduce the market-economy mechanism.

a perfect business opportunity. There was enough demand for the service in coastal areas because people there were wealthy, and a large workforce was available to support such a labor-intensive industry. "Generally speaking," Zhang explained, "the foot massage health care market is still in its nascent stage in China. Owing to increasing personal incomes and greater realization of the importance of health, there exists tremendous opportunity for market development, especially in northern Chinese cities."

Allen could not overlook the confidence and ambition that Zhang possessed.

Kangzi Foot Massage Health Care Center

Zhang continued, "I established my first foot massage center way back in 1992 in my hometown in Anhui Province. Since then, I have personally trained several people on each and every aspect of the system. But, you know, Chinese medicines and equipment are easy to purchase from the market. Even skills can be learned when one has an effective training system in place." At this point in the conversation, the plane hit a turbulence zone, but none of them noticed it as they were immersed in the conversation. Zhang went on, "However, making a good hamburger does not mean that you can run a McDonald's successfully. There are lots of lousy foot massage centers, which are unhygienic and offer poor, and at times, even sexual services; these will be shut down, sooner or later, by the authorities."

Despite the lack of formal education, Zhang had successfully established a large empire of Kangzi Foot Massage Health Care Centers (KFHCs) in China after 10 long years of hard work and determination. Today, he boasted of possessing about 200 foot massage centers in cities across the country. "I have established the Kangzi Foot Massage brand name on a national scale. It ranks first in terms of size and customer awareness," Zhang could not hide his pride, "But the market of Shanghai is getting saturated. The next step for me is to enter Beijing, where competition is still limited."

Zhang had a strain of worry on his face, "I should feel relieved since I have already captured a big market share and earned large revenues; however, that is not the case. Profits are not satisfactory yet." He admitted that while certain KFHC centers were performing well, others were unsuccessful and sapping revenues.

Zhang was the founder, a sort of father, of the enterprise. Most department managers were either his relatives or, at least, his townsmen. He made almost all major decisions by himself. Allen then realized that Zhang was slowly losing control of his company.

Zhang had achieved success on the back of high-quality service. After years of persistent efforts, he had built a reliable brand name. He had recruited foot masseurs from his hometown in Anhui. Before putting them on the job, he made them undergo a three-month "military" drill and another three months of foot therapy training at a special school. Zhang believed that discipline was the first lesson that his employees needed to learn in order to ensure high-quality customer service. He was thus an extremely hard taskmaster. Interestingly, this tough style was well-accepted by the employees since the life they were now living was considered to be far better than the harsh lives in their rural homes.

However, despite the quick expansion and apparent success of his business, Zhang was under tremendous mental pressure. One of his main concerns was that most KFHC centers targeted high-income people based in flourishing cities, but a few centers only provided ordinary foot massage service without any differentiation. Moreover, the concept could be easily copied. Further, the company suffered from severe cash flow problems. Although more KFHCs were being launched, the total profit from existing centers was on the wane.

With about 200 KFHCs nationwide, Zhang was becoming increasingly dissatisfied with his management team. He was encountering difficulties in finding the right talent for managing the centers. Although he took considerable efforts to ensure high-quality service, customer complaints were increasing, especially as clients were becoming more demanding.

Allen's gut feeling was that Zhang had opened too many KFHCs, in which he was either the sole investor or the majority stakeholder. Being a farmer's son, Zhang's philosophy was to control everything. Further, Allen believed that the company's brand value had not been fully capitalized on, and a majority of the cash was locked up in real estate. Following the detailed discussion with Zhang, Allen felt that he could offer help and, in the bargain, grab an investment opportunity for himself.

"Hey, why don't we meet again after I return to Shanghai?," Allen said, "You know, I was just looking for new business opportunities, and your company seems to be the perfect match for my current needs. I need to talk with a few people, but I might be able to gather a small number of investors. Let's meet again when we are back in Shanghai and explore the issue further. We can work out a business plan for a potential partnership. I want to better understand the current situation of your company (**Annex: The Business Plan**). If it works, I can put money in it; otherwise, you will still benefit from my suggestions."

"That's a great idea!" Zhang exclaimed, "Call me when you are back. I am sure we can achieve a lot together in the future." Although nothing was yet certain, Zhang had already started counting on Allen as a partner.

Amid such plans of collaboration, the aircraft landed at Lanzhou's Zhongchuan airport. Allen was overwhelmed with happiness as he stepped onto his hometown. He felt the urge to mix with the crowd: Most people were headed for their family reunions, and had an expression of unmistakable longing on their faces. He shook hands with Zhang, exchanged New Year greetings, and promised to contact him as soon as he reached Shanghai. Curiously enough, Allen was struck with the same feeling that he had when he started his first company eight years ago.

Annex:The Business Plan

Once he returned to Shanghai, Allen presented the plan to a few of his friends. Eventually, an investment team was formed. It comprised eight members, all of whom were successful entrepreneurs looking for opportunities for a second investment. Together, they carried out a study on KFHC to analyze whether this was a promising line of business. After an initial brief brainstorming session, a plan was worked out, which included personal visits to certain Kangzi Foot Massage (KFM) centers, a customer survey, and a series of interviews with Zhang and his key managers. The following is a summary of the report prepared by Allen and other investors.

Preliminary Study

Problem Identification and Recommendations

Zhang enjoyed the greatest authority in KFHC since it was a privately owned company. He and his relatives occupied all the important positions in the organization. However, the firm lacked a clear organizational structure. All the decisions, whether critical or insignificant, were made by Zhang. It was not uncommon to find Zhang encircled by people seeking instructions on trivial matters.

Zhang had categorized his organization according to various "regions." Each region covered several provinces, such as the northeast region, which included the provinces of Lianing, Jilin, and Heilongjiang. Further, each region had a regional manager. Thus, the organization was structured geographically. In addition, regional managers were not only required to manage cities/centers in their territory, but also expected to set up their own departments and teams for marketing, training, development of new centers, quality control, etc.

The Kangzi brand name was a major advantage enjoyed by the company. Equally critical to the success of the business were standardized services and quality control procedures. In addition, setting up a foot massage center required careful planning—decisions needed to be taken on issues ranging from site selection to lease contract negotiation. These decisions determined the success or failure of a new center, even before serving the first customer. Zhang was the sole decision maker of the firm, but the current scale of the business did not allow him to indulge in such detailed work anymore. Moreover, with his hold losing over his business, the number of unprofitable deals increased, adding to his woes.

KFHC's strategy was to establish a professional and standard service. The company sought to distinguish itself from low-quality service providers and was successful in capturing a large share of the high-end market. By standardizing service procedures and enforcing stringent work policies, KFHC ensured a consistent service level. It was military-style management, which, however, greatly helped KFHC in providing the same service to every customer. If employees did not follow procedures, they were penalized. This style was suitable for a labor-intensive business, but greater training was required to develop a more professional and service-oriented attitude. Further, KFHC did not have an effective incentive system as employees received a fixed amount of money for serving customers. This posed the threat of plunging employee morale and enthusiasm.

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Investors led by Allen therefore proposed that the company should resolutely follow a high service standard, while a new incentive system must be designed in accordance with the profit that every center made.

Anhui—Zhang Kang's home province—was among the most populated provinces in China. However, it was difficult for young people to find a job there: This provided a large labor pool for KFHC. Salaries for young people were also extremely low. Meanwhile, working for an entrepreneur operating in one's province was thought to increase loyalty among employees. Owing to these factors, KFHC recruited people solely from Anhui.

However, the new investors recommended that KFHC should emphasize an appropriate educational background for selecting candidates, as opposed to stressing the place of origin. If employees lacked requisite knowledge, it would be difficult for them to understand the nuances of health care and foot massage. A senior middle school degree was proposed to be the minimum requirement for working at KFHC. Further, in order to find the right employees, investors suggested that KFHC should consider candidates from other provinces.

At the same time, it was suggested that KFHC should select managers on the basis of their professional achievements, instead of family affinities. The investors felt that the current managerial team was not large enough for a business with 200 outlets, and plans to add another 200 in the near future. The time was ripe to set up a professional organization and bolster its brand name, which was probably the most valued asset in a business segment with extremely low barriers to entry.

In addition, field survey statistics of KFHC centers in flourishing commercial areas revealed that most customers rarely came alone. It was normal to regard a foot massage as a social activity. As per the survey results stated below, customers usually came in groups of two to four persons:

- Visit by 1 person: 9%
- Visit by 2 people together: 23%
- Visit by 3 people together: 29%
- Visit by 4 people together: 21%
- Visit by 5 people and more together: 18%

The design and decor of most KFHC centers was similar, if not identical. Zhang laid great importance on the notion of "standardized service." However, certain centers had identical "private" massage rooms with four massage couches, which were either not optimally used or were not big enough to accommodate large groups of customers. There was thus room for building massage rooms of different sizes. Additionally, removable partitions could be set up for meeting the needs of large groups of customers. By implementing this simple change in layout, it was estimated that the number of customers per day would increase 7.8%, significantly improving the turnover of a few centers, especially those located in the busier areas of downtown cities.

The investors recommended that since KFHC was an established brand name with nationwide coverage, Zhang should abandon the idea of "owning" all the centers. They also proposed the franchise system as an alternative to complete ownership. The new KFHC centers were capable of providing the required level of service; thus, it was not necessary for Zhang to be the sole owner. The investors advised Zhang that the franchise system would considerably reduce the capital required for opening new KFHC centers.

Meanwhile, it was also time to consider the less competitive market of Beijing. Supported by the well-established Kangzi brand, KFHC was expected to expand quickly through franchises in the city. Establishing a flagship center in Beijing was the most important task for the company at this stage. It was envisaged as a center with world-class decor and service standards, which could be differentiated from other parlors, and thus successfully penetrate the new market.

However, there were certain challenges to consider. One of the biggest concerns was Zhang himself. He had an overbearing style of management, which was not easy to change. This was a potential area of conflict between the different partners, as they believed in a different management philosophy that entitled employees and professional management teams to more autonomy.

The group also needed to consider threats from possible competitors, such as Chinese medical massage centers, sauna shops, beauty salons, gyms, and even massage centers in hospitals. All of them could easily change their service range to enter this market segment. However, after considering all the pros and cons, the investor team considered that the return on investment (ROI) for this business could be quite attractive. Therefore, the team advised Zhang to invest in a new center in downtown Beijing. This center would be the pilot project and, depending on its success, could represent the birth of a new Kangzi. This center would also be the model for the franchise chain.

End of Preliminary Study

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After the initial study, the investor team came up with a proposal to set up a new foot massage health care center in Beijing. Allen and his friends would adopt Kangzi's service standard, with the right to use the "Kangzi" brand. Zhang understood that the new center required another business model, a different process and style in order to become successful. For Allen, there were several challenges ahead, but he was rather excited by the new venture. Equally convinced, the other investors signed a memorandum of understanding (MoU) with Zhang in April 2006.

Memorandum of Understanding between Zhang and Investors

Based on the earlier analysis, the investor group proposed that Zhang should open a new center in Shanghai. This center would serve as a model for a franchise chain in the future. Other terms of the MoU are stated below.

- An investment worth RMB 6 million would be made. The amount would be pooled in by the investors, while Zhang would contribute intangible assets, including the Kangzi brand, goodwill, management expertise, standard foot massage service, and franchise, which was valued at RMB 1.8 million (30% of the company's total shares).

- A limited legal entity for a new center in Jianguomen[4], Beijing, would be established.
- The Board of Directors would comprise the eight members of the investment team and Zhang.
- Allen would be appointed the Chairman of the Board, while Zhang would assume the role of the General Manager, responsible for all business decisions.
- The company would have a registered capital of RMB 1.8 million (30% of the total investment).
- The new company would be set up in June 2006.
- The center would be opened six months later.

Business Plan for the New Center

Foot massage services were the core business of the newly established center, but other services, such as body massage, sauna, and traditional Chinese medicinal treatment, were also proposed to be incorporated. The center's long-term goal was to become a high-standard, multi-functional health center.

Pricing Strategy

The center was proposed to be located in a conspicuous area to attract the target customers—businessmen and white-collared workers. For this, the investors recommended the Saite Plaza at Jianguomen, Beijing, a famous high-level shopping center located in the commercial heart of the city. Further, the KFHC staff needed training to improve its attitude toward serving customers.

It was recommended that VIP cards should be issued to frequently visiting customers. These would offer both recognition and discounts. There were two kinds of VIP cards: Those offering 10% discount and those giving 20% discount, based on how frequently the customer visited the center.

The company used differential pricing for foot massage to provide benefits to preferred customers. Other service items were to be available at a fixed price. The quoted price was applicable to one-time consumers, while the favorable price was extended to card members.

Table 1: Quoted and Discounted Price (RMB)

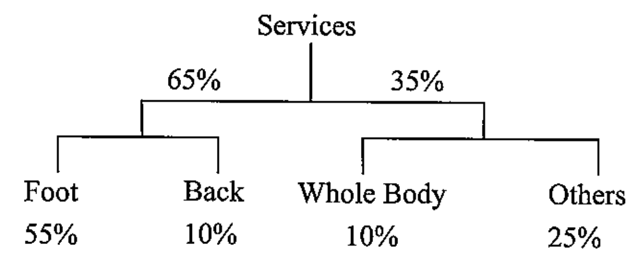
Price of Service	Foot Massage	Body Massage	Back Massage	Acupuncture	Herbal Skin Anti-Aging Treatment	Qigong Relaxation Treatment	Sauna
Quoted	98	118	28	48	48	148	38
10% Discount	88.2	N/A	N/A	N/A	N/A	N/A	N/A
20% Discount	78.4	N/A	N/A	N/A	N/A	N/A	N/A

[4] One of the premium commercial areas in Beijing

Other Sources of Income

KFHC also decided to introduce new services that borrowed from traditional Chinese medicinal treatments.

Structure of Income from Traditional Businesses



Expenses Incurred by the Center (area: 3,000 sq. m.)

- Business equipment: RMB 500,000
- Decor: RMB 2 million
- The depreciation period was five years. There would be no salvage value at the end of the depreciation period. Depreciation was calculated by the straight-line method.
- Rent: About RMB 250,000 per month (down payment: RMB 1.5 million for 6 months)
- Salaries and benefits: Monthly salaries (including commission) for a center with 28 staff members: RMB 56, 000
- Advertising: RMB 200,000 (The main advertising methods were newspapers, billboards, and leaflets.)

Return on Investment

The company expected that its costs and expenses would increase 10% a year, while revenues would increase 20% a year till the third year of operations, and then remain constant.

Table 2: Return on Investment (RMB '000)

Item \ Year	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Revenue		4,992	5,391	5,823	5,823	5,823
Investment	2,500					
Rent		3,000	3,240	3,499	3,499	3,499
Wages		672	726	784	784	784
Advertisements		200	216	233	233	233
Other expenses		300	324	350	350	350
Total outflow	(2,500)	(4,172)	(4,506)	(4,866)	(4,866)	(4,866)
Net cash flow	(2,500)	820	886	956	956	956

Internal Rate of Return (IRR) = 23%

Business Process in relation to Critical Success Factors (CSF)

BUSINESS PROCESS

Shop Selection (A)
↓
Shop Approved by Authorities (B)
↓
Shop Rent Negotiation with Landlord (C)
↓
Staff Recruitment and Training (D)
↓
Shop Decor and Facilities Purchase (E)
↓
Shop Operation and System Standardization (F)
↓
Customer Satisfaction (G)
↓
Low Operation and Maintenance Costs (H)

CSF (after analysis)

The location of a shop is critical to make profits. A large customer flow and customers who are "willing to pay" guarantee profit flow. Advertisements are also required at appropriate places.

The joint venture will assure authorities that the center will comply with regulations and obtain its final approval.

Through skillful negotiation with the landlord, a reasonable rent amount can be settled on, which is crucial for maximizing profits.

Qualified staff members can offer good service and they form the basis of running such a business.

The shop will be designed following an inexpensive, popular, and unified architecture style. It was also decided that similar facilities would be purchased elsewhere and used to bolster the brand name. Further, retail chains of the store were planned to be launched.

Standard services will guarantee a high quality of service that will help maintain and develop the brand name.

The customer is always right. Various promotional services will be carried out to attract and retain customers.

The JV will strive to maintain low operating costs to maximize profits. Only the shop incurring the lowest cost can survive the competition.

Exhibit 1: Foot Reflexology Chart

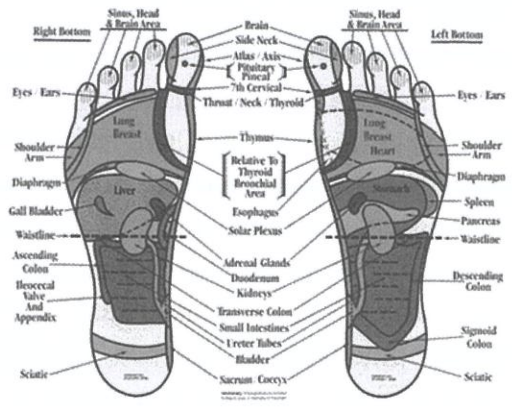


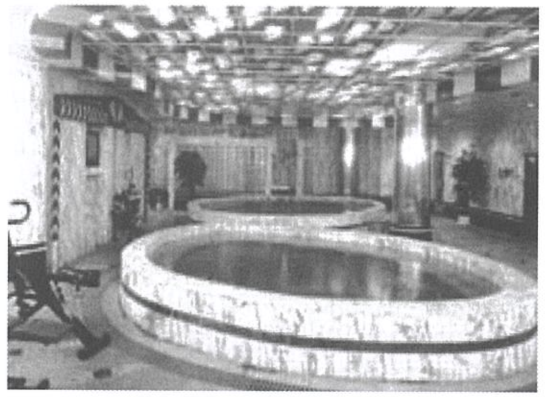
Exhibit 2: Foot Massage Process

Customer Arrives
↓
Customer's feet are dipped in hot medicinal water
↓
His/Her feet are massaged and illness diagnosed
↓
Back is massaged
↓
Customer Departs

Exhibit 3: Foot Massage

Exhibit 4: Entrepreneurs/Professionals at a Foot Massage Center

Exhibit 5: Massage Centers



CASE COMMENTARIES

COMMENTARY 1

Rama Velamuri

PHD Professor of Entrepreneurship,China Europe International Business School (CEIBS)

There is a story of a real estate entrepreneur, a banker, and a media and entertainment (M&E) expert who met over dinner. The real estate entrepreneur was attracted to investment opportunities in banking, the banker thought that the M&E sector offered attractive returns, while the M&E expert was looking to invest in real estate. The story highlights the illusion that entrepreneurs and managers sometimes fall prey to, which is best encapsulated in the old English saying—"the grass always seems greener on the other side of the fence." It takes many years of experience in a specific sector to realize how difficult it is to make money in it.

Allen Lee seems to have fallen prey to the same illusion. His business in telecommunications software development doubled revenues every year over a five-year period. Yet, when he met Zhang Kang, he concluded that diversification into an unrelated business—Kangzi Foot Massage Health Care Centers (KFHC)—would offer him higher long-term growth than IT.

Allen considered several factors that would drive growth in a lifestyle business such as foot massage centers: China's high macroeconomic growth resulting in higher disposable incomes, a stable currency, and a large pool of manpower. Yet, one could argue that the same factors could also have a favorable impact on the IT business in the long term. Therefore, the first impression that one gets from reading this case is that Allen has perhaps been too hasty in concluding that investing his money in Zhang's business is more attractive than investing in his own company.

From the viewpoint of Allen and his friends, there are a number of red flags that a potential investment in KFHC should throw up. The first question to ask is whether Zhang Kang is the type of entrepreneur who would feel comfortable sharing the ownership of his business with strangers. Based on what Allen and his friends have seen, it would appear that the answer is "No," since Zhang seems to be a traditional entrepreneur in all respects: He trusts only his family members with key positions in the company, makes all the decisions on his own, and has not shown any willingness to share the ownership of his business to date.

Second, the sector itself faces certain problems: Barriers to entry are low, the concept can be easily replicated, sustaining consistent service quality seems difficult, there are several substitute services, and Zhang's business is facing profitability problems (profitability per outlet is declining at an alarming rate).

Third, would Allen and his friends, who are university educated and working in knowledge industries, share the same values as Zhang, who is uneducated and relies primarily on unskilled labor to drive his business? Zhang's focus on discipline that is akin to a military approach to management might work in an industry where workers have low opportunity

costs, but it is quite different from the IT industry that Allen is accustomed with. Fourth, Zhang's main problem seems to be the lack of managerial talent to drive his company's growth. However, in the business plan prepared by Allen and his friends, their role in the governance of the business seems limited to board positions. Thus, although Zhang seems to be interested in the managerial expertise of the new investors, the business plan suggests that Allen and his friends view themselves as purely financial investors.

The new investors proposed two changes in the business. They recommended changing the layout of the outlets, which they believed would result in a productivity improvement of 7.8%. They also recommended a franchise system, which would allow KFHC to grow faster, without having to invest large amounts of capital. Allen needs to realize that the second recommendation is not going to be easy to implement, for two reasons. First, a prerequisite for franchising is standardization, which is necessary to ensure replicability. This standardization applies not only to the quality of customers' experience but also to every single organizational process, from identifying store locations to recruiting, training, and incentivizing workers to performing all the administrative tasks. This level of standardization can only be achieved through a high level of process orientation, which Zhang does not seem to possess (the fact that he has to make all the key decisions indicates that decision-making processes are poor in the organization). He has admitted that even the quality of customer experience has proven difficult to standardize. Thus, Allen and his friends must be ready to overcome a number of challenges before the business model is ready to be franchised.

In brief, this case raises a number of interesting issues:

1. Why does Allen think that investing in KFHC is more attractive in the long term than doing so in IT, a business that he has vast experience in?
2. What do Allen and his friends think they can contribute to KFHC, beyond financial capital? What is their role going to be in the day-to-day operations of KFHC?
3. Is there a fit between the values of Zhang and those of Allen and his friends? Will Zhang be willing to share the ownership of the company with investors who are not connected to him through either his family or his village in Anhui Province?

COMMENTARY 2

Allen Lee's[5] reflections

Allen Lee met Zhang Kang, the founder of Kangzi Foot Massage Health Care Center (KFHC), for the first time on a flight. These are his reflections, one year after that meeting.

When I made the investment, I was confident that the foot massage business was promising. The other seven investors shared my sentiment. I could have never imagined that things would go wrong. We were going to build the biggest foot massage center in Beijing, but the reality is

[5] This commentary is an interview of Allen one year after he decided to invest in KFMH. His real name has been changed to protect his identity.

that we lost approximately RMB 20 million.[6]

Zhang told us that he owns 200 foot massage health care centers; however, we later discovered that this was far from the truth. "Kangzi" was a famous foot massage brand name. There were more than 200 Kangzi foot massage centers across China. But Zhang did not own them all. At least seven companies were using the Kangzi brand.

However, I believe it was not his fault but ours. We believed that he was an expert in his business. When he asked us for investment, we gave him the money without any hesitation. We trusted him and allowed him to do what he wanted. In the beginning, we gave him RMB 10 million. Later, when he required more money, we provided him with that as well. This happened more than once. We had signed a contract that was only a piece of paper with our names and the amount of investment made by each shareholder.

We rented the fourth floor of a well-known eight-story shopping mall at Saite Plaza, Jianguomen, and paid for a half-year lease. After three months, I called Mr. Zhang to know the progress on interior decoration. His answer was that work was under way. Earlier, he had told us that interior decoration would be over in two months. In addition, he told us that something new was required to be introduced, along with foot massage, at the center. He told us to consider importing the "Secret Stone House," a kind of sauna room, from Korea. For this, he suggested visiting Korea. I was busy at that time, so I told him to check with the other shareholders. They were busy too. Thus, he twice went to Korea alone. And it took almost three months to import the Secret Stone House.

At that time, the six-month lease contract expired, and the property owner raised the rent, so we had to invest more and renew the lease for another six months. Three months after that, the decor was still under way. When I inquired about the reasons, he gave various excuses. Meanwhile, I came to know that he had opened another foot massage center in Shanghai, using the same decor company and material suppliers.

When the decor work was about to finish, he again asked us for money. He said he had invested RMB 1 million, so everyone else also needed to increase his or her contribution. We gave him another RMB 10 million. We were anxious to know when the center would be officially opened. After one year, he was still working on the decor. All the shareholders flew to Beijing to have a meeting. Meanwhile, the lease contract expired again. The property owner asked us for money.

Actually, the owner did not like Zhang as he did not comply with construction regulations. The water leakage at our center soaked shoes worth RMB 40,000–50,000 of an exclusive shoe store. The store owner complained to the property owner about it and asked for compensation. But Zhang refused defiantly. In addition, the decor work made the floor sink. A considerable amount of steel was used, which endangered the building's load capacity. The property owner wrote a letter to us on eight issues, including extensive use of steel and water leakage, saying that he was unwilling to continue the lease. He did not want to talk to Zhang, since he regarded him a man without reason. Following this, we had another board meeting

[6] RMB is China's official currency, whose basic unit is yuan. In 2008, 1 USD = 6.8 RMB.

in Beijing and paid compensation to the shoe store. Within two days, we presented a plan to modify our design by adding more supporting framework. We also promised the property owner to pay the rent within 10 days, in the hope of continuing our lease.

Several months later, everything was ready, but we had no money to start the business. We had to buy TVs and furniture. Zhang borrowed RMB 2 million from a few of my friends and promised them to return the money within two months. The center was opened, but it did not continue for too long. Within one month, the fire department asked us to stop operations. According to regulations, we had to obtain a license before opening the center, which Zhang never did. He explained to us that he had never encountered such a regulation before and Beijing was different in this regard from his province Anhui. We finally resolved the problem and paid RMB 100,000 to obtain the license. In addition, we had to alter the pipelines in accordance with the fire regulations, which involved an investment of RMB 300,000. At last, we were allowed to open the center. Zhang promised me that there would be no problem this time and we would start earning money soon. He apologized, explaining that he did not realize that things are more complicated in Beijing than in his province.

However, in less than 30 days, other authorities in Beijing stepped in saying that we had not complied with one or the other regulation. At this point, all the shareholders became furious and asked Zhang, "Why didn't you obtain all the permits in advance?" Zhang answered, "In my province, we use money [under the table] to solve these problems, but Beijing is different." To top it all, the court sent us a letter stating that we owed RMB 5 million to the decor material suppliers. This came as a surprise to everyone. We had another board meeting in Beijing, and we decided to get rid of Zhang. It was still hard to accept the failure of the project. In total, we lost approximately RMB 20 million in this venture.

The company was declared bankrupt and put on sale. Zhang's accounting books were a mess. I could not figure out any precise number. The company was worth approximately RMB 5 million, which would cover some of the debts that we owed to suppliers and shareholders.

We learned the lesson the hard way. Afterward, we wanted to find who Zhang really was. He had a Mercedes-Benz 600. But was that really his car? We did some investigation and found that he had bought the car on installment. He still needs to pay RMB 40,000 per month; so it was not really his car. Evidence was aplenty that he was actually not as wealthy as he pretended. For example, when we traveled abroad for a golf event outside China, he did not even have a credit card for foreign currency. He borrowed USD 7,000 from one of my friends. After returning to China, he only paid USD 2,000 to him.

We also visited the Kangzi foot massage centers in other provinces. We asked the people employed there, "Is Zhang your boss?" "No" was the answer. "Do you have to pay him money every year?" "Absolutely not." When we asked Zhang about this, we finally got to know the truth. The first Kangzi foot massage center was opened by him in Anhui. As time passed, many staff left the center and opened their own foot massage centers at other locations. As Zhang had not registered the name Kangzi, other owners made Kangzi their centers' name. Many of these Kangzi centers had no relationship with Zhang. In reality, he owned only 10 centers, but many of them did not pay him any money. The managers at Zhang's centers were not well-educated and did not follow contracts and legal obligations.

A few days ago, I was at one of Zhang's foot massage centers and met him. He complained that we did not help him while he was on the construction site all day through. We were busy and had left everything for him to do. I admit, we also made mistakes. As Zhang had limited business education, we felt we could not ask him for a business plan, feasibility report, budget plan, etc. We trusted him as he looked reliable, and we believed that he was an expert in this business. It was, in part, our fault.

I regard this as a precious learning experience. First, we realized never to make any future investments blindly. Second, we must stick to proper procedures while making investments. If we want to open a center in Beijing, we must hire an accounting firm or people with expertise in finance to take control. For any important decision or expense, board members must have a thorough discussion. And for every cent that is spent, there should be a written agreement on how it will be spent. From this experience, we realized that foot massage is not as profitable a business as Zhang had told us. However, if well-managed, it could have generated reasonable profits. We are in negotiations with a company that runs this type of centers. We believe that with their help we can turn this business around.

Note: The Foot Massage Center was still not open four months after writing this case.

CHAPTER 2

Accidental Ventures and Sustainability

CASE STUDY
Wanbo Technology Co., Ltd.[1]

HOU Guotai, the general manager of Inner Mongolia Wanbo Technology Co. Ltd., hesitated as he pondered over the company's annual sales target for 2007. He was sure that the company could increase its annual sales to RMB 150 million from RMB 100 million in 2006. As the New Year had just started, he wondered whether it would be better to consolidate than to expand. However, his major concern was whether he would be able to resist pressure from the board to pursue continued growth at the historically aggressive rate.

Company History

Wanbo was established by a state-owned group in the late 1990s for developing a website on the nomadic cultures of Inner Mongolia. However, the poor performance of the group forced it to stop investing in Wanbo, leaving Wanbo to survive on its own. Wanbo dropped the website, which had shown poor prospects. In 2001, Wanbo became a private company and started dealing in computer hardware components.

Wanbo targeted computer assemblers and retailers in small- and medium-sized cities in China, which sold various computer products. Wanbo supplied them with a variety of computer hardware components based on their needs.

In the beginning, Wanbo sold different categories of branded and generic computer hardware components as well as assembled computers to computer stores. It also became involved in the software development business; however, it was not successful in this business. As its business grew, Wanbo gradually stopped selling products with low sales volume for which it was unable to provide competitive pricing and after-sales services, and instead started focusing on products with large sales volume.

After five years, Wanbo was earning the majority of its revenue from selling and distributing computer hardware components, including CPUs, EMS Memory, keyboards,

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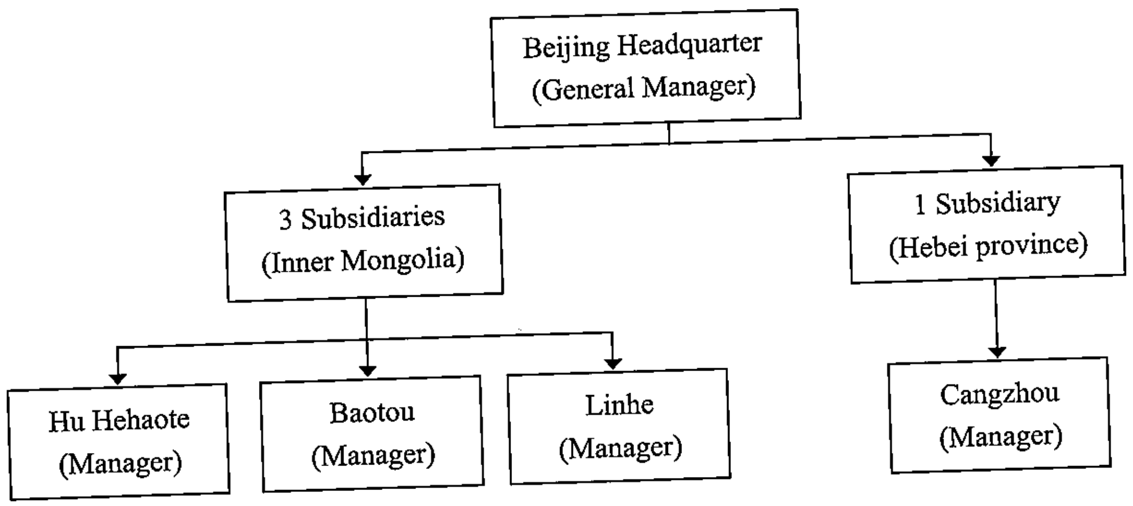
[1] The case was developed by Professor Dr. Per V. Jenster and Research Assistant, Cheng Yiting of the China Europe International Business School with the helpful collaboration of Wanbo Technology Co. Ltd. The case was developed as a basis for classroom discussion rather than to highlight effective or ineffective management of administrative situations. Facts and figures have been disguised to retain proprietary rights. Not to be used without written permission.

screens, hard disks as well as branded computers (mainly Haier).

Wanbo's geographical focus was northern China, especially the Inner Mongolia Autonomous Region and Hebei Province. Initially, the company was registered in Huhehaote, the capital city of the Inner Mongolia Autonomous Region where management was familiar with the local market. During its early years, it opened three stores in Huhehaote. Supported by its geographical proximity, it also sold computer products to the People's Republic of Mongolia (often referred to as Outer Mongolia). As its head office was located in Beijing, Wanbo also performed well in the Beijing market. For example, it was one of the numerous distributors of Intel products in the Beijing district. In 2006, it featured among the top four companies in Beijing in terms of sales volume, with potential to feature in the top two in the following year.

The organization of Wanbo was as follows: headquarters in Beijing and four subsidiaries—one in Hebei Province and three in Inner Mongolia. The decision-making process and control of the logistics were vested with the Beijing office, while client services, physical distribution, and order processing were developed and maintained in local markets. Hou, the general manager, worked in the Beijing office, with four directors each in charge of one sector of products and one director in charge of regional management reporting to him. The management structure outside the Beijing office comprised four managers, each in charge of one of the subsidiaries. Mostly, Hou supervised the subsidiaries through reports from the four managers and the inventory accounts that reflected the business performance of each subsidiary. The number of staff employed was 48: 18 in Beijing, 22 in Huhegaote, and the remaining in the other offices.

Wanbo: Organizational Structure



The rapid growth of the company—from annual sales of RMB 3 million in 2001 to about RMB 100 million in 2006—had left little time for developing the organization and formulating personnel policies, as well as for forward planning and organized training. Hou targeted to keep the working capital within RMB 2 million for 2007, but can we make this according to the financial tables of 2006, where working capital had exceeded RMB 3 million,

he was afraid that the objective would be hard to achieve.

Computer Component Distributor

There are numerous distributors of computer components like Wanbo in the Chinese market. While big city markets are hard to break into, smaller cities provide opportunities to new entrants.

When Wanbo entered the market, computer stores in small- and medium-sized cities were in need of a major supplier that could offer a complete range of products based on their needs. Those computer stores usually sold a variety of products; therefore, segmented purchasing was costly as well as inefficient for them. In big cities, where computer facilities were more accessible to sellers as well as consumers, the situation was quite different. Computer wholesalers distributing computer components could have a less diversified product portfolio; even a company dealing with one major product line could survive well in such markets.

From the very beginning, Wanbo targeted computer stores in small- and medium-sized cities in northern China. Wanbo played the dual role of a major supplier to computer stores as well as a distributor for computer manufacturers. Its business range changed with the needs of the market, which was quite unstable. Wanbo gradually phased out its low-sales volume products and focused on brands that sold in large volumes. It gradually gained a reputation in these markets by responding to the current needs of the computer retailers as well as by maintaining a strong relationship with its suppliers. Many computer manufacturers and agents sought Wanbo's cooperation, especially those interested in exploring the Inner Mongolia market. Thus, Wanbo successfully maintained its sales network and continued to offer a wide range of products and quality services to its clients.

However, several similar players were exploring opportunities in small cities in China. Some of them made a fortune for a while and then disappeared from the market. Hou explained that Wanbo's five years of growth had resulted from strong business ethics and "no-trick" practice norms, without which it would have been difficult for Wanbo to retain its clients.

Until the beginning of 2007, Wanbo had been making good profits as compared to similar firms. However, there were concerns about future risks: once profits from the general dealer became smaller, the situation for small distributors like Wanbo would become tougher. With the prospects of slimmer margins, Wanbo would be well advised to be prepared in advance.

Determined to strengthen Wanbo's role as a distributor in small cities in northern China, Hou was also thinking about setting up a computer (assembly) business instead of merely being a component distributor. Hou explained that although DRAM sales were not bringing in huge amounts of revenue for the company, it intended to retain this business for the time being.

Finance and Personnel

Wanbo had one finance department in Beijing that was in charge of all the financial operations. Hou evaluated the subsidiary's sales performance, primarily by checking the accounts. However, the staff in finances was often a step behind in updating accounts related to purchase, sales, and inventory. In addition, subsidiaries did not feel the urge to settle overdue payments until Hou checked the accounts. The accounting staff was unable to provide clear accounts of purchase, sales, inventory, and financial analyses of product and customer profitability. Financial controls within the company were not working well; a loose control was maintained on credit and cash flow.

Before 2006, Wanbo had faced difficult times at the beginning and end of the year. The company encountered capital shortages when paying creditors because of the overdue debts of tardy customers. The situation improved in 2006; Hou explained why, "There were several reasons for the financial improvement. Our suppliers allowed a longer term of payment; temporary loans were available from other related companies; market expansion into People's Republic of Mongolia and years of sales growth resulted in accumulated funds at the company's disposal."

Hou had the four subsidiaries report to him as he conveyed the company's decisions and objectives to the local staff via the four managers. He was not sure whether the local staff was loyal to the company's decisions and if they were motivated enough to provide better performance. Until 2007, the company had not provided any organized training to its staff.

Despite his concerns, Hou felt comfortable that a sales growth of 40–60% would be possible in 2007: "And who knows, these opportunities might not return any time soon?"

Table 1: Key Financial Data (2006), in RMB yuan*

Sales	Cost of Sales	Profit	Margin
105,347,877	103,558,330	1,789,547	1.77%

Table 2: Annual Sales (2004–2006), in million RMB

	2004	2005	2006
Sales	10	30	105

Table 3: Number of Employees (2004–2006), in person

	2004	2005	2006
Beijing	5	10	24
Subsidiary	15	13	26
	20	23	50

* Data are provided by Wanbo Technology Co. Ltd.

Table 4: Number of Employees by Department and Location (2006)

	Sales	Administration	Finance	Logistics	Total
Beijing	12	4	3	5	24
Hun He hate	8	3	3	2	14
Baotou	4	1	0	0	5
Line	2	0	0	0	2
Changzhou	3	0	0	0	3
Total	29	8	6	7	50

CASE COMMENTARIES

COMMENTARY 1

Tony Koo

Assistant Dean of Global Management Education Institute, Shanghai University;

Jiao Hao

PhD Candidate of Fudan University

Through continuous efforts, Wanbo Technology Co. Ltd. transformed itself from a Web business into a computer hardware dealer with an annual turnover of more than RMB 100 million. Hou of Wanbo chose the right strategy and market positioning, focusing on computer hardware sales in small- and mid-sized cities in northern China, especially the Inner Mongolia Autonomous Region and Hebei Province.

Wanbo is now confronted with two questions: (1) whether to expand geographically, that is, should Wanbo turn to mid- and large-sized cities? (2) whether to expand business, that is, should Wanbo move from a computer hardware dealer to a complete computer manufacturer?

Wanbo's competency and knowledge is not strong and convincing enough for it to take higher business risks. However, it can consider enlarging its market by expanding to mid- and large-sized cities. Nevertheless, this strategy is recommended under the assumption that Wanbo keeps computer hardware business as its core business and makes use of its core competitiveness to gain market share in mid- and large-sized cities. Wanbo should not expect most local companies to make the mistake of irrational diversification as its competitors are not yet ready for diversification.

COMMENTARY 2

Dwayne Canfield
Director, Asia Platform Definition Center, Emerging Markets Platform Division, Intel Corporation

Wanbo and Hou have enjoyed considerable success during the past five years, as the economy in China has skyrocketed and the PC business in China has become the second largest in the world. This kind of growth provides a wonderful opportunity, but also often masks fundamental flaws in the strategies and execution of companies involved. When your company is enjoying phenomenal top line growth and profitability, it is hard to imagine that you have issues that will eventually threaten your business, and they are particularly difficult to identify if your reporting mechanisms are weak. Hou finds himself in this situation.

First, consider the history of the PC industry in the US. During the late 1980s and the early 1990s, the industry witnessed rapid growth, with many small PC companies and component distributors enjoying growth and profitability. Many of these companies have now ceased to exist: they were swallowed up during the consolidation phase or moved into adjacent businesses such as value-added services. Of the companies that filled the pages of the PC magazines with advertisements at the time, only Dell remains as an independent entity.

In China, the PC business has grown quite differently because of the different conditions. A visit to a PC mall in any major Chinese city will show a collection of small companies selling components, peripherals, and computer integration services; or reselling branded PCs from larger suppliers such as Lenovo, Founder, or HP. Two conditions helped create this environment: first, it was relatively easy to enter this market and an individual required a relatively small amount of capital to start a small PC integration company. Second, the market was extremely price sensitive and therefore focused on integrated desktop systems that allowed selection of low-cost components and custom loading of pirated operating systems and software. This helped propel the need for a diverse group of component distributors who could provide for the large number of integrators in the market.

In view of this, Hou has several strategic issues that he must resolve in order to continue to grow profitably in this business. He has financial challenges, growth issues, strategic market changes, and personnel issues that must all be addressed. He has obviously demonstrated the ability to retain profitability while growing rapidly, but it seems like it involved some good fortune on top of sound business philosophy and execution.

Financially, it is critical that he gets his reporting and analysis under control. It seems that currently the reporting information is too delayed and too incomplete to serve as a management tool in guiding deal terms, sales team focus, purchasing needs and trends, and by the time any issues related to demand or supply is reported, it is too late to take action. He cannot assume that he can continue to hold inventory turns to such a low number, or count on continuing to receive liberal credit from suppliers. He is also attempting to hold working capital at an aggressively low amount, and if either inventory turns or the credit situation changes, he will face cash flow issues. Customers who cannot get the parts they need will soon turn elsewhere to avoid losing business themselves.

Regarding growth, it is unlikely that he can or should try to sustain the growth rate Wanbo has enjoyed recently. On top of the working capital challenges mentioned above, Hou has more than doubled his staff size in the last year and has certainly not fully integrated this growth into Wanbo's operations. It is tempting to focus on top line growth; however, he is likely to drive a greater return in profitability by investing his energy in operational improvements instead. Even a modest increase in the profit margin to 2.5% will increase profitability more than a 40% top line growth at the current margin.

From a personnel perspective, he needs to focus more on the current activities of the staff, and use improved financial reporting information to focus on the skill development and training needs of his sales force. The kind of new employees he mentions are not only looking for financial rewards but also to hone their skills. He obviously has some business, strategy, and relationship skills that would be valuable to his new sales employees, and his organization is still small enough for him to deliver this training on his own. It could serve to strengthen the familial feeling, and allow him to not only gauge the skills of his management team but also identify future leaders for his teams. With growth, it is important to be visible, and it seems as if he has not been there the last year.

Finally, Hou has some strategic market issues to tackle. The business environment that led to his rapid growth is in the process of changing; the PC business is moving away from desktops toward mobile systems, the large multinational PC companies are taking China seriously, and the larger local PC companies are committed to grow deeper into the smaller markets in China. Some of these trends could create opportunities for his business or could pose threats, depending on how he responds to the situation. Additionally, consolidation is happening. He should consider if there will be a time when he would seek to consolidate with other similar businesses to create greater scale or pursue acquisition by a larger distributor who is not strong in his region of operation.

I would not recommend Wanbo to enter the PC assembly business at this time. It could make the company compete with its customers and, maybe, with its key system suppliers such as Haier. If Wanbo's integration customers are looking to buy at higher levels of integration for convenience, it should consider the option of strengthening its distribution relationships with system suppliers to fulfill that demand. Also, the PC integration business would further challenge the company while it addresses other considerable challenges and may also require funding and building capabilities that Wanbo currently does not have.

As Andy Grove famously said, "Only the paranoid survive," and the case that nearly 20 years with Intel has helped hone the ability to identify problems suggested. However, it seems reasonable to end with the considerable strengths that Hou and Wanbo have. Wanbo has increased its year-over-year revenue fivefold while retaining profitability, has a top 3 position in the competitive Beijing market in sight, and a leader in Hou with proven business savvy and relationship skills. The challenges facing Wanbo can be tackled with increased focus and do not require any significant strategy shifts, at least not yet. However, if it continues to operate in the same way, it seems inevitable that Wanbo will eventually face a business situation that it is unprepared for, which will cause it to fade as rapidly as it has grown.

CHAPTER 3

When the Dream Vanishes: Financial Component of a Successful Venture

CASE STUDY
Gao Weidong: A Milestone in an Entrepreneur's Life

Ms. Wu,[1] I need your help to find a solution to a problem my business is facing. My company is in a critical state. The funny thing is that I have a very successful business but I recently made some decisions that have seriously affected my company's future. I am a creative person and have a very active mind, but I must admit that I am not good at managing an office. Let me tell you my story and I hope you can give me some advice.

Personal History

I was born in 1969 in Baoshan, Shanghai. When I was at school, a question haunted me all the time: How could I become an outstanding person? Then came a turning point in my life. At that time, high jump was popular in our school. I was a short boy, but I decided to try it anyway. With this determination, I bought a self-learning book on high jump and practiced by following the instructions. I became an expert in high jump in the first year of my high school. I could jump to a height of about 1.7 m when my own height was 1.5 m. At a school sports competition, I came second in high jump, beating even those trained in special sports schools. With this prize, I suddenly became extremely popular in school. I will never forget that.

My parents did not encourage me to get into business, but the example of their lives did. As both were teachers, they devoted their lives to education. However, upon retirement, the only thing they owned was a small apartment. I always felt that they did not have a worthy life because they got so little after so many years of effort. My father wanted me to be a teacher like him but I was not satisfied with the idea of making a salary of only a few hundred RMBs[2] a month. I already had the attitude of a businessman. While at the university, before the New Year holidays, I used to purchase some greeting cards from wholesalers and then sell them moving from door to door in the dormitory buildings. I was able to earn RMB 80–100 in this way, which was big money for a student. At that time, I was also vice-chair of the Student Union, responsible for administering the funds that the union received from the university. With that money, I could not only organize student activities but also save some for the

[1] Wu Hanning is a consultant. This case describes her meeting with Gao Weidong, founder and CEO of California Vinery.
[2] Renminbi (RMB), literally "the people's money," is China's official currency. In 2008, 1 dollar = 6.8 RMB.

benefit of the different branches under the union. So I always thought that I could be a good businessman.

Upon graduation, I found my first job as a salesman in Apollo Company. Apollo was famous in the tonic industry in the early 1990s. At that time, its marketing strategy and advertisement designing were rated first class in China. The company was recruiting about 20 salespeople in east China, for which about 1,500 college graduates were applying. Fortunately, I was recruited. It was 1991. I learned much about sales in this company.

I first worked as a salesman in Zhejiang Province. Within a year, I helped increase sales in the province from less than RMB 5 million to about RMB 100 million. I was soon promoted to assistant manager and then general manager in the East China Office as a result of my outstanding performance. Later, I decided to leave Apollo because I was not satisfied with the changes in the top management. Then I had an annual income of about RMB 100,000.

I was jobless between 1993 and 1994. In 1994, I joined a Taiwanese company called Tingyi, where I worked under a Taiwanese manager responsible for east China. There were three people working in the Shanghai Office including this Taiwanese manager. We generated sales worth RMB 80 million per month for Kangshifu instant noodle. I learned much about sales from this Taiwanese manager. I left this company after nine months when a new challenge came to me.

An opportunity prompted me to work as an agent for a well-known domestic distillery, Kongfuyan, whose annual sales in the country was estimated at RMB 1 billion. One of its distributors had invited me to dinner. He told me that he was impressed by my achievements in sales. He then complained that his company's sales in Shanghai were below RMB 300,000. He asked me about my annual income in Kangshifu, which was about RMB 150,000, and told me that he would pay me RMB 1 million to promote the sale of Kongfuyan in Shanghai. At first I thought it was a joke. Then, within the following week, he gave me RMB 200,000 in cash as well as a mobile phone which then cost 10 times of what it costs today. He asked me to organize a marketing team within two weeks. I hesitated at that moment because I did not want to quit the job at Tingyi. But I finally decided to accept the challenge. I started my business in a simple office and organized a team of young salespeople. It was my first company, Donghong. At the beginning, we did not even have a tricycle. The hardest time was when the shipping workers were on holiday, and I had to ride a tricycle myself to ship the bottles. Just imagine, earlier I was the sales manager of a big company and now I was riding a tricycle. But I did not mind it because I was my own boss. I gave distributors an attractive commission on sales to stimulate their enthusiasm. I also paid much attention to supermarkets such as Hualian, Lianhua, and Nonggongshang. During 1994–1995, supermarkets were not popular in Shanghai and not many companies did business with them. I was one of the first to give credit to supermarkets. That required funding but I was lucky because a big SOE[3] offered to finance my business. Our supermarket sales produced very good results. The highest annual sales that I achieved for Kongfuyan in Shanghai stood at RMB 30 million.

[3] SOE stands for State Owned Enterprise.

I also started to work as an agent for other companies. I helped four different brands of liquor and wine, including Kongfuyan, Great Wall, and Grand Dragon, to achieve the highest market shares in Shanghai. Take the Grand Dragon wine for example. Before I became its agent, it had recorded annual sales of RMB 70 million in the whole of China. After my first year with the company, its sales in Shanghai alone was worth RMB 5 million, RMB 15 million after the second year, and RMB 20 million after the third year. Grand Dragon has benefited greatly from extending the business model I applied in Shanghai to the whole of China. The Great Wall wine reported sales less than RMB 3 million in Shanghai before I took over the brand in 1998–1999. In 1999, it had the third largest share in the Shanghai market. Currently, their overall sales in China are RMB 500 million.

Why I started California Vineyard

I began to seriously consider setting up my own brand after I had taken four different brands of liquor and wine to leading positions. I thought of myself as the Milutinovic[4] of the wine industry. Milutinovic was the highly successful coach of the Chinese soccer team. Much in the same way he led the Chinese team to the World Cup, I was going to lead California Vineyard to the wine "World Cup."

I registered California Vineyard Winery in July 2000 in the city of Suzhou. I came to Suzhou because of the preferential policies, cheaper land price, and, especially, the support of the local government. I chose the name California Vineyard myself. As California is world famous for producing wine, I thought that the word California would lend fame and add value to my own wine. It was advertising without having to spend money. Also, the word "vineyard" suggests top-quality wine. My winery rolled out the first bottles of wine in the beginning of 2001.

Then, I decided to stop representing all the other brands and start concentrating on my own California Vineyard. It was a great risk that I was taking as the annual sales of all those brands for which I acted as an agent were close to RMB 40 million and I had been making an annual profit close to RMB 4 million. I was a very successful agent and all the wine distributors in Shanghai knew me.

I will never forget that time. I thought it was right to change my business, but many people could not understand it. Then things started to happen in a way that I did not expect. I faced the most difficult time of my life from 2000 to 2001. It seemed that I was besieged on all sides. All those companies that were once my associates and friends became my enemies. They began to undermine my business, luring away my employees with higher salaries. They even offered my drivers double the salary I paid them. A large number of my middle managers left the company to join other wineries for higher salaries. I felt that I had trained all those managers to become my competitors. Of course, losing so many employees was also my fault. I had concentrated on selling and did not pay much attention to management, employees, and,

[4] Bora Milutinovic was the chief coach of the Chinese soccer team at that time.

in particular, communication. I did not quite understand the needs of my employees, neither did they understand me. All the middle-level employees, including sales, marketing, and purchasing personnel, left my company. I should have communicated more with them about my plans and about the new company. I should have also combined the company's future gains with their benefits.

In addition, I was too focused on immediate success at that time. If I had been more prudent, I should have adopted my new business gradually. I could have, in fact, continued as an agent for other brands while taking care of my own brand.

The Chinese Wine Market

The most important factor for success in this industry is marketing. Customers care about brand, price, packaging, quality, and taste. California Vineyard is not well known and it is not possible for me to invest in large-scale advertisement all over China. What we are trying to do is a kind of brand-building without advertising. The name is easy to remember. Once you have seen it or tasted it, you will not forget it. Wine prices in China are about RMB 30 per bottle. My company also offers top-quality wines priced at RMB 200–300. Actually, there is a market for high-priced wine, but domestic wineries do not dare to tap this market. So the key is how to grasp this high-price market. My biggest competitors are brands such as Dynasty, Zhangyu, Great Wall, Grand Dragon, Shangri-La, Yunnan Red, and Huangxuan.

Organization

My organization is very simple. On top are the board of directors and the CEO. Under them are the three sales companies and my new plant in Suzhou. The three sales companies are located in Shanghai, Suzhou, and Nanjing, and they are completely autonomous. As the CEO, I also act as general manager for the Shanghai Sales Company. The finance department is located at the plant and centralizes the finance of the three sales companies. I want to have clear information about the cash flow, sales, and balance sheets of the three sales companies. We do not have an HR department; each local general manager takes care of its human resource. I control the finances of the group, but I let the sales companies control their own sales, sales team, HR, sales objectives, company culture, etc.

Our strength lies in quality, packaging, the California Vineyard brand, and the six-year experience—with both successes and failures—in the wine industry. Our weakness is that we are a new company; therefore, we face difficulty in getting finance. We need money for the plant and for marketing, but we do not have much money. Therefore, we have to secure our position and market share first. Our second weakness is that our brand is not strong enough. We are trying to build our brand, but we do not have the finances to invest in brand-building exercises. The third weakness is the lack of management talent. Unfortunately, we cannot afford to give salaries of RMB 100,000–200,000 a year. I now recruit college graduates and train them. I am also trying to combine their benefits with the future of the company. The most important thing for me is to retain them.

China's inclusion in the WTO is a threat as well as an opportunity. With so many new

brands entering China, in addition to the existing brands, there will be a wine battle in the next few years. There will be a revolution in the market but I am not afraid of competition. My biggest problem is finance.

Why I set up this plant

Before I decided to build a plant in 2000, I came to know that I needed only RMB 4 million to build it and that the land was not expensive. I first bought the land and then built the plant. So far, I have invested over RMB 10 million in it. I thought that people would not believe in my company if I did not have my own plant. Moreover, it would have been difficult for our salespeople to promote our wine. On the other hand, there was the government administration that welcomed foreign companies but was very unsupportive to me. To set up my plant meant that I had a solid company and could overcome those obstacles.

The plant construction increased my costs and drained all my cash. I need to generate more cash by increasing sales but that is a vicious cycle. To generate enough cash to pay for the plant, I need to increase my market share, but to increase the market share, I need funds, and whatever funds I had are invested in the plant. For instance, supermarkets do not pay cash, so increasing my sales to them means that accounts receivable would also increase. The normal payment term for supermarkets is 60 days but some delay payment for 75 days or later. I cannot count on banks. Banks in China do not easily give loans to small- and medium-sized companies. I can get money from my accounts receivable but only at their maturity. Moreover, it is impossible to sell my fixed assets.

Many people are helping me now. One of my old classmates works for the Suzhou City government. He helped me a lot when I was building the plant. My friends in the wine industry also supported me and gave me many suggestions. When Lianhua supermarket delayed payments for too long, one of my classmates used his contacts to make them pay. Moreover, within the company, I got considerable support from my employees. As I have told you before, the middle level left me but my lower-level employees stayed on. Some of the storehouse employees worked overtime for free and slept only 5–6 hours a day. Some salesladies, aged about 20 years, sacrificed their free time to help in the storehouse during the busiest time of the year. Some employees even offered to give up their bonuses to help me when the cash flow was at its worst.

Financial Situation

When I started to work as an agent, I had a personal deposit of only RMB 400,000. In 1995, I got in touch with an SOE. They saw great potential in my business and agreed to finance me. They lent me money and I gave them an annual interest in return. The highest percentage was 20% and the lowest was 8%. But later, the SOE stopped financing me due to a ban from the State Council and withdrew all its money. That was in 2001 when I had already started building my plant. Within 45 days, RMB 2 million was withdrawn from my account. It was a terrible time for me. I had never felt so tight for money. Earlier, I could get enough money with just a phone call to the SOE. I could get as much as RMB 5 million without a problem and without having to deal with banks. This withdrawal of money hit my business hard. The plant needed money, and so did the marketing initiatives, but the SOE claimed its money back. If only I had been informed about this ban before setting up the plant, I would not have invested so much money in it.

I did not have a good construction budget or a professional who could help me with that when I started the construction of the plant. I did not even take water and electricity into consideration, and I realized much later that these were huge cost factors. I wanted my plant to be modern, like a joint venture. I wanted it to be the best. I even had air-conditioning and a background music system installed.

Then, all those rumors started. Many people who knew me started spreading baseless rumors. I am worried by those rumors. They say that my brand will not do well, that the company does not have enough money, and all the money is buried in the plant. These rumors can affect my credit among suppliers. Normally, suppliers allow a credit term before payment. If they are affected by the rumors, they will lose confidence in us and may change their conditions. They can claim their money back before the payment is due. It would also be impossible to get experienced and devoted people to work for me in such a circumstance. I can tell you that being an entrepreneur is not easy. I am not afraid of challenges. I have a great talent for marketing and understand the wine market in China well. I hope that I can be very successful when I am still young. After that I want to settle down and enjoy my life.

Can you help me, Ms.Wu?

Exhibit 1: Consolidated Balance Sheet (in CYN thousand)

December 31, 2001

	Beginning of Year	End of Year
Assets		
Current Assets		
Cash	2,728.0	2,906.2
Accounts receivable	0.0	1,119.1
Advances to suppliers	575.9	1,264.5
Other receivables	1,555.1	1,912.8
Inventories	1,526.1	3,052.3
Prepaid expense	4.4	0.0
Total current assets	6,389.5	10,254.9
Long-term Investments		
Long-term investments*	0.0	300.0
Fixed Assets		
Fixed assets-cost	21.8	778.7
Less: Accumulated depreciation	0.5	30.3
Fixed assets-net value	21.3	748.4
Construction in progress	0.0	4,517.7
Total fixed assets	21.3	5,266.1
Intangible and Deferred Assets		
Total intangible and deferred assets	0.0	0.0
Other Assets		
Other long-term assets	161.2	77.5
Total Assets	6,572.0	15,898.5
Liabilities and Owner's Equity		
Current Liabilities		
Short-term loans	1,392.4	1,968.0
Notes payable	1,209.4	0.0
Accounts payable	204.3	642.1
Advances from customers	533.8	806.7
Other payables	802.4	373.6
Accrued payroll	2.0	0.0
Taxes payable	–84.2	6.3
Other current liabilities	0.0	1.1
Total current liabilities	4,060.1	3,797.8
Long-term Liabilities		
Total long-term liabilities	0.0	0.0
Owner's Equities		
Paid-in capital	2,523.9	7,730.6
Undistributed profit	–12.0	4,370.1
Total owner's equity	2,511.9	12,100.7
Total Liabilities and Owner's Equity	6,572.0	15,898.5

* Here it refers to the registration expense for Suzhou Sales Company.

Source: Company reports

Exhibit 2: Consolidated Income Statement (in CYN thousand)

December 2001

	Current Period	According to Current Year
Sales	1,302.1	14,993.5
Less: Cost of sales	757.1	8,777.7
Selling expense	2.8	1,047.9
Sales tax and additional tax	1.1	5.0
Income from Main Operation	541.1	5,162.9
Less: General and administrative expense	123.3	832.2
Financial expense	20.4	–72.0
Operating Income	397.4	4,402.7
Less: Non-operating income	0.0	20.8
Add: Adjustment to prior year's income and expense	0.0	0.2
Income before Tax	397.4	4,382.1

Exhibit 3: Consolidated Balance Sheet (in CYN thousand)

February 28, 2002

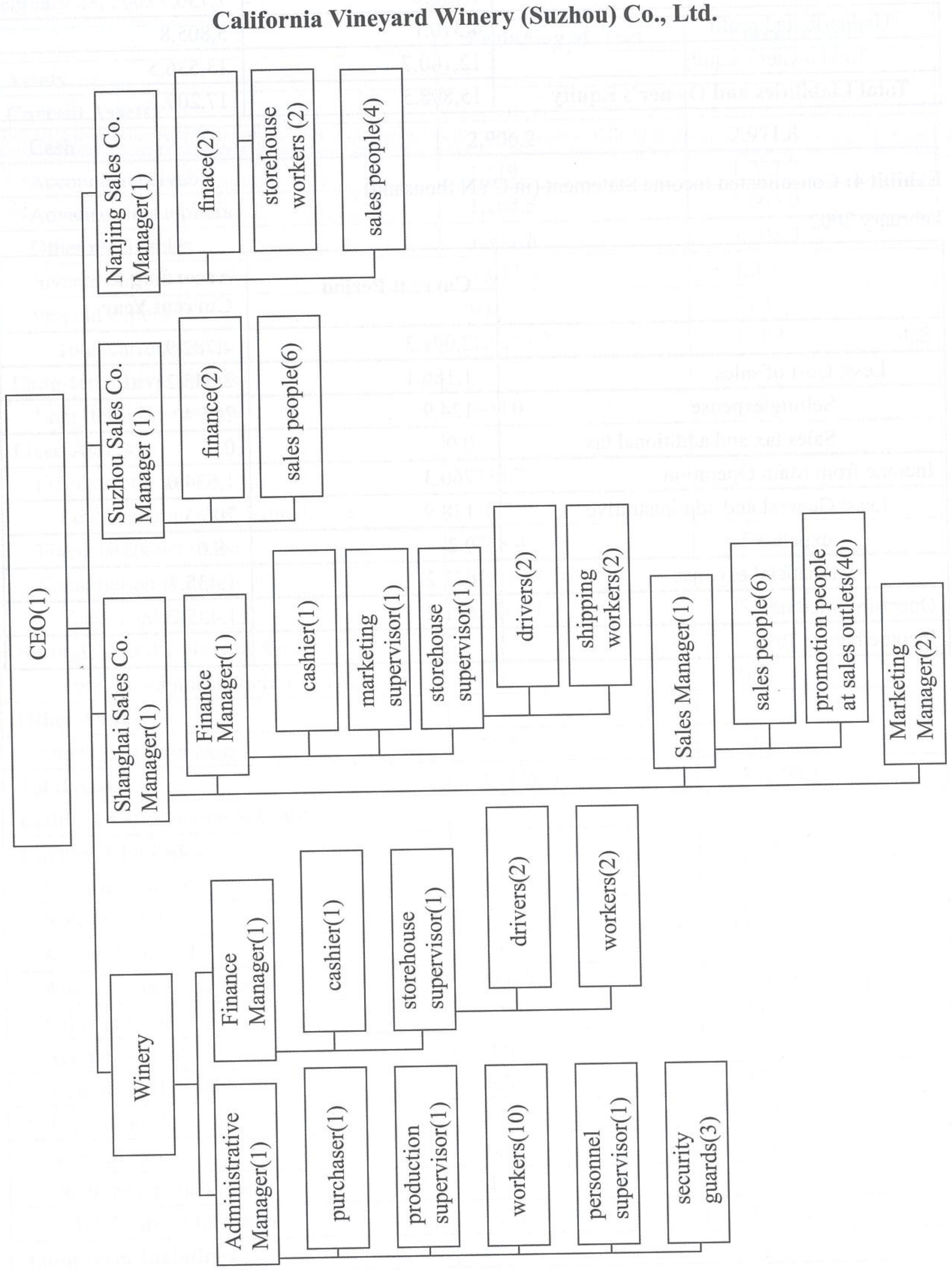
	Beginning of Year	End of Period
Assets		
Current Assets		
Cash	2,906.2	2,971.8
Accounts receivable	1,119.1	1,722.7
Advances to suppliers	1,264.5	1,065.0
Other receivables	1,912.8	2,298.9
Inventories	3,052.3	3,004.4
Prepaid expense	0.0	29.3
Total current assets	10,254.9	11,092.1
Long-term Investments		
Long-term investment	300.0	300.0
Fixed Assets		
Fixed assets-cost	778.7	831.7
Less: Accumulated depreciation	30.3	47.7
Fixed assets-net value	748.4	784.0
Construction in progress	4,517.7	4,944.5
Total fixed assets	5,266.1	5,728.5
Intangible and Deferred Assets		
Total intangible an deferred assets	0.0	0.0
Other Assets		
Other long-term assets	77.5	88.5
Total Assets	15,898.5	17,209.1
Liabilities and Owner's Equity		
Current Liabilities		
Short-term loans	1,968.0	1,968.0
Notes payable	0.0	60.0
Accounts payable	642.1	654.4
Advances from customers	806.7	650.0
Other payables	373.6	318.0
Accrued payroll	0.0	16.8
Welfare fund payable	0.0	11.3
Taxes payable	6.3	–9.9
Accrued expense	0.0	4.0
Other current liabilities	1.1	0.0
Total current liabilities	3,797.8	3,672.6
Long-term Liabilities		
Total long-term liabilities	0.0	0.0
Owner's Equity		
Paid-in capital	7,730.6	7,730.7
Undistributed profit	4,370.1	5,805.8
Total owner's equity	12,100.7	13,536.5
Total Liabilities and Owner's Equity	15,898.5	17,209.1

Exhibit 4: Consolidated Income Statement (in CYN thousand)

February 2002

	Current Period	According to Current Year
Sales	2,071.3	4,782.9
Less: Cost of sales	1,186.1	2,943.2
Selling expense	124.9	205.4
Sales tax and additional tax	0.0	0.3
Income from Main Operation	760.3	1,634.0
Less: General and administrative	138.9	206.3
expense	0.2	–8.0
Financial expense	621.2	1,435.7
Operating Income	621.2	1,435.7
Income before Tax		

Exhibit 5: California Vineyard Winery (Suzhou) Co., Ltd.



* Figure in brackets indicates the number of staff for each position.

Exhibit 6: Gao at the Gate of His New Plant

Exhibit 7: Wine Selection

Exhibit 8: View of the New Plant

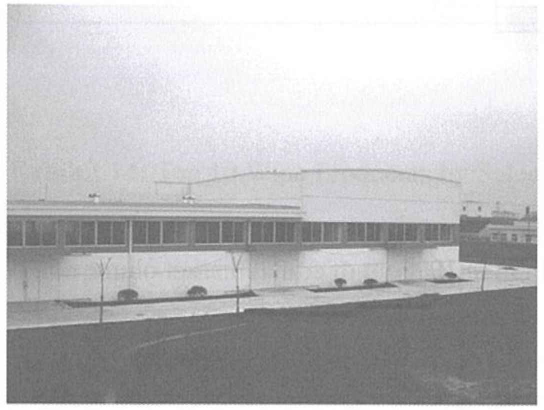
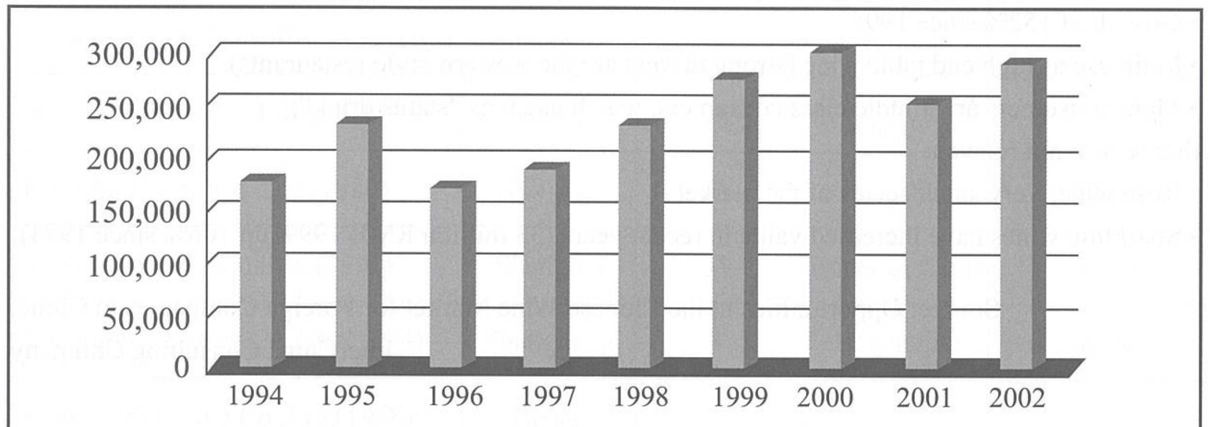


Exhibit 9: View of the New Office Building

Exhibit 10: Wine Production Volumes (h l,000) 1994–2002



Source: China Food Statistics Year Book, China Alcohol Industry Association

Exhibit 11: Main Consumption Areas

Exhibit 12: Market Segmentation

Predominance of White Wines

- Total retail sales volume of white wines reached 1.6 billion in 199, out of a total market olume of 2.5 billion.
- Growth of 108.8% since 1994.
- Main Consumers are Chinese women.
- Also used now as basis to produce Red wine.

Red Wine: growing importance

- Retail Sales to 888 million RMB in 1999.
- Growth of 152% since 1994.
- Main use as high end table wine (strong drivers are the western-style restaurants).
- Main consumers are middle class consumers, which use it as "status drink".

Other wines: not relevant

- Rose wine, Very small sector of the market
- Sparkling wines have increased value in recent years (33 million RMB 1999, up 106% since 1994)

Source: Opportunities in the Chinese Wine Market for Foreign Companies in China, InterChina Consulting Company

Exhibit 13: Domestic Production

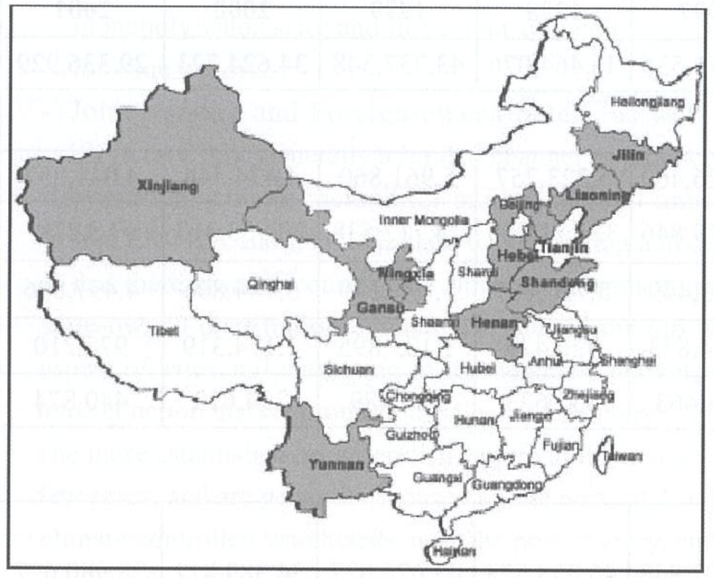


Exhibit 14: Top 10 Wine Producers by Sales Volume (2000)

Company(year of establishment)	Location	Nature of Investment	Rrand	Total Sales (Million RMB)
Changyu Group Co.,.Ltd.(1914)	Shandong	State-owned	Chanyu	1,665.64
Dynasty Wine Co.,Ltd.(1980)	Tianjin	JV	Dynasty	541.51
The Great Wall Wince Co.,Ltd(1985)	Hebei	JV	Great Wall	455.82
Weilong Grape Wine Co.,Ltd.(1983)	Shandong	-	Weilong	233.97
Huaxia Winery Co.,Ltd.(1991)	Hebei	JV	Huaxia-Great Wall	204.78
Fengshou Wine Co.,Ltd.(1980)	Beijing	JV	Fengshou	97.67
Shenma Winery Co.,Ltd.(1991)	Shanghai	JV	Imperial Court	62.96
Baiyanghe Winery Co.,Ltd.(1994)	Shangdong	-	Baiyanghe	60.30
Lankao 999 Wine Co.,Ltd.(1958)	Henan	-		57.91
Yunnan Red Wine Group(1997)	Yunan	-	Yunnan Red Wind	55.08

Source:China Market Yearbook

Exhibit 15: Wine Import 1994–2001 (liters)

Year	1995	1996	1997	1998	1999	2000	2001
Total	738,503	5,139,106	35,371,536	46,464,076	43,737,348	34,624,723	29,336,929
Country:							
France	412,021	2,438,339	12,226,460	5,223,257	5,961,860	4,474,544	4,041,857
Spain	6,339	990,996	14,919,846	32,121,060	28,712,538	20,753,313	7,8,278
Italy	13,209	122,246	1,633,449	5,710,467	5,892,140	5,744,806	4,497,896
USA	18,998	523,367	1,044,873	426,479	1,133,895	1,174,319	975,210
Australia	32,381	153,814	1,48,463	432,623	539,489	394,613	440,874
Products:							
Wine (Red+White) (Liter)	662,346	5,001,735	34,902,948	46,358,573	43,626,827	34,389,812	28,980,627
Sparckling wine(liter)	76,157	137,371	468,588	105,503	110,521	234,911	356,302

Source:China Customs Statistics

Exhibit 16: Distribution in the Domestic Market

- Distribution is characterised by a rapidly improving but still inadequate transportation infrastructure, geographically fragmented markets, lack of skilled and reliable personnel, a chaotic distribution system evolving from the previous state-run system and heavy restrictions on foreign involvement in distrobution.
- The previous state-owned distribution metwork was structured per sector and in decreasing levels (nationa, provincial, municipal and down). This system has completely disintegrated and what exists new is a chaotic conbination of the remnants of the state system, and new (mostly private Chinese) companies. There is a bewildering array of capabilities, and enormous differences in geographic reach, financial strength and functional competence.
- State owned distributors are the result of the former local distribution monopolies and they form the majority of locals distributors nowadays. They usually inherit many disadvantages that foreign companies must learn to deal with, such as lack of market transparency, minimum inventory control, very limited geographical reach, poor financial basis, etc...
- While wholesales markets are a key element for the distribution of the goods in China, both on the formal and informal channels, they usually break the chain of product tracking. In China there is a lack of information on retail outlets, pricing, sales figures, etc... that at the end makes it very difficult for a FIE to improve its distribution and retail strategy. Also, the lack of control in the Wholesalers level allows many counterfeiters to introduce copies of the goods into the market.

- Traditionally, wine entered the market via two channels, namely:
  - China National Cereals, Oils & Foodstuffs Import and Export Corporation (CEROILS), the state monopoly wholesaler and distributor of alcoholic beverages. Traditionally it is the main channel for wine imports.
  - Joint Venture and Foreign-owned hotels, as well as duty free stored under China Travel Services(CTS). Generally a limited channel as products are restricted from general distribution.
- However, the current method for most successful importer/distributors is to obtain a sub-license from CEROILS and then to handle the marketing and distribution themselves. The main advantage is that there is more control over brand development, proper handling, and storage compared to a state-owned distribution company. A few of the top wine importer/distrbutors engage in every aspect of sales and marketing in the domestic market, including climate-controlled warehousing, trade eduction,market promotion, sales, and delivery.
- The more established importer/distributors in the market have become quite sophisticated in the last few years, and are generally focused on the ports of Tianjin and Shanghai. Some companies employ climate-controlled warehouses near the port of entry, and keep the wine in bond until needed in the local market. This reduces the up-front costs for the distributors as duty is not paid until the wine is released from the warehouse.
- With the increased demand in the market, foreign players tend to put their efforts more in the general retai sector, such as supermarkets, instead of the traditional channel-hotels and luxurious entertainment places.

Source: Opportunities in the Chinese Wine Market for Foreign Companies in China.
InterChina Consulting Company

Exhibit 17: Top 10 Wholesalers of the Sector (2000)

Company	Location
China National Sugar & Alcohol Group Corp.	Beijing
Shanghai Sugar, Cigarette & Wine (Group) Co.,Ltd.	Shanghai
Jiangsu Sugar,Cigarette & Wine Co.,Ltd.	Jiangsu
Shenzhen State-Owned Duty-free Commodities (Group)Co.,Ltd.	Guangdong
Zhaoqing Blue Ribbon Distribution Co., Ltd.	Guangdong
Shehong Tuopai Distribution Co., Ltd.	Sichuan
Xinxing Distribution Co., Ltd.	Shandong
Shenzhen Qingdao Beer Distribution Co., Ltd.	Guangdong
Langfang Zhongtang Huayang Industry Co,	Hebei

Source:China Market Yearbook

Exhibit 18: Market Trends

- There is a trend of slower growth for imported wines, due to:
  - Increase of domestic production: domestic companies, short of red wine but with strong resources of white wine are mixing both and using chemicals to produce their own red low end brands of red wine.
  - China's national wine output will double in the next 15 years.
  - Also smuggling is a threat to foreign importers.
- Market siza is forecasted to reach 4 billion RMB in 2004, growing 6% since 1999.
- Red Wine remains the fastest growing segment.
- Increased opportunities for in vestment, distribution and trade after WTO accession - according to China's WTO commitment for tariff reduction, wine import dutyd will be reduced by 10% each year until reaching the final rate of 14% in 2004

Source: Opportunities in the Chinese Wine Market for Foreign Companies in China.
InterChina Consulting Company

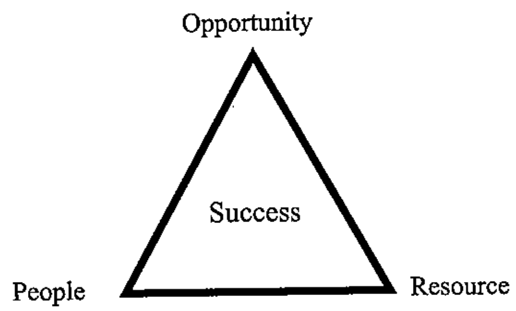
CASE COMMENTARIES

COMMENTARY 1

Dr. Gary Liu

Assistant Director of the Case Development Center and Lujiazui International Finance Research Center in CEIBS

Entrepreneurship is the most tempting as well as challenging job in every country. Being successful in starting up a business needs the combination of several factors such as people, resources, and opportunities.



As an entrepreneur, Gao is ambitious and eager for success. He is strong in sales. Moreover, he has excellent experience in the wine industry. However, he is inexperienced in managing a company. In fact, he could not even formulate a sound budget for his new building. What made things worse was that he could not afford to hire professionals. As the

CEO, he failed to demonstrate leadership and charisma, which are indispensable to retain talent in a new company.

Another concern for Gao's business is capital. Capital is the most important resource to start up a business. At the outset, an entrepreneur should raise enough capital not only to build factories and recruit staff but also to run the company until the second round of investment is obtained.

There are several challenges that an entrepreneur faces in China. As we can see from this case, there is quite a bit of uncertainty with an SOE partner. The SOE partner could suddenly withdraw its investment due to governmental requirements. Sometimes, the CEO of the SOE might suddenly be imprisoned on corruption charges. In China, key accounts such as supermarkets have strong bargaining power, which amplifies the risk of accounts receivable. Moreover, in China, the government is powerful and it has a thousand of ways to make your business difficult. However, Gao is lucky that he has good friends in the government.

Wine is a promising market in China but Gao lacks the people and resources to realize his business dream. Given his strengths and weaknesses, Gao should not continue to fight alone. He should attract some professionals to share his dream and form a strong management team. These new partners could bring either new capital or new skills. Gao should also give some stocks to the core employees as incentive. Otherwise, he will never be able to recruit experienced professionals. He should also focus on improving HR management and finance.

Gao should also try to find new investors. In order to do that, he should make a detailed business plan and then contact potential investors including venture capitalists and other potential investors. For a start-up in a mature industry such as wine, it is important to have a clear strategy and differentiating points. It is not enough to have a good name such as "California Vineyard." One needs to find answers to a few questions: Who is the target customer? Who are the main competitors? How can customers be made to trust a new brand? What is the selling point? How should the marketing be done? How should the product be priced? What distributional channels are suitable? What is the operational plan and cash-flow forecast for the next few years?

California Vineyard is an opportunity, but Gao would have to attract enough capital to restart and realize his business dream. Meanwhile, he should give up some shares to recruit professionals. Above all, he needs to formulate a clear strategy and business plan to persuade others to chase his wine dream with him.

COMMENTARY 2

Wu Hanning

Founder and President of Shanghai Jiangshan Real Estate

I met Gao Weidong in 2000. We both were students at the same university. I met him in a class celebration that we had organized to meet people from other classes. Gao and I were sitting at the same table. He talked about his job as an agent for some famous wine brands. He was very successful; he told me that he was earning millions. He really understood the wine market in

China and knew how to sell wine. He told me that there is a big margin in the Chinese wine market and that he was going to start his own company, California Vineyard. He was going to import wine from California and sell it in China under his own brand.

I expressed interest in his business and asked him for more details. He asked me to invest some money. I also introduced some of my friends to him. The first year of his business was successful. He sold wine worth RMB 80 million that year and earned a 50% margin. Then he decided to go big, so he invested in land and started the construction of a warehouse and an office building. He did not want to subcontract the filling of bottles to another company; he wanted to make all the money himself. He also wanted to create an image of a big company.

When he started with the construction, he did not have enough money to pay for it. Moreover, he did not have any idea about construction and was cheated by the construction company. I offered him help but he refused. He said that he could handle it but the reality is that they managed to cheat him. He also thought of himself as a big executive. He wanted to have a plush office with high-quality marble and luxury furniture—big dreams but little money. At the end, he ran out of cash and it is then that everything went wrong.

He started to move money from the business to pay for the construction. He sold the wine and used the money to pay for bricks. On top of that, supermarkets started to delay payments, though normally payments are made 60 days after the sales. Only Metro, the German chain, paid on time. But all others, including Carrefour, took 75 days or even more. That created additional cash-flow problems for him.

Then came a time when he did not have money either to import wine from California or to pay for the construction. As a result, he could not replenish the shelves at supermarkets with his wine as he did not have enough money to import new wine. This led to reduced cash flow. Then he decided to use local wine instead of imported ones. That way he tried to reduce his costs, but quality suffered. Moreover, consumers were not stupid and his sales fell. He made a big mistake when he decided to build the office and warehouse. Although his business concept was good, it did not work due to a bad decision. We believed in him, but he made a mistake.

He now had to borrow money from a bank using the land as collateral to pay for the construction. But the loan was not enough to complete the construction. At the end of 2002, the bank asked for repayment of the loan. He was very scared, so he did not go to the bank. The investors could not find him either. He disconnected his mobile phone and nobody could find him. He did not want to confront the bank, and that was a big mistake. I am sure he could have got an extension for the loan payment. But because he went into hiding, the bank had to find a solution to recover the money. Somebody paid the loan back to the bank and got the property for a fraction of what Gao had put into it. It was a very sad ending. That is what happens when you have big dreams, but not a good foundation. The higher you want to build a house, the deeper the foundations have to be. Gao only saw big dreams.

All the investors lost their money; we never recovered ours. I saw him some time ago and he was distributing water to homes. I asked for my money, but he was no more a rich person. He had just enough money for subsistence. Perhaps one day he can start a good business and recover. I hope he has learned a good lesson.

I have also learned something from this experience. I trusted him because he was my classmate. I did not go into the details of the business. I listened to him, but never questioned him or his business. He never gave us details of the cash flow or a business plan. We gave him total freedom to manage the business. When he made mistakes, he never told us. We should have had a board in place and worked together with him. We were not a team; we just gave him money with no control. He made all the decisions. He never asked us before investing in the office and in the warehouse. He destroyed a good business as a result of a bad financial decision. I learned that business is not only about a good product and marketing, it is also about finance.

CHAPTER 4

Where is the Money?
– Sources of Finance

CASE STUDY
Envisioning the Future: Shanghai Venture Capital (SHVC)

On a summer morning in 2004, Gao Jian, the vice president of Shanghai Venture Capital Co. Ltd. (SHVC), stepped into a small park on Huaihai Road, one of the busiest avenues in Shanghai. He was walking toward the white four-story building where SHVC was located, when he suddenly noticed Tony Chen, the chief of the company's investment department. On seeing him, Jian remembered what Chen had asked him the day before: "Should we continue to focus on investment through management companies or should we shift our attention to the establishment of joint funds?" Chen's words were still ringing in Jian's mind.

Bearing the twin mission of promoting high-tech as well as venture capital (VC) industries in Shanghai, SHVC was soon about to enter its fifth year of operations. The initial investment from the government had been largely used to fund projects that had long cycles for achieving returns—usually longer than five years. Thus, it was about time that the company devised its future strategy.

Overview of China's VC Industry

Following the introduction of China's "Reform and Open-Door Policy,"[1] the country's GDP maintained a stable 8–9% annual growth rate for more than 20 years, in comparison with the average of 3% GDP growth worldwide. China had become one of the largest trading countries and FDI recipients in the world in 2008. The favorable political and economic environment in the country created lucrative opportunities for the VC industry. The Chinese stock market was launched with the establishment of the Shanghai Securities Exchange Building on December 9, 1990. Further, state promotion of corporate governance mechanisms and the liberalization of property rights offered an open playing field to VC players.

Further, the government's intention to develop the high-tech industry also generated opportunities for VC companies. In 2008, there were 53 national and 120 regional high-

[1] The Third Plenary Session of the Eleventh Central Committee of the CPC in 1978 marked the start of China's "Reform and Open-Door Policy." Economic development zones were set up in southern China to attract foreign investment and technologies, and advanced management methods to introduce the market-economy system.

tech industry development zones. However, the high-tech industry was still small in China as compared with developed countries. Investment in the high-tech industry was far from sufficient, but was steadily growing (Exhibit 1). The percentage of R&D as a part of the GDP was 0.9% in 2000 and 1.2% in 2005, far lower than the 3% worldwide average. This R&D investment was not sufficient to meet the requirements of high-tech growth. These factors, along with an increase in personal savings, the regulation of the insurance business, and the modernization of the financial system, helped prepare China for the expansion of its VC industry.

On the output front, China emerged as a large-scale exporter of high-tech products (Exhibit 2). Its high-tech exports were worth USD 218 billions in 2005 and accounted for almost one-third of its total exports. This trend is clear in the flow of trade of high-tech products between China and the US (Exhibit 3). In 2000, the US exported USD 1 for every USD 2 of imports from China; in 2004, the ratio was USD 1 of exports for every USD 5 of imports from China.

In 2005, there were about 150 local and foreign investment companies in China. The combined capital of these companies increased from USD 43 billion in 2003 to USD 61 billion in 2005 (Exhibit 4). With regard to the sourcing of funds, private companies were the main contributors, followed by the Chinese government (Exhibit 5). Most VC firms were located in Beijing, Shenzhen, and Shanghai (Exhibit 6). Education, followed by Internet communication, was the main sector for VC investment in 2004. Other important targets were traditional industries, financial services, and manufacturing (Exhibit 7). The investment flow was in accordance with the government's plans of promoting the high-tech industry as well as the VC industry in China. According to Yu Ming, the president of SHVC:

> *Comparatively speaking, investment in mature projects is less risky. Besides, private funds will pursue guaranteed returns. If we invest in high-tech companies at earlier stages and help them grow, there will be greater confidence in the market. The real purpose of companies like ours is to encourage more VC firms in the market.*

SHVC and the Shanghai VC Industry

Venture capitalists started making inroads into Shanghai in the 1990s. The central government set up 10 investment companies in 1992. At that time, the VC market in China was at a nascent stage of development. There were insufficient regulations and policies regarding the VC industry, and people still did not have a clear idea about what VC was. In May 1998, the Shanghai government issued "Regulations on Promoting the Transference of High-Tech Research Outcomes," popularly known as "18 Regulations." These regulations were promulgated to promote the commercialization of the outcomes of high-tech research. The same year, the Shanghai government announced that it would invest RMB 600 million in high-tech industries. Shanghai Venture Capital Co. Ltd. was founded in 1999. It was decided that its operations would follow the model of investment funds in foreign countries.

In 2004, Shanghai had more than 90 firms in the venture capital sector. One-third of them were VC companies, with an accumulated capital of RMB 10 billion; another one-third

was formed by management companies, and the rest were professional agencies. SHVC was the largest among the VC firms. SHVC had set up 15 funds in collaboration with universities and in high-tech development zones. The firm mainly provided seed money and finance to start-ups and growing companies. At the time of preparing this case, SHVC had invested approximately RMB 2.2 billion in about 140 projects (Exhibit 8).

SHVC's Initial Strategy

The purpose of setting up SHVC in 1999 had been laid out clearly. First, the Shanghai government wanted to encourage the commercialization of high-tech research outcomes and the growth of Shanghai's high-tech industry, particularly after the former state-owned investment companies failed to promote high-tech technology. Second, the VC industry in Shanghai was in desperate need of stimulation. SHVC, besides being a direct investor in new ventures, also had the role of attracting more funds from the private sector as well as foreigners. The Shanghai government wanted to learn from the experience of foreign countries. From the very beginning, it was emphasized that the company's mission was to develop the VC industry in Shanghai, in particular, and in China, in general. One of SHVC's main objectives was to build a team of qualified fund managers. As the VC industry was very new to China, there was a scarcity of trained professional fund managers. Tony Chen said:

> *At that time [2000], the VC business was almost unknown to Shanghai. So we had to do several things at the same time: set up funds, select management companies, and find qualified personnel. Further, we had to establish connections with high-tech development zones, universities, and other institutions. We had studied the origins of VC development in other countries very well, so we knew what we needed. We were creating a new industry.*

SHVC – Organizational Structure

Entirely financed by the Shanghai municipality, SHVC was a wholly state-owned limited company from a legal point of view. The Shanghai Science and Technology Investment Committee was set up in 1999 to supervise the operations of SHVC. The committee comprised 18 government officials who gave strategy-level instructions for the operations of the VC firm. The committee focused on several specific areas—Finance Administration, Shanghai Science Committee, and Shanghai Planning and Development Committee. At the time of preparing this case, the company had 16 full-time employees, all of whom were working in its central office in downtown Shanghai.

Since SHVC was an SOE,[2] it did not have a board of directors. It was the company's decision (as opposed to that of the committee) to choose and invest in various projects. The company had a president and four operational departments—investment, management, capital administration, and office administration (Exhibit 10). As the executive vice president responsible for the

[2] SOE: State-owned enterprise

management of VC investment, Gao Jian was in charge of the investment and management departments. Another VP was responsible for controlling the company's investments in the financial market. In addition, the company invited researchers from various universities to chair its Strategic Research Center. For example, the Venture Capital Research Center (VCRC) at Fudan University was one of SHVC's partners. The VCRC studied the situation of Shanghai's VC industry, initiated exchange programs with foreign research institutions, and offered training programs.

Operations at SHVC

The limited partnership (LP) model was the most popular legal format on which VC companies based their operations in foreign countries. In this format, pension funds, investment banks, non-financial organizations, and wealthy individuals, among others, acted as investors. However, because of legal constraints, general partnership (GP) was the most popular organizational model in China. In 2004, SHVC had 18 management companies taking care of its long-term investment needs. It did not invest directly, but through these management companies. In foreign countries, fund management companies enjoyed complete authority in controlling their investments. However, because of the lack of professional fund managers in China, entrepreneurs, at times, directly approached SHVC. As a result, SHVC had to collaborate with management companies on certain occasions.

In brief, the operations of SHVC, though principally similar to those of foreign companies, possessed certain unique characteristics. SHVC, which was the first VC company in China to conduct its operations in this manner, had become a role model for other companies (Exhibit 11).

The investment capital of SHVC was divided into three equal parts. One part was allocated for the establishment of joint funds; another for investment in start-ups through management companies, while the third part was reserved for financial investment. With its earnings from the financial market, the company paid its general expenses and management fees to the fund management companies. Management fees was paid every quarter in accordance with the amount of money entrusted to management companies for their control.

In the beginning, SHVC selected a total of five management companies. Each one focused on a specific industry and received different fund amounts to manage. One management company specialized in biomedicine, another in IT, and the third in both these industries. Each of these three companies managed RMB 15 million. The fourth management company focused on new materials and optoelectronics, and managed RMB 20 million. The fifth did not have any special focus and managed RMB 50 million worth of investment. The initial funds allocated to these management companies were more for the purpose of testing. If the companies delivered efficiently on their promises, they would get more funds to handle. Each of these companies received 2% management fee to pay for administration expenses. In addition, SHVC paid a success fee to companies that performed well. SHVS had the option to drop its partnership with companies that failed to deliver, and switch to other, more profitable companies. All these management companies were located in Shanghai—three in Jiaotong

University, Fudan University, and Zhangjiang High-tech Development Zone; and two in the New Scientific City Tower on Beijing Road. Gao Jian said:

> *We have concentrated on several areas, such as universities and development zones. Our mission is to promote the commercialization of research results. And where are the sources of innovation? They are in universities and high-tech developing zones. We have focused our attention on those institutions.*

Currently, SHVC has invested in more than 140 companies through fund management firms. On an average, it holds 20–30% of the shares of those companies. SHVC's investment committee is responsible for analyzing the feasibility of project plans and the selection of investment targets. The basic criterion for selecting an investment target is "high growth, high-tech." The high-tech industry includes IT, biotechnology, environment protection, and new materials, among others. Another criterion is that the industry must have an expected 20% growth rate in the next five years. Third, the company must have an efficient management team.

Seeking partners for joint funds, SHVC initially approached universities and high-tech development zones in Shanghai. It started from the top two universities and the two largest high-tech development zones in Shanghai—Fudan University, Jiaotong University, Caohejin High-tech Development Zone, and Zhangjiang High-Tech Development Zone. The investment pattern for all these partnerships was 50:50. For example, with regard to the joint fund with Shanghai Industrial Holdings Co. Ltd. and China Stock Exchange Research and Planning Center, SHVC committed to invest RMB 200 million, 50 percent of the total investment.

SHVC initially prioritized cooperation with local universities and high-tech development zones. However, it gradually realized that to obtain more capital, it needed to build alliances with foreign investors. The company had set up a network in Shanghai by establishing funds in different areas. In addition, foreign funds had begun to usher into China. In 2004, SHVC set up three cooperative funds in collaboration with organizations from Hong Kong, the Silicon Valley, and Singapore. (Exhibit 12)

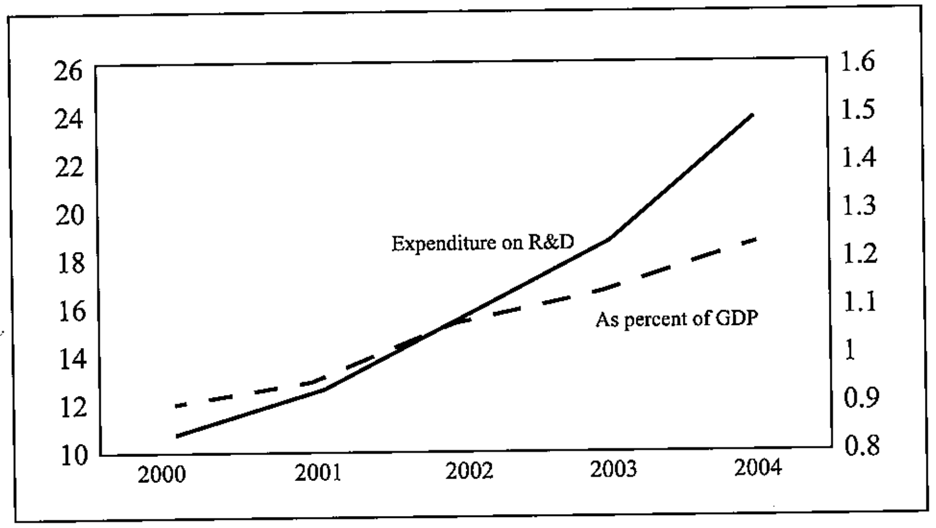
Since the local currency was not fully convertible in 2004, SHVC could not invest outside China. To get around the regulations, SHVC had to operate through parallel funds. There were two parallel funds: domestic and foreign. The two funds signed a co-investment contract.

Gao Jian realized that the company had arrived at a critical juncture on its future strategy. Continuing investments through management companies threatened to deplete its capital reserve as the investment cycle usually took over five years and exit options were still extremely restricted. The venture capital market in China was not yet mature and did not provide options for exit. Therefore, it was difficult to recover the initial investments. SHVC itself had completely or partially withdrawn from 20 projects. The highest ROI was 3:1 for a project carried out in two years. In addition, SHVC had to make decisions on whether to focus on direct investments or develop more joint funds, and whether to focus on China or abroad.

Foreign funds posed two major questions with regard to their investment in China. First, how does one transfer profits out of China after withdrawing from a project? Second, how does one bring funds from abroad without resorting to the cumbersome application procedure? Within China, possible sources of funds were still limited. There were obstacles in trading new shares, pension funds were still weak, and insurance funds were just emerging. Besides, these funds were not allowed to invest in high-risk operations. Other financial institutions were also not allowed to enter the VC industry.

Thinking of the future of SHVC, Gao Jian picked his phone and called Tony Chen, chief of the investment department. "Hey, Tony! Good morning. Why don't you come to my office later and have a talk about the near-future strategy of the company? You see, there are so many things to be done and all of us are wondering which path is the best for the company." "Sounds good," Chen answered. Both knew that it would be a long day ahead.

Exhibit 1: China's Research and Development Expenditure, 2000–2004
(USD billion and as a % of GDP)



Source: National Bureau of Statistics, China Statistical Yearbook 2005

Exhibit 2: China's Global Trade in High-Tech Products, 2000–2005 (USD billion)

	Ministry of Science & Technology	
Year	Imports	Exports
2000	52.51	37.04
2001	64.12	46.45
2002	82.86	67.86
2003	119.31	110.32
2004	161.43	165.54
2005	197.71	218.25

Source: Ministry of Science and Technology, Science and Technology Statistics

Exhibit 3: High-Tech Trade between the US and China, 2000–2004 (USD million)

Year	Imports	Exports
2000	10,700	5,500
2001	13,365	7,243
2002	20,094	8,304
2003	29,345	8,290
2004	45,698	9,401

Source: US Census Bureau, Foreign Trade Division, Science and Engineering Indicators.

Exhibit 4: VC Companies and Capital

	2003	2004	2005
Number of VC Companies*	180	141	150
VC Capital (USD billion)	43	58	61

*Number of companies that responded to the survey
Source: China Venture Capital Year Book 2005

Exhibit 5: VC Sources in China (%)

Origin	Government	Financial Institutions	Enterprises	Individuals	Others
2003	26	6	52	11	5
2005	32	15	46	3	4

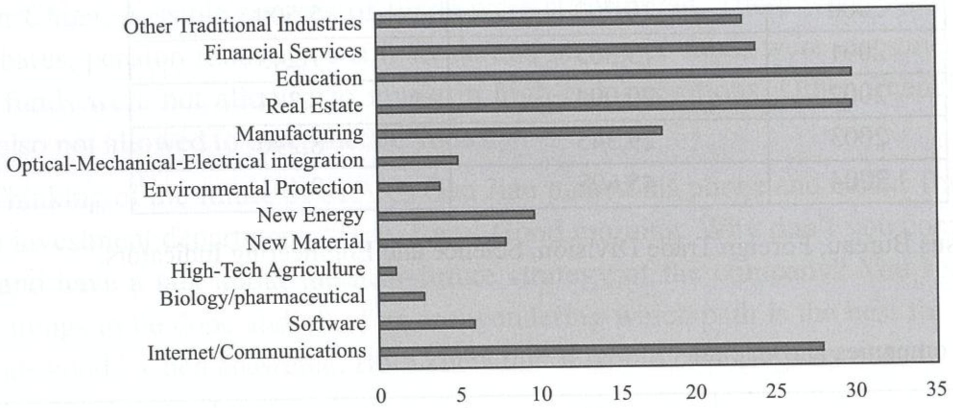
Source: China Venture Capital Year Book 2005 (figures for 2004 not available)

Exhibit 6: Distribution of VC Capital in China

Year	Beijing	Shanghai	Shenzhen	North-Eastern China	North China	Eastern China	Central-South China	Western China	Total
2005	31	11	18	3	5	11	11	10	100
2004	23	6	26	1	5	16	18	5	100
2003	15	10	26	6	6	14	11	12	100

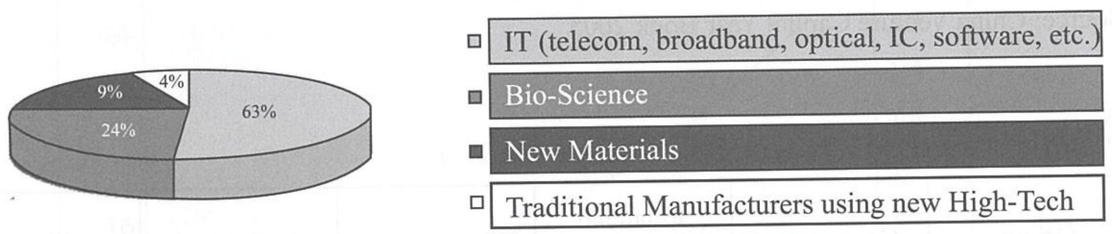
Source: China Venture Capital Year Book 2005 (% of VC capital from Exhibit 1)

Exhibit 7: Distribution of New VC Projects in Different Industries (2004)



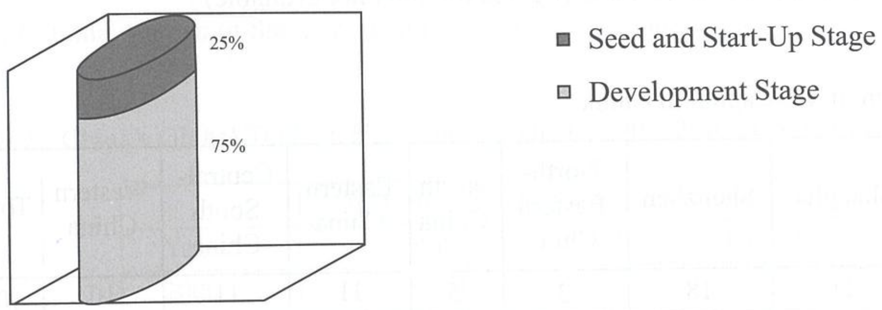
Source: China Venture Capital Yearbook 2005

Exhibit 8: SHVC Investment by Type



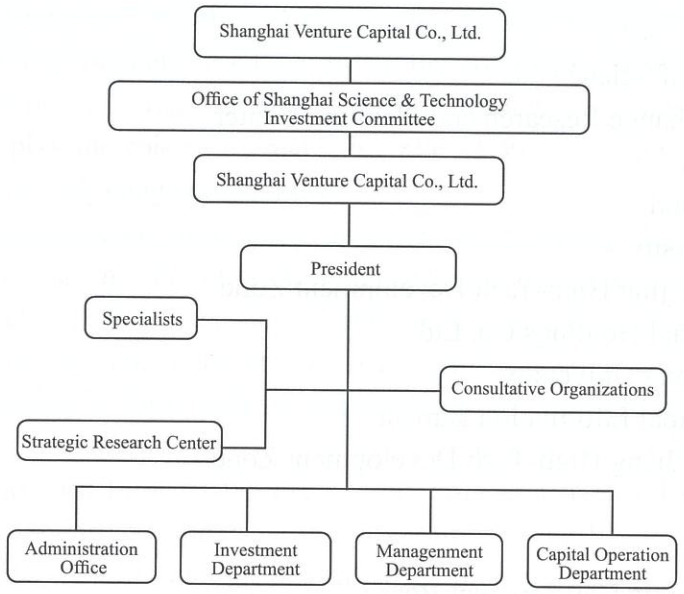
Source: SHVC's website www.shvc.com.cn

Exhibit 9: SHVC Investment Stage (number of deals)



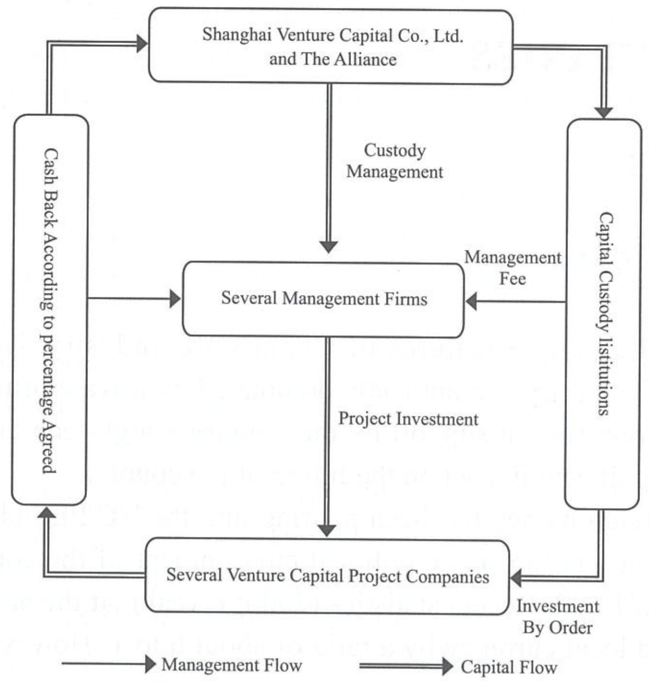
Source: SHVC's website www.shvc.com.cn

Exhibit 10: SHVC's Organizational Chart



Source: SHVC's website www.shvc.com.cn

Exhibit 11: Operations of SHVC



Source: SHVC's website www.shvc.com.cn

Exhibit 12: Funds with Local and Foreign Partners

Local

- China Academy of Science
- China Stock Exchange Research and Planning Center
- Fudan University
- New Material Fund
- Qing-Hua University
- Shanghai Cao-he-jing High-Tech Development Zone
- Shanghai Industrial Holdings Co. Ltd.
- Shanghai Jiao-Tong University
- Shanghai Municipal Information Bureau
- Shanghai Zhang-Jiang High-Tech Development Zone

Foreign

- Singapore Economic Development Board
- (USA) Acorncampus Fund
- HK Company

Source: SHVC's website www.shvc.com.cn

CASE COMMENTARIES

COMMENTARY 1

Yan Gao
PhD Professor of Finance, CEIBS

This case highlights the unique features of China's VC industry. Unlike several other countries, where the VC industry is completely dominated by private firms, local state-owned VCs have played a pivotal role in supporting the country's high-tech and other developing industries that have a significant impact on the future of the country.

In recent years, foreign money has been pouring into the VC/PE industry because of the fast pace of development and the stable political environment of the country, as well as the expected appreciation of RMB. Recent statistics (2006) reveal that the amount of foreign VC/PE investment outpaced local currency by a ratio of about 6 to 1. However, only one-third of the total money was invested in early-stage companies, implying that most foreign investments are focused on late-stage, low-risk investment opportunities in traditional industries, even in the field of TMT (technology, media, and telecom). For example, it is much easier for an

Internet gaming company or a restaurant chain to raise foreign money than a semiconductor design company or a biotech company. As a result, there is a huge funding gap for local firms that are really "high tech." In other words, foreign VCs are shying from high-risk investments and acting more like bankers in China, given the complexity of the local environment. It is the local state-owned VCs that find themselves responsible for filling the gap to finance early-stage firms and play the role of a "real" VC, like SHVC. As a comparison, 75% of SHVC's investments are in early-stage companies.

Can state-owned companies play the role of supporting the growth of the high-tech industry in particular and the VC industry in general? Based on US experience, the answer is no. Pretty much like in China, the VC industry in the US was founded by the government. Small business investment companies (SBICs) were introduced in 1958 to finance early ventured companies in high tech by using cheap government money. However, as they say, "Many roads to hell are paved by good will." SBICs never delivered good economic performance, nor did they foster high tech. This is attributed to inefficient corporate governance and incentive policies of the government. The VC industry in the US took off in the 1970s, with the introduction of limited partnership and other government policies to encourage private participation in this industry.

Therefore, the problem SHVC is facing is much deeper than strategic direction and geographic expansion. State-owned VCs are forced to take on a role that, without competitive incentives and governance to attract much-needed experts and managers, they are unlikely to fulfill.

Does this mean there is no future for state-owned VCs in China? Not necessarily. Just as we see big Chinese SOEs gaining competitive advantage in an increasingly market-oriented economy, state-owned VCs may also find a way with the features characterizing the Chinese industry to get stronger over time, as long as they are willing to adapt to the changing environment.

Chinese VCs do have certain strengths that foreign VCs do not possess, as SHVC showed, including a vast network of universities and research institutions, local knowledge, and government support. They are in a better position to identify good early-stage projects and profit from them. Last year, Shenzhen Venture Capital Company, an entity similar to SHVC, generated astounding profits by listing many of its invested early-stage firms on the newly established Shenzhen Small and Medium Enterprise Board.

For the future strategy of SHVC, the following could be considered:

1. It should enhance its incentive system to boost performance and attract talent.The newly established law that allows limited partnership in China has already aided the creation of several local private VC firms. The incentive systems of these firms could serve as a good reference. The new management and incentive system could enhance the performance of SHVC's investment partners.
2. An important issue to think about is the direction of strategic focus: local or foreign business. The strategic focus, because of its background and

current capability, may still be on local business. The company could strengthen its relationships with partners, expand its network to other geographies, such as Shen Zhen, attract more local money and new contacts, and enhance its relationship with the government. More joint venture funds with local firms or foreign VC firms in China are a viable option to meet SHVC's current funding needs. Cooperation with foreign partners should be placed above strategic framework. The cooperation should not be aimed at attracting money, but gaining foreign experience, expertise, management skills, and talent. The company can also consider cooperation with various PE funds or the investment arm of big corporations to create future acquirer of its portfolio companies.

3. Foreign parallel funds should be considered as a long-term strategic option, not an immediate one. The goal should not be getting more deals in China, since there is little value that foreign partners can add, but to look for investment opportunities abroad that can help the growth of the firm's portfolio companies in China.

COMMENTARY 2

Huang Yi

Assistant to the President, Shanghai Venture Capital Corporation

Huang Yi has worked at SHCV for three years. Before that, he worked for 10 years at the Zhangjiang High-Tech Development Zone, five years in the marketing department, and the remaining in the investment department. He is currently serving as the assistant to the president and is responsible for the investment management department.

The Chinese high-tech industry is developing very quickly. The most important challenge for our country is to commercialize the results from the laboratories. Without that, research will remain in the laboratories and never reach the market. Our mission is to ensure that research reaches the market and to do so we provide funds to start-ups in the high-tech industry.

All our money comes from the Shanghai municipal government, while we also get returns from our investments. We are involved in three things at the moment: (1) Fund of funds, (2) Direct investment, and (3) Key project management. The reason is that if we act only as a fund of funds, we get returns quite slowly. Thus, we make direct investments to get faster returns. The second reason is that there are still key projects and high technology that are important for the society and we have to support them.

In total, we had USD 80 million, which is now worth USD 90 million due to the appreciation of the RMB. Of this, two-thirds is in the fund of funds, while one-third is direct investment. Most of our investments took place three or four years ago and we still need some time to cash out. About 20–30% of our investments have already successfully cashed out or launched their IPOs. However, 10–20% of our investments did not do well: a few of the start-ups failed, while others are struggling to stay afloat.

We have 20 subsidiary funds, and each has its own management company. Two will be closed because they have completed their assignments. Thus, there will be 18 management companies in total.

We also have a few joint funds with foreign VCs. Most of them are 7- or 10-year programs, and will conclude in another three or five years. These funds are performing quite well. For example, TDF with Singapore has invested in Baidu and Alibaba, large-scale Chinese companies. But certain regulation problems persist; for example, limitations on the free exchange of RMB. The next plan is to invest directly in other countries, while foreign funds invest in China.

We have some contact with foreign VCs. For instance, we exchange information or look for projects together. Currently, the Chinese law does not allow foreign funds to directly invest in China. Although a few foreign funds have local representative offices, their investments are considered foreign investments.

Qualified management teams with good track records are still a rarity. On the upside, though, more and more people are getting to know about the VC business. It is still not very easy to get qualified people, but the situation is much better compared with a few years ago.

We introduced certain changes at SHVC since this case study three years ago. In 2004, the Shanghai government asked us to mange certain key projects for the city. The project was termed "Rejuvenating the city through science and technology." We are one of the two management companies in charge of it. The total investment is RMB 6 billion. SHVC manages RMB 3 billion. The money will be used for the development of high-tech industries, such as IT, life sciences, and new materials. We established the key project department to manage this project. It is the government's money. The government decides where to invest; we just manage it. We have formed the investment management department by merging the investment department and the management department. I am in charge of the new department.

SHVC needs to adapt to the changing environment. We are now getting most of the money from the government. The next step is to get money from private and foreign investors. Second, most of the investment is in Shanghai currently. But in the near future, we will support certain companies outside Shanghai, in Zhejiang and Jiangsu provinces. Zhejiang, Jiangsu, and Shanghai are going to cooperate more closely in developing the high-tech industry in the region.

The number of VC firms is growing in China because the Chinese economy is growing and China's capital market is improving. The government is also encouraging research to be industrialized. However, several things to be improved for the VC industry since it is not isolated and needs an entire support system—a favorable regulatory regime and a professional credit system. The US and Singapore are examples of extremely favorable systems. But these are not as good as in other countries. In Shanghai as well, we are learning and improving all the time.

The future of the VC industry in China is very bright, but we need to address certain problems. There will be some ups and downs along the way.

CHAPTER 5

When Success is Looking for a Strategy

CASE STUDY
Shanghai Red Star Engineering*

In June 2005, Hong, Fang, and Li, the three founders and owners of Shanghai Red Star Engineering (Red Star), were on the horns of a dilemma as they had just received a three-year RMB 10.2 million order from Vulcan Trucks of China, the company's principal customer. The order was valued at 50% of Red Star's 2004 annual sales of RMB 20.4 million.

The owners were concerned that the order, if accepted, would increase Red Star's sales dependence on Vulcan to about 40% of its total production.

Company History

Red Star was founded in 2000 by siblings, Hong and Fang, and their brother-in-law Li. Hong and Fang were engineers who had worked for a large state enterprise, whereas Li had experience in marketing with a foreign enterprise.

During the course of work, Li got the opportunity to deal with a number of customers, including foreign companies. A customer told Li that he and his brothers-in-law should start their own enterprise. After much deliberation, they launched Red Star by pooling their own financial resources and borrowing money from a foreign friend.

Hong became managing director and was also responsible for finance, while Fang was responsible for all manufacturing and engineering operations. Li assumed the role of sales and marketing director.

Other management members included a works manager and a production manager reporting to Fang; a chief accounting and purchasing manager reporting to Hong; and a sales manager and a marketing manager reporting to Li. The company did not have a personnel department; however, management kept employees informed about the development in the company through informal channels.

As the company grew at a rapid pace, an average of 20% over the past five years, management did not have the time to formulate personnel policies, and plan and upgrade computer systems. Moreover, there was no organized training or promotion system in the company.

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* This case was prepared by Professor Jeffrey V. Ramsbottom of Manchester Business School (MBS), UK, and China Europe International Business School (CEIBS), Shanghai, PRC, as a basis for classroom discussion.

Manufacturing and Engineering

Red Star's factory was located in the Huipu district of Shanghai. The transportation system in the district was satisfactory with adequate road and rail linkages. Moreover, local transportation services were considered to be adequate by workers.

The company employed 300 people including production line, staff, and management, and was a top private employer in the area. However, the rapid economic growth in the region led to a shortage of skilled workforce, and the local companies were competing for the available labor force. Other manufacturers in the area included plastics companies, chemical companies, food processors, engineering companies, and construction firms.

Red Star's manufacturing plants were working at full capacity in normal day shifts and with overtime when critical bottlenecks affected production. Attempts to introduce multiple shifts in the past had been unsuccessful, largely due to labor shortage and difficulty in arranging a full shift. Production capacity at the existing facility, however, could be increased by up to 40% should the need arise.

Over 50% of the machine tools and other equipment at the factory were more than five years old. Fang estimated that the existing presses, lathes, and grinding machines at Red Star could not be replaced with their new models before a year or two. However, according to him, "There was always the possibility of buying reconditioned or second-hand machine tools from a state-owned enterprise or even leasing equipment."

Accounting, Costing, and Finance

Hong considered that management was managing costs effectively at Red Star and figures showed that materials on an average accounted for 25% of annual sales in 2004. Labor costs were 30–35% of sales in the past three years, while overheads (which excluded sales and marketing expenses) averaged 20–25%. Profit before tax ranged between 8% and 10% during the past five years.

Financial control and budgeting was satisfactory, while credit and cash flows were under tight control. For example, accounts receivable (debtors) and accounts payable amounted to RMB 4 million and RMB 3 million, respectively, at end-2004. Inventories of raw materials, semi-finished products, and finished products stood at RMB 3.6 million at end-2004.

Despite the company's steady growth, the owners were not keen on increasing their financial exposure and wanted to retain their hold on the company. This explains why they had not explored the possibility of selling shares to outsiders.

Future Objectives of Red Star

At the June 2005 meeting, Hong, Fang, and Li decided to draw up a plan of action to bring together the necessary physical and human resources required for completing the new order. But almost immediately, differences of opinion arose among them. They were all concerned about the impact (both positive and negative) that Vulcan Trucks' order would have on Red Star's growth.

Fang suggested they should first consider whether to accept the new order. He believed

that the company had been fortunate to reach its present size without encountering any major difficulty and the time might now be right for consolidation rather than further expansion.

Hong partly agreed with his brother, but pointed out that declining the order could hit the current business from Vulcan Trucks—the company was known to cancel orders if it felt that its suppliers were not responding to its needs.

Li agreed on this point and stated that the new order will increase profitability. Although the proportion of the company's sales coming from Vulcan Trucks was high, he felt that this would fall as the company was receiving orders from other customers and may even export in the future. Although he did not undermine the difficulties of increasing the output to cover the new order, he felt it would be wrong to go back on a policy which has established Red Star as "a company capable of producing quality products at a competitive price."

From previous discussions and negotiations with Vulcan Trucks, Hong knew that they must quickly come up with a course of action. He recalled that in the early days of Red Star, they had talked about limiting the size of the company to 300 employees and about RMB 20 million in sales. At present, the company has crossed this mark and he wondered whether they have reached the point where they should consider establishing a separate company specifically to cover the new order from Vulcan Trucks or meet the entire demand from within Shanghai Red Star Engineering.

CASE COMMENTARIES

COMMENTARY 1

Dr. Jeffrey V. Ramsbottom

Senior Fellow, Manchester Business, UK, and Visiting Professor, China Europe International Business School, Shanghai, China

The case is about Shanghai Red Star Engineering, a small job shop engineering company, and opens with the news that it has just received an unexpected large order from Vulcan Trucks, one of its major customers. In its first five years, the company has met its two original objectives—sales of RMB 20 million and a staff of 300 employees.

The three founder directors, who are related through relations and also the senior managers, have different opinions as to whether to accept this order or not. Li, the sales and marketing director, wants to accept this growth opportunity without question, but Fang, the manufacturing and operations director, wants to "stabilize" the company after its rapid growth and therefore wants to reject the new large order. Hong, the managing director/finance director, is equivocal. This new order raises questions as to what the company should do in the future as opposed to what it has achieved in the past.

But before the future can be addressed, some assessment of the past has to be made. Is Shanghai Red Star a successful company and if so, why? What constitutes success for an SME in China and is that different from elsewhere? The company has experienced high growth and is profitable, but is it profitable enough for the future? At this point in its existence, what are the company's strengths and weaknesses, especially with regard to successfully accepting or rejecting the big order? There is sufficient financial information in the case to make rough assessments of the impact on the company of either alternative.

If Shanghai Red Star rejects the order, a critical question is what will Vulcan Trucks do? There is a strong possibility that Vulcan might cancel the existing orders; how much and how important are they? By any reasonable assumption, Shanghai Red Star is highly vulnerable to bankruptcy if Vulcan Trucks withdraws its existing business.

And if they accept, it is necessary to look at the effects on the P&L statement and the balance sheet. A simple P&L sheet can be constructed from the data in the case in order to understand the cost structure. As a first order effect on the P&L, the impact of paying overtime or second shift premiums to complete the big order in a tight labor market shows the vulnerability of the thin profit level. On the balance sheet, the increase in working capital required to support the increase in sales demonstrates that the company needs much more working capital to support this extra business. If fixed asset purchases are included to fulfill future growth, then the company is significantly undercapitalized and could go bankrupt.

The three principals and founders cannot seem to agree. Does this matter? It will do soon because the harsh interpretation of our brief analysis of this "successful" Chinese SME is that if it rejects Vulcan's new big order, it could go bankrupt; if it accepts Vulcan's new order even then it could go bankrupt; and sure as heck, if it does nothing it will go bankrupt.

All of this begs the question as to what is Shanghai Red Star's strategy? Indeed, has Shanghai Red Star had a strategy and if so, what? It certainly had objectives to go with the founders' original vision—20 million RMB sales, 300 employees—which were achieved. Maybe the strategy was to establish a viable SME business making quality products for satisfied repeat customers and to profitably grow the business. But that old approach is now insufficient after Vulcan Trucks' new big order because doing business as usual could well lead to bankruptcy.

In fact, the case is not as much about numbers, profitability, and cash flow, important and vital as these are, as it is about goals, objectives, and strategy. Probably unwittingly, Vulcan Trucks has forced Shanghai Red Star Engineering to face the future and answer the questions, "What are your future goals and objectives, and what is your strategy for achieving them?"

Neither the "reject" nor the "accept" option is right or wrong. However, whichever is chosen will require vastly different strategies to succeed. In the former, some way of preventing Vulcan from withdrawing its existing business would be important, may be delaying fulfillment of the order until Red Star is properly equipped. For the latter, a new source of financing is imperative. There may be a chance to get Vulcan to invest in the business.

Alternatively, the current situation of "**success waiting for a strategy**" is an ideal opportunity to re-evaluate the whole business venture and its future direction. The common 80:20 rule of business suggests that frequently 80% of a company's profits come from only

20% of its customers. Perhaps this is an opportunity to focus on a few of the more profitable customers and expand the business with them. Or maybe it is a time to specialize in a particular area of engineering and develop away from a commodity job shop company with low margins toward a specialist high-margin operation.

The purpose of the case is to show that companies cannot stand still and that strategy, evolving and emerging, is critical to successfully achieving objectives, especially as companies grow.

COMMENTARY 2

Comments from Mr. Xu Chuan,

General manager and founder of Future Mechanical & Electrical Technology Co., Ltd.

Red Star's remarkable achievements in the first five years of operations were mainly attributed to the reliable partnership among founders, who worked in clearly defined roles. In my mind, their success was due to a number of favorable factors—established customer base, in-depth knowledge of customers' needs, team spirit, expertise in engineering, and healthy external environment—and the thriving Chinese economy.

After five years of its establishment, the company had reached a production scale and capability to generate profit. Meanwhile, the market and the customers also underwent great changes. The company's management/owners needed to come to an agreement on a clearly defined strategy and standardize the internal management to ensure sustainable growth. I would like to suggest that the company consider the following initiatives:

1. Strategy adoption: The challenges and disputes Vulcan's big order posed to the company highlighted that even after five years of rapid growth, the company was still facing a critical choice for a development strategy. Lack of consensus on a clear development strategy was not a big issue in the beginning, but an obstacle in maintaining long-term sustainable growth.
2. A development strategy will help answer: Where is the company going? How can the company achieve the goals? Does the company have enough resources to support the development? What are the capabilities that need to be enhanced? What is needed to improve competency? What are the resources required to execute the strategy?

Before formulating the strategy, the founders should ponder over the missions and prospects of the company. Why does the company exist? Where are we leading the company?

A thorough understanding and analysis of the external environment and the industry is a prerequisite to foresee the trend. Red Star should conduct an unbiased strength, weakness, opportunity, and threat (SWOT) analysis, and discover its unique value to its customers by comparing itself with the existing and potential competitors in terms of strengths and weaknesses. Red Star's expertise in engineering and manufacturing helped it attract a big client such as Vulcan. Will the expertise continue to innovate and add value to the brand? Will it be able to create a new market and attract customers from other industries?

Red Star had good financial control in the first five years. In the backdrop of a rapidly growing Chinese economy, the company's growth and profitability were not exceptional. It will have to enhance the core competence, which requires the formulation of an effective strategy and its successful execution.

The decision to accept the order or not will be based on the desired strategic position in the future. Thus, the founders need to redefine their corporate mission, prospect, and strategy. They also need to establish a standardized and scientific regulation and workflow, use information technology, automate the manufacturing systems, and reduce cost, especially labor cost. With respect to human resources, Red Star needs to set up a performance management system, which will inspire innovation, increase investment in staff training, and enhance employees' job satisfaction .

Finally, let me just add a comment on growth. The growth of this company in the future relies on the approach of the top management team. The founders of Red Star need to get access to formal business education in order to change their mentality and form a management team capable of leading the company to a brighter future.

CHAPTER 6

The Dangers of Rapid Expansion: The Road of Franchising

CASE STUDY
Ahua: The Franchising Dilemma

It was the end of 2002. Chen Renhua, the owner and general manager of Ahua, was pondering over the future of his organization. His main concern was the franchising system that his company was employing in its operations. Ahua was the pioneer and market leader in the mother-baby care industry in China. From its initial product, the baby-hair pen, it had expanded into various lines of business: pre-natal education for pregnant women, pre-school education for 0–3-year-old babies, nursing services for new mothers and babies, rehabilitation program for new mothers, and services for the entire period from pregnancy till the baby is three years old.

When Ahua adopted the franchising system, Renhua thought it was the perfect solution to ensure rapid expansion in the number of outlets. The first franchise was opened in 1994, in the city of Dalian, Liaoning Province. By 2002, it had grown to 106 units. However, after several years of the franchising system, he found that reality was not as glamorous as he had envisioned. He was considering abandoning the system and using the company's own outlets instead. Many things were in his mind, but he was not sure of the pros and cons of the options. The implications were numerous. He decided to call for a meeting of his management team to re-evaluate the system and decide on the course of action. This, he knew, was a critical question for the company's future:

> *As a general manager, I have many decisions to make. Though all of the decisions have an impact on our business, I believe the decision about the franchising system is a milestone in the company's development. It is a difficult decision to make alone. I really feel it is the time for Ahua to clarify where we want to go.*

An Entrepreneur's Dream

The company was founded in 1993 by Chen Jianhua and her husband Chen Renhua. Jianhua graduated from Xia Men University as a music student in 1992. After trying for several years to make a career in music in Shanghai without much luck, she took an unexpected path. Jianhua loved her mother very much and after the latter's death, she wanted to have something from her person as a memento. There was a tradition in China to make brush pens using human hair, so she decided to do it with her mother's hair. During the process of communicating with the brush pen craftsman, Jianhua found that there was a special brush pen made of baby-hair instead of adult hair. In the past, people called this type of pen the Zhuang Yuan[1] pen because it was believed that students who used baby-hair pens would obtain the highest marks in their examinations. The tradition was forgotten for a long time, so there was no demand for this kind of pen. But Jianhua realized the business potential of this tradition. Her logic was very clear. Due to the one-baby policy prevalent in China, the child had become the most valuable and cherished member of the family. So, Jianhua thought she could give parents something they could keep forever and remind them of the time when they had their baby.

Jianhua decided to leave her musical career and founded Ahua to make baby-hair pens. It was the first company in China to manufacture baby-hair pens. Jianhua said:

> *I believe Ahua created in China an industry that did not exist at the time. I was the first person who commercialized the idea of baby-hair pens.*

Initially, the business did not expand rapidly. The main challenge was how to approach the new parents. It was not possible to go from door to door offering this service. Besides, most parents just did not keep their babies' hair. Moreover, to be able to make baby-hair pens, the hairdresser is required to be experienced enough so that the hair is cut neatly.

Jianhua, after realizing this problem, decided to offer hair-cutting services as a way to introduce the idea of baby-hair pens to parents. This strategy was a key decision for the company's future. Since a baby's skin is delicate, almost all parents want specialized hairdressers to cut their babies' hair. The hair-cutting service offered several opportunities for introducing baby-hair pens to customers. In fact, most of the customers who used their hair-cutting services also decided to get baby-hair pens made. That was the beginning of Ahua and its rapid expansion.

Products And Services

During the first phase of development, from 1993 to 1998, the company had limited products. Ahua witnessed gradual growth as it responded to the needs of its customers. For example, some parents wanted to keep mementos of the entire process of their babies' growth. Ahua decided to provide those parents with all that they needed: baby-hair pens, pictures, albums, and even the creation of Web pages featuring their babies. In the second phase of expansion that started in 1998, some new products were added, and new services, such as pre-natal education for pregnant women, pre-school education for 0–3-year-old babies, and nursing services, were also added. The products were effectively promoted.

Parents could choose any time span for the services: for example, 0–3 years or 0–6

[1] Zhuang Yuan was the person who obtained the highest marks in an examination that was designed to select government officers in ancient China. Now, Zhuang Yuan refers to the person who gets the highest score in important tests such as college entrance examinations.

years, as they liked. They could also adjust the service package according to their budgets. The firm tried to provide a comprehensive array of services throughout the first six years of a child's life. At that time, other players, encouraged by Ahua's success, appeared in the market but they only provided a number of disconnected services. This differentiated Ahua from its new competitors.

Ahua's business was divided into two main categories: products and services. Products were further divided into two types: products developed in-house and those manufactured by others. The company owned the brands of the souvenirs developed in-house. The company's in-house products included nutrition for pregnant women, clothing, souvenirs, fingerprinting and footprinting, and toys. All these products used Ahua's brand. Ahua's factory was located in Luwan, Shanghai, and employed about 80 workers.

Apart from its own products, Ahua also acted as an agent for other manufacturers. Although many products, such as milk powder, clothes, and toys, could be found in supermarkets, its unique direct sales system attracted many customers. If the customers wanted to buy something from Ahua, they only needed to contact the company and the company delivered those products to their homes. As Renhua indicated:

> *We provide the products at the same prices as the supermarkets; besides we take them to the customer's home. Pregnant women and new mothers do not need to go out to buy the things they need for their babies. We take care of that. Convenience makes us our customers' first choice. In addition, we provide one free lecture to the customers who spend more than RMB 3,000 on education programs.*

Starting with the original service, i.e., hair-cutting and hair pens, Ahua developed several products and service programs targeting the needs of different customers. For example, when pregnant women came to hospitals to have their regular health examination, Ahua provided free coaching to them. That was usually the way customers developed their first contact with the company. After that, they bought more products and attended other programs such as nursing and early age education for 0–3-year-old children. The company's target customer groups were pregnant women and families with 0–3-year-old children. Ahua's business concept consisted of creating synergies among different products and services. The relationship between hair-cutting and baby-hair pen-making was a clear example.

Business Concept

Renhua could not send his salespeople door to door to solicit business since customers were averse to that. Neither could he wait for customers to come to Ahua, although he tried tacitly to entice customers to approach the company. Health advisors played a key role in this strategy as they formed a relationship of trust with customers. As every pregnant woman had to do health checkups in hospitals, health advisors tried to reach out to them at hospitals. These health advisors were actual salespeople who attracted customers by introducing other service possibilities to them. Usually, the products were specialized, which meant customers had to get professional information before making a buying decision. The role of health advisors was to help customers make the right decisions and choose the right products. Counseling was, in that way, an important component of its services. Once customers got to know what products they needed, they could contact their call center. As Renhua indicated:

> *We do not have a traditional direct selling system; actually, it is the health advisors who sell the products. Their main mission is to educate the customers. In this way, customers can make wise choices and that is the foundation of their loyalty to us.*

In fact, Ahua did not face strong competition in the market. There were some small competitors that only provided one or two products and services. As Renhua declared:

> *Our competitors are not strong. Besides, they are product oriented but we are service oriented. We are unique in the way we operate. So our main goal is to improve the quality of our products and services constantly. Of course, this does not mean that there is no competition pressure at all. For example, in Ahua, the price for nursing service is RMB 2,200-4,000 per month in Shanghai, more expensive than what some small companies offer. But that does not harm our market share much. What we do to convince customers is that we assure them that our services are of the highest quality and the safest in the market. Nobody wants to play with the safety of their children. Our strategy is high product quality, not low prices. Some people think that it is too expensive, but once they get to know what kind of service we provide, they will think it is worthy. Our nursing service is provided by professionals, often former nurses, equipped with good knowledge of nursing.*

The secret is to win the trust of customers so that they buy our services. Some small companies think that healthcare is a simple business and offer prices as low as RMB 800 per month. However, this means that the service of quality they provide also corresponds to that price level. A high-quality service might charge a high price and that means the customer receives professional service, which ensures proper care of the mother and the baby. We are trying to change customers' notions so that they start paying our prices for healthcare services. Therefore, the main responsibility of the health advisors is to get the trust of the customers by providing an excellent, professional, and reliable counseling service.

Regarding their target segment, Renhua explained:

> *In Shanghai, more than 40% of the new families are our target customers. In other cities, it is somewhat less - 20-30% is our target customers there. This is a very large customer group. According to our definition, families whose income is above the average income level of a city can afford our services. We also make some adjustments in our service prices based on the income level in different cities. Labor is the major cost component of the services we provide.*

> *Since the labor cost is different in different cities, we have different service prices. But the prices for products are the same everywhere.*

Ahua's target market is extremely large and is estimated to be RMB 40 billion, according to its own estimates. It hopes to develop a professional and unified standard for this industry. At the moment, small competitors do not follow a clear standard. As Renhua explains:

> *Standardization of services is crucial but difficult. It takes time and effort to standardize a service. Our principal profit source is sale of product, not service. The profit generated by services is only a small part of our total profits. Nevertheless, standardized service is the key to attract customers for the products.*

The Franchising System

Attracted by the large and rapidly expanding market, the firm decided to adopt the franchising system in 1994. It invited franchisees in most of China's major cities. Following advertisements published in newspapers, many candidates interested in becoming franchisees contacted Ahua. After many negotiations and visits to the cities, Ahua appointed 101 franchisees in about 7 years. This was an important expansion of the business; the company was now present in 101 cities.

Ahua chose only one franchisee per city, even in the large ones; each franchisee, in turn, was free to open several demonstration stores in its city of influence. The company also provided a call center to each franchisee. This call center was under the control of the company's headquarters.

The company also chose four cities to be the city operation centers. These were Beijing, Tianjin, Nanjing, and Hangzhou. The city operation centers were owned and operated by the company, directly under the control of the central office. China is so big that it was not realistic for Ahua's headquarters to manage all the training and logistics itself. The city operation centers had been designed to be responsible for training, sales, and logistics within their regions. They had an organizational structure similar to that of the headquarters in Shanghai. Also, the city operation centers served their cities as normal stores, so there were no franchisees in these four cities. In a sense, the city operation centers played two roles: first, they provided support to the franchisees in the region, and second, they were the business operators in the cities where they were located. The total number of cities where Ahua operated at the time of writing this case was 106—101 managed by franchisees and 5 managed by Ahua directly (4 city operation centers and the headquarters in Shanghai).

The headquarters' responsibility was to support the franchising system. First, it provided the products the franchisees were selling. Second, it provided management support such as administration, finance, sales, enterprise resource planning (ERP), and more importantly, customer relationship management (CRM). Third, and most importantly, it provided training support. It was critical to appoint professional staff at the franchisees in order to deliver professional services to customers. Without the necessary training, it was impossible to ensure standard quality at every outlet. Finally, the headquarters was responsible for the company's communication and public affairs. For the direct selling system to work, the brand name needed to be promoted and various promotional campaigns had to be organized. Ahua had good contacts with many professional magazines and websites where customers could find information on the company. It also had agreements with some hospitals and healthcare organizations through which it could market its services. Many franchisees were attracted by the strong market support Ahua provided.

It was after a long debate that they decided to adopt the franchising system. Although the benefits of franchising were foreseeable, they doubted whether they had enough resources to manage the system well. But after careful analysis of the development trends in the market, they decided to go for it. At that time, there were some capital constraints for developing business across different cities. Growth in operations would have been much lower if the company had employed its own resources alone. For instance, opening a new unit in a large city (with over 2 million inhabitants) required an average investment of RMB 1 million; RMB 600,000 in a medium-sized city (1–2 million inhabitants); and RMB 200,000 in a small city (lesser than 1 million inhabitants). It was not so easy to decide how much to invest in a city. As Renhua indicated:

> *The only way to have access to that customer base is to be present in that city. There is a clear advantage for the first mover as the latecomer undoubtedly has to make an extra effort to gain market share. Gaining a foothold in the market quickly is the right strategy, and that was the first motivation for Ahua to adopt the franchising system.*

There were many reasons that supported the adoption of the franchising system at that time. Franchisees had good knowledge about the customs and traditions in their zones, and this gave them a better understanding of the needs of their potential customers. They also hade the right connections with doctors and hospital administrators, and it was easier for them to build good business relationships with the local hospitals.

Ahua paid much attention to the quality of the professional staff; this was a key factor in the healthy expansion of the business. For instance, they recruited many healthcare professionals as teachers in the educational programs for parents, such as the pre-natal education program and pre-school education program. Some famous health experts worked part-time with the company as consultants. The local resources the franchisees employed facilitated the task of finding these professionals and experts.

Another important advantage of the franchising system was that they did not need to create organizations in each city. The franchisee was responsible for the local management and they were their own bosses. Ahua was not required to help a new franchisee in terms of investment. Meanwhile, the company could concentrate on developing a strong professional team at the central office to provide the necessary support to the franchisee.

After several years of rapid development, and as the company gained experience, the franchising system was perfected by increased control over key resources. For example, the

company owned the call center phone number. If a franchisee left the company, the telephone number still belonged to Ahua, which meant that they retained the contact. Besides, the CRM system was controlled by the company itself. It was the only entity that had access to information regarding customers all around China. The franchisees could not access information about customers in other cities.

However, some problems did appear. The franchisees usually had a short-term approach and their main motive was to make quick profits, which was in conflict with Ahua's long-term objective of building a relationship of trust with customers. As Renhua explained:

> *The promotion of our brand name all around China is a long-term investment. However, franchisees that have contracts of only 3-4 years are more concerned about maximizing their profits during the duration, without consideration of the business conditions they leave after the contract ends.*

High-quality, standardized service programs were the key points that differentiated Ahua from its competitors. As Renhua said:

> *Ahua's profits ultimately come from sales of products; high-quality services are the reason why the customers come to us and stay with us.*

The company had developed many professional health programs, such as healthcare for pregnant women, rehabilitation care for new mothers, pre-school education, and free coaching. These special services helped increase customer loyalty – although products similar to those sold by Ahua were offered by other companies, customers chose Ahua because of the professional services it offered. Therefore, it was imperative that the franchisees also understand the importance of building long-term relationships with customers.

Another issue was the quality of services as they depended on the people employed by the franchisee. It was a challenge to provide standard service with the same level of quality everywhere. Although the company provided extensive training to the franchisees, the implementation of the services varied from franchisee to franchisee and it was very difficult to control. As Renhua explained:

> *Sometimes the franchisee lowers the quality of service to increase its profits. For instance, the teaching material is standard for all the cities, but the learning effectiveness is different from different teaching styles. Since the experienced teachers cost more, many franchisees hire less experienced professionals to save costs. But that results in inferior learning and bad feedback from customers. Actually Ahua has developed strict standard for selecting teachers, for example, from the level of associate doctor or associate professor up. We expect the franchisees to select teachers from large local hospitals, but some franchisees hire a recently graduated doctor because he/she is much cheaper. If this practice continues, we will lose all the customers in the long run.*

According to Ahua's own estimates, the direct cost of developing a customer ranged only from RMB 12 to RMB 20, but then they incurred high indirect costs. For instance, Ahua provided customers with free coaching, and the customers could attend the free activities hosted by the company if they bought Ahua's services or products from any franchisee. The ideal situation was to maintain the business relationship with a specific customer for about four years (from pregnancy till the baby is three years old). Some free or quasi-free services were often provided to retain customers. In Shanghai and Beijing where Ahua operated by itself, if a customer spent more than RMB 3,000 within a year, she could attend diverse activities such as lectures, coaching, and meetings with experts free of cost. This was an effective way to motivate customers to remain loyal to the company. However, some of these services and activities were financed by the franchisees, which meant they had to sacrifice their short-term profits. Since the contract term for the franchisees was about 3–4 years, they did not care much about the future and had a short-term view of making quick profits. They did not want to spend much money on retaining customers. After all, they thought 80% of the income came from selling products, not from services. According to the company's records, the customer loss rate ranged from 4% to 8%. However, the low loss rate did not mean it would not hurt their businesses. For Ahua, the loss of a customer was a great problem. The lowering of the service quality not only damaged the image of the company but also offered its competitors an opportunity to gain market share.

As Renhua said:

> *It is a demanding job to supervise more than 100 franchisees. It is impossible for us to supervise them in every aspect. For example, it is prescribed that the franchisees can only sell the products provided by Ahua but some of them began to do some business beyond the contract restrictions. Though it is possible to penalize them when detected, many franchisees still continue with this practice because we cannot monitor them all the time. Besides, we cannot control the quality of these products, and sometimes bad products can endanger the health of our customers. And at the end, the customer thinks it is Ahua's responsibility. This harms our image, which is very damaging for our long-term success.*

Lack of effective control also gave way to fraudulent accounting reports. The management fee charged by the company from the franchisees' income was a major source of profit, but many franchisees presented fake accounting reports to Ahua. For example, if a franchisee with an annual income of RMB 3 million reports just RMB 1.4 million, the company could lose much of its management fee, which could range from 1.2% to 2% of the annual sales income. What is more, if such false accounting reports were not detected in time, the situation became worse as the end of the contract approached. If the franchisees provided fake accounting reports, the company could not even punish them. It was impossible for the company to spend time and money to detect and punish all of them. What was more, the supervision cost was extremely high. It was not feasible for the company to assign a person in each city to monitor franchisees' behavior. Moreover, detecting fake account reporting was not so easy; it was time and money consuming. So it was impossible for Ahua to control the

franchisees effectively.

What to Do?

To stop the franchising system would mean to stop operating in many cities as the company could only handle around 10 cities with its present team. They would have had to hire and train many managers and store assistants. Besides, during the period, many competitors would have managed to take advantage of the vacuum created by Ahua's retrenchment and break into the market. Renhua put it very clearly:

> *To stop the franchising system would mean to start from zero again.*

If the agreement is terminated under the conditions specified in the contract (such as force majeure), Ahua does not have to compensate the franchisee. But neither Ahua nor the franchisee had any right to terminate the agreement until the conditions specified in the contract were not met. That meant that Ahua had to wait till the contracts expired to take over the cities. There would be new demands on Ahua if the system was to be terminated. Renhua had many questions in his mind; it was not certainly an easy decision to make. The business' future was at stake.

Exhibit 1: Control Terms of Franchising Contract (Part A stands for Ahua and Part B refers to the franchisee)

Rights of Part A:

1. Part A has the right to request Part B to submit the financial reports and all the data related to business. Part A also has the right to use the information Part B provides according to business needs.
2. Part A has the right to decide whether Part B is committing the requirements prescribed by the Ahua Mum-Baby Life Hall franchising system or has broken the rules of the system, according to the *Management Handbook of Ahua Mum-Baby Life Hall franchising system* and the *Operation Handbook of Ahua Mum-Baby Life Hall franchising system.* If Part B has broken these rules, Part A has the right to punish Part B accordingly.
3. If Part A determines that Part B has broken the rules of the franchising network, Part A has the right to punish B by written notice, deducting the down payment, or canceling the franchising agreement.

Obligations of Part A:

1. Part A has the obligation to ensure that Part B is the only franchisee in the city Part B is in.
2. Part A has the obligation to provide necessary guidance and support for Part B to facilitate the operation and business.
3. Part A has the obligation to provide Customer Relationship Management support for Part B.

4. Part A has the obligation to provide all the forms which are necessary for Part B to operate.
5. Part A has the obligation to provide uniform image design of the shop for Part B.
6. Part B has the obligation to provide uniform image of the Ahua Mum-Baby Life Hall franchising system for Part B.
7. Part A has the obligation to provide necessary credentials for Part B to operate.
8. Part A has the obligation to provide Part B with all kinds of handbooks related to operation, management, and service.
9. Part A has the obligation to provide Part B with all necessary professional service.

Rights of Part B:

1. Part B has the right to enjoy exclusively the rights granted by the franchising network within the franchised city.
2. Part B has the right to use the Ahua brand during the operation.
3. After the expiration of the contract, Part B has the priority to continue the contract at the same condition.

Obligations of Part B:

1. Part B has the obligation to confirm the rules and requirements prescribed by the Ahua Mum-Baby Life Hall franchising system.
2. Part B has the obligation to adopt the uniform image prescribed by the Ahua Mum-Baby Life Hall franchising system.
3. Part B has the obligation to operate only in the franchised area.
4. Part B has the obligation not to operate any business which is similar to the Ahua Mum-Baby Life Hall franchising network but owned by others.
5. Part B has the obligation to submit the management reports and related information prescribed by Part A.
6. Part B has the obligation to repay the deposit within 14 days after notice to make up the original pool which has been taken over by Part A as penalty if Part B violates the term of the contract.

Other terms related to control: Within 2 years after the contract is terminated, Part B promises not to operate, either by itself or by cooperating with the third party, the business which will thread or compete with Part A's business. If Part B does not follow this term or if Part B uses Ahua's brand before it is permitted by Part A, it will be considered as infringement. Part B will be responsible for it by law, and will also pay Part A for its loss.

The contract will terminate:

1. When the expiration date is due;
2. When the contract cannot be implemented because of force majeure;
3. Part A has the right to terminate the contract if Part B sells the products of other companies or products similar to Part A's products, under the name of Ahua or Ahua Mum-Baby Life Hall;
4. Part A has the right to terminate the contract if Part B is convicted by criminal law;
5. Part A has the right to terminate the contract if Part B heavily infringes on the terms of the contract;
6. Part B has the right to terminate the contract if Part A cannot provide the necessary support guaranteed by this contract for 3 months out of Part A's inaction.

Exhibit 2: Maturity of the Franchising Contracts

Note: The term of the contract is either 3 years or 4 years.

Number	Province	City	Maturity	Population(in '000s)
1	Zhe Jiang	Wenzhou	2004	1,826
2		Jinhua	2004	424
3		Taizhou	2003	1,492
4		Quzhou	2005	286
4		Wenling	2004	1,163
6		Ningbo	2003	1,467
7		Shaoxing	2003	633
8		Zhuji	2004	1,070
9		Haiyan	2005	388
10		Jiaxing	2006	882
11		Lishui	2003	348
12		Yiwu	2004	913
13	Jiangsu	Kunshan	2003	740
14		Kunsan (new)	2003	740
15		Zhenjiang	2004	694
16		Huai'an	2004	1,200
17		Jingjiang	2003	639
18		Xuzhou	2005	1,082
19		Changzhou	2004	1,082
20		Jiangyin	2003	1,314
21		Wujin	2006	1,420
22		Suqian	2004	244
23		Wujiang	2005	847
24		Nantong	2004	771
25	Liaoning	Dalian	2005	3,344
26		Shenyang	2003	4,302
27		Liaoyang	2006	728
28		Panjin	2004	603
29		Chaoyang	2004	474

30		Kuandian	2003	409
31		Fushun	2004	1,434
32		Anshan	2004	1,446
33		Dandong	2003	780
34	Heilongliang	Harbin	2003	3,481
35		Jiamusi	2005	860
36		Qiqiha'er	2004	1,440
37		Mudanjiang	2004	807
38	Jilin	Dunhua	2004	189
39	Shandong	Jinan	2005	2,999
40	Shandong	Binzhou	2005	600
41		Linyi	2003	1,938
42		Yantai	2003	1,724
43		Tai'an	2004	1,438
44		Zibo	2005	2,817*
45		Heze	2004	1,280
46		Qingdao	2004	608
47	Hebei	Shijiazhuang	2005	1,432
48		Baoding	2006	902
49		Handan	2003	1,330
50		Tangshan	2004	1,711
51		Qinhuangdao	2005	818
52		Xingtai	2004	436
53		Langfang	2003	714
54		Cangzhou	2005	444
55		Chengde	2004	368
56		Dingzhou	2004	203
57	Shaanxi	Taiyuan	2003	2,448
58		Changzhi	2003	649
59		Jincheng	2004	304
60		Jiexiu	2004	373*
61	Inner Mongolia	Huhehaote	2006	1,407
62		Haila'er	2003	262
63		Baotou	2004	1,394
64	Henan	Zhengzhou	2005	2,489
65		Luoyang(jia)	2003	1,492
66		Luoyang (chen)	2005	1,492
67		Jiaozuo	2003	747
68		Bo'ai	2006	419*
69		Wuhan	2004	8,312
70		Jingmen	2004	483

71	Hubei	Xiangfan	2003	871
72		Suizhou	2005	1,498*
73		Qianjiang	2004	992*
74		Huangshi	2003	643
75	Hunan	Hengshuijiang	2005	340*
76	Anhui	Huainan	2004	709
77		Tongling	2004	362
78		Fuyang	2004	1,719
79	Guangdong	Huizhou	2004	492
80		Zhanjiang	2005	1,341
81		Guangzhou	2003	8,424
82		Shantou	2005	3621
83		Zhongshan	2003	2,633
84		Chaozhou	2005	363
85		Fanyu	2004	1,630*
86		Meizhou	2003	314
87		Jiangmen	2004	436
88	Fujian	Fuzhou	2004	2,124
89		Zhangzhou	2005	468
90		Ningde	2003	400
91		Pucheng	2004	321*
92		Fuqing	2006	1,174*
93	Guangxi	Nanning	2003	1,767
94		Liuzhou	2003	1,740
95		Yulin	2004	4,633*
96	Hainan	Haikou	2005	830
97	Shanxi	Ankang	2003	843
98	Gansu	Jiayuguan	2004	149
99		Lanzhou	2004	288
100	Sichuan	Panzhihua	2003	691
101		Luzhou	2004	1,243

* Including the population of suburbs and counties governed by the city

Exhibit 3: Organizational Chart of Headquarters

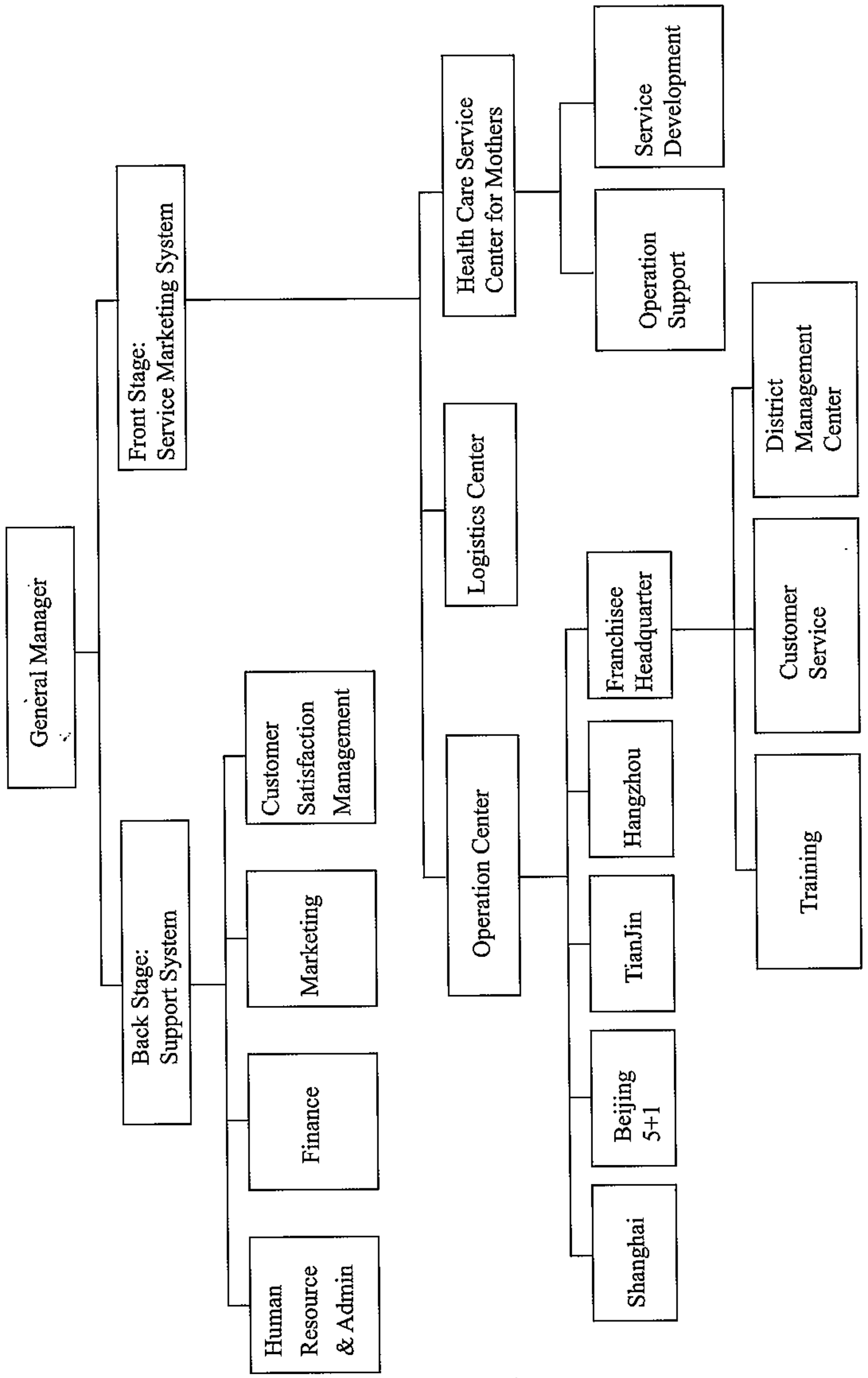
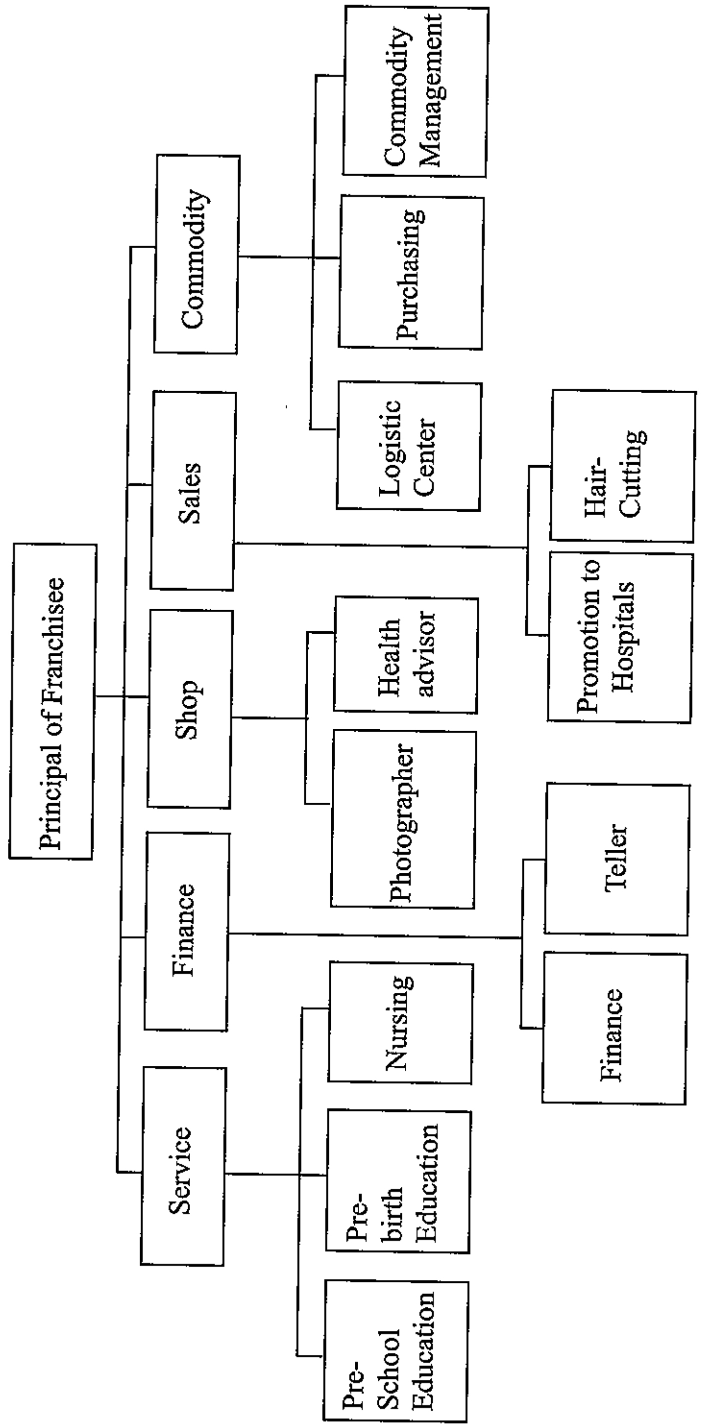


Exhibit 4: Organizational Chart of Franchisee in Big Cities



Pre-school Education: Responsible for taking care of the pre-school education program, such as program arrangement, teacher assignment.

Pre-birth Education and Nursing are similar to pre-school education.

Photographer: Responsible for taking photos of babies and mothers.

Promotion to Hospitals: Responsible for contacting hospitals and promoting service programs and products to them.

Exhibit 5: Photo of Chen Renhua, General Manager of Ahua

Exhibit 6: Chen Renhua and Ahua's Major Products

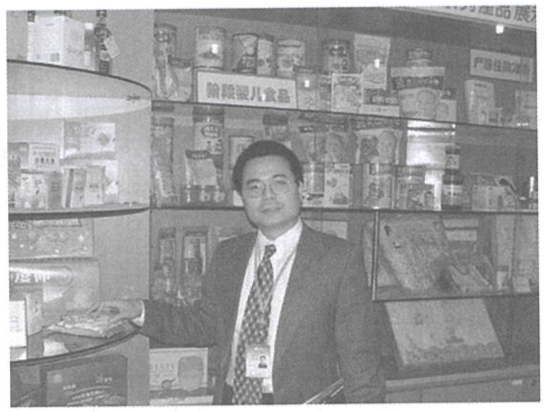


Exhibit 7: Ahua Mum-Baby Life Hall

Exhibit 8: Mission

Translation: This is our….
Spirit: "Da Mu Qiao"

Our spirit is a combination of accountability, professionalism, and teamwork. This is the core of our corporate culture.

The shop on Da Mu Qiao Street was our first. At the early stage of our development, we lacked resources, staff, and capital, but everyone in our company was highly motivated to develop the business. Our rapid development and excellent performance was only possible because of the sense of survival deeply rooted in our employees and the understanding and care between our staff and our customers. Today, we still hold high the banner of the Da Mu Qiao spirit, to work hard continuously…

Tenet: Care about mother and baby, service society

Women should be respected by the whole society, because they are not only half of the society but also create life so that our society can continue and develop. Babies' physical and

intelligent health is closely related to the prosperity of our country.

All the products and services we provide are meant to improve the quality of life and happiness of the mother and baby.

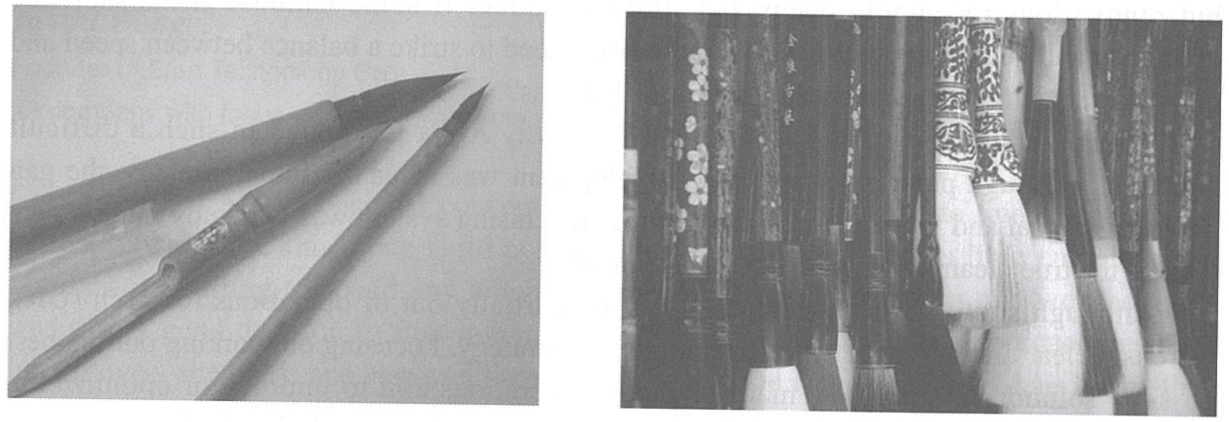
Mindset: Small project, large market

Our business is not a traditional one. We explicitly connect our products and services. We have a large customer target, and so, each small project we implement is specially designed, planned, and marketed to satisfy a large market.

Management Idea: People-oriented

We believe that human capital is more important than financial capital. So we designed all our management processes—marketing, finance, service, and quality control—based on our staff. We try to regulate our staff's behavior, and make full use of their potential, to achieve the goal of "attract talent by wealth, and create wealth by talent."

Exhibit 9: Chinese Writing Brushes



CASE COMMENTARIES

COMMENTARY 1

Dong Bian
Professor of Strategy, EM Lyon Business School

Ahua was the mother-baby care industry leader in China in 2002. After about eight years of franchising, the company started facing problems: Ahua was losing control over the service quality of its franchisees; the objectives of the franchisees were short-term and not in line with that of Ahua's; there were reports of fraudulent accounting, which seriously endangered Ahua's profitability and harmed the image of the company.

Ahua might have to decide on whether it should continue the franchising mode of business development or discontinue it and run the business by itself. However, any move could prove to be extremely expensive. Staying where it is might force Ahua to work out and implement a feasible and effective solution to its current problems, while switching to operations under its own management would be resource- and time-consuming and give room for Ahua's competitors to sprout.

The case of Ahua is interesting. It not only exposes the students to a very difficult strategic situation but also triggers in-depth thinking about the underlying rationale of strategic management. Before providing comments on this case study, let me share with you some of the results of our research in Europe. After a month-long interview with Chinese firms in Spain, France, Germany, and the UK, we were surprised to find that most foreign employees shared the same impression about Chinese firms: "Chinese make decisions very quickly ... and perhaps that is why China is growing so fast ..." However, behind this "admirable" trait, quickness in decision making and implementation could also bring with it subsequent problems: buildings are erected within months in China, but problems come soon after; after-sales services are delivered within hours, but the number of complaints do not drop accordingly; infrastructure is widely developed to pave the way for economic development, but renovations repeatedly occur. It is time to ponder if some Chinese firms sacrifice efficiency and quality for speed. Do Chinese firms need to strike a balance between speed and quality, especially when it comes to strategic decisions?

Going back to the Ahua case, we may ask why Ahua is trapped in such a difficult situation. Although pursuing sustainable development was Ahua's original strategy, the gap between its goal and the implementation of the franchising system was evidently huge. Then, what is the true meaning of strategic management?

Although strategic management studies are partially out of operations research (OR), there is a clear distinction between operations and strategy. Focusing on working out the best possible solution to a problem mathematically, operations aim to improve or optimize the performance of a system, while strategic management implies that firms can choose to lose something for the moment to win in the future. It is true that Ahua should develop the market rapidly to enjoy the first-mover advantage in this emerging industry, but a defect in strategic decision making may make it difficult for the firm to get out of a problematic situation. It could even endanger its survival.

Ahua actually owned a very good business model in the mother-baby care industry. Leveraging health consultancy to attract and educate customers, formulating complete solutions to serve parents and babies, and providing professional services to nurture trust and loyalty—all these contributed to the company's growth. However, upon carefully examining these products or services, readers can easily see that these activities are more operational than strategic. Although these resources or events are usually connected in Ahua and help build up competitive advantage, how can they sustain Ahua's development in the future when other firms copy this business model? Strategy per se is not supported only by individual ideas, resources, or simply a combination of them, but relies on an underlying corporate capability

that can efficiently identify problems, generate innovative ideas, and organize relevant resources to solve them.

Ahua adopted the franchising system to quickly expand its business in China. The company grew very rapidly, but when problems occurred, Ahua was not able to resolve them. The misalignment of the incentives of the franchisees with that of Ahua's simply exposed the gaps in corporate capability. Problems have accumulated to a degree that Ahua is unable to cope with them, therefore, punctuated re-organization might not help, at least, in the short term.

Ahua may improve the situation by issuing some motivation policies, giving up the franchising system to put it under its own management, training professional staff so that the franchisees can provide standard services, etc. However, if Ahua does not realize that it is the corporate capabilities instead of the above-mentioned techniques that can sustain its development in the long run, it will continue to face similar problems in the future. We hope that students can move from the surface of the case (discussing how to solve the problems tactically) to an intrinsic understanding of how to set up a dynamic learning organization.

COMMENTARY 2

Justin Wong

Founder of Start Technology Co.

(A company with focus on wind power, solar power, and other renewable energy sources)

I must say that Ahua's business concept is very good. They managed to find a niche in the market. Owing to China's one-child policy, children are considered as little emperors and families are willing to spend any amount of money on their education and well-being. It was a very good decision to start this business. Besides, Chen Jianhua's approach has been impressive—she did it one step at a time. First, she had the idea of the baby-hair brush, then the haircut business; she kept adding products around the original idea. As they say in the case, she and her husband created an industry that did not exist at the time. However, the challenge they are facing is whether to stop the franchise or continue in a different way.

I will now list some of the mistakes I perceive they made, and later, offer some recommendations based on my experience.

I believe they grew too fast without creating the right systems. I understand they wanted to grow fast to get the business to as many cities as possible before any competitor could do it. Given that strategic decision, franchising was the right way to go unless they had the financial resources to finance their growth. However, it seems they did not have those resources at that time. It was a good decision to start the franchise to expand the business. The benefit of a franchise system is that you can expand much faster than by using your own resources. The mistake was that they did it without creating a solid foundation. Now they are facing a critical problem as some of their franchisees do not respect the rules and are jeopardizing the reputation and future of the brand. In a way, they are learning by doing, but I think it is not too late to correct the situation.

The first thing they should do is hire a good lawyer and revise the contracts with the franchisees. Many of the contracts will mature soon. Therefore, it is a good time to revise the contracts and include strong clauses to protect the brand name of the company. The contract should also specify the quality requirements for the operation of the franchise, such as cleanliness of the place and minimum medical experience of the consultants. The contract should also specify very clearly the consequences in case a franchisee does not meet the specified criteria. It should specify penalties and even have the right to cancel the agreement. It should also include a clause on compensation in case of any wrongdoing.

Another area that requires improvement is control systems. Chen Renhua should organize a regional control office, with a team in charge of controlling the operations of different outlets in the region. I also recommend having frequent, surprise visits to the outlets to check whether they are adhering to the regulations and quality requirements. They should also audit their books and see if they are playing any trick with the numbers. It would be good to use a spy system so the inspectors contact clients and check if they are getting the services and products recommended by the company. They could also pose as a client, calling the franchisee and asking for products other than those recommended by the company.

These control measures should be complemented by positive actions. Ahua should provide good value to the franchisees so they are motivated to stay in the system and behave professionally. One of the complaints is that the contracts are for a three-year period because of which the franchisee has a short-term profit mentality. The company should offer the possibility of long-term contracts to those franchisees that follow the rules and generate profits for the system. Another way of adding value to the franchisee is to offer training and corporate promotions to enhance sales. The franchisee has to see the value in being a part of the organization. You need to give them assurance of a better future with the organization so that they feel the need to remain associated with the organization.

The next step is to take some strong actions to correct the situation. There is a saying in China: "Kill the chicken to scare the monkeys." I would recommend them to do the same. Focus on one or two bad cases and sue them. Go really hard against them. Use good lawyers and spend money on that. Ask those franchisees to compensate the company with a huge amount of money. Then share the lesson with other franchisees. You have to send out a strong message that you will not tolerate this type of behavior. As the people running the franchisees are not highly educated, they will get worried. You cannot afford to be soft in this business. If you are soft, they will not listen to you. You need to strike a right balance between toughness and fairness, so that people respect you and take you seriously. Show them they can benefit if they follow the rules, but that it would be very painful if they do not.

I do not think it is a question of the Chinese being trustworthy or not; a franchise can work in China as anywhere else. That is not the problem; the problem is that there is a mentality of becoming rich overnight. Ahua needs to educate its franchisees and establish the necessary control systems. Franchisees must understand if they respect the system, they will be rewarded.

CHAPTER 7

Leadership in Crisis:
When 24 Hours Just is not Enough!

CASE STUDY
Fuqima Washing Machines Corporation

In early January 2006, Wang Dong, CEO of Fuqima Washing Machine Corporation (FWM), was going through the reports of the company's different departments for 2005. He was disappointed with the company's poor performance and tried to identify the real problems that the company was facing. He was also worried about the board meeting at the end of the month where he had to present the company's strategic plan for 2006.

Establishment and Operations in Late 1980s

Wang Dong, an engineer in a machinery plant, formed FWM in 1988. Wang believed that there was huge market potential for washing machines in China, a country with 1.3 billion consumers and headed toward modernization.

With investments from Foshan No.1 Machinery Works and the local government, Fuqima Washing Machine Corporation was established by Wang in Fushan, Guangdong Province. The company's first model, HDT-100, was launched in 1989. Its features, such as durability and low price (about 50% lower than similar imported models), ensured that it became an instant hit in the market. Distributors from all over the country queued up to place orders. The company received orders covering its entire production target for 1990 by as early as mid-1989.

Growth of FWM

Besides his responsibilities as CEO of FWM, Wang Dong was personally in charge of the company's manufacturing operations, and also supervised all the functions, including procurement, sales, and finance.

Recalling those early days, Wang said, "At that time, it was really easy to make money. The distributors themselves waited for you with checks in their hands." Wang added that all they had to be concerned about was increasing the production capacity in order to meet the growing demands. To expand FWM's production capacity, Wang and his production team worked day and night.

In 1996, FWM bought another production line from Japan, which increased its production capacity (two shifts) to 200,000 units annually. In 2000, Wang set up a new plant in Shunde, about 50 km from its Fushan plant, with an annual production capacity of 300,000 units (one shift). He closed the old factory in Fushan and moved all the production to Shunde. This new plant provided FWM the capacity to produce three different models simultaneously. In 2002, Wang acquired two local washing machine companies, one in Shenyang and the other in Chongqing, increasing its production capacity to 1.5 million units (one shift) annually. In 2003, the company became a public company with its stocks listed on the Hong Kong Stock Exchange.

Sales Operations

While Wang was deeply involved in production expansion, he also made considerable efforts to build a strong national sales network. In 1990, FWM opened its sales office in Guangzhou (the capital of Guangdong Province) and by 1995, it had five offices in Shanghai, Beijing, Chongqing, Shenyang (the capital of Liaoning Province), and Zhengzhou (the capital of Henan Province).

By end-2000, Wang's sales team comprised 235 sales representatives, 18 provincial sales managers, and 5 regional sales managers. Each of the regional sales managers was responsible for coordinating sales and promotional activities in 3–5 provinces. Wang traveled across the country, meeting big distributors and managing the sales representative office. Shen Jun, sales manager, said:

> *Mr. Wang visits our sale offices without notice and checks all expenses and income. He reviews all the contracts that we had signed on behalf of the company and asks us a lot of questions. Mr. Wang works for long hours in the day and also through the night ... Although it is not stated in the company's regulation, it is widely believed that all the advertising budgets should be approved by Mr. Wang.*

Products

In 2002, FWM launched a successful flagship model, the HDT-600. It had a more powerful engine, with a better washing capacity and performance. Wang said:

> *We have a greater edge in terms of technology when compared with domestic models, and in terms of price in comparison to imported models.*

In this policy of innovation, FWM launched new models every one or two years. However, the HDT-800, the latest model launched in January 2005, was not well-accepted in the market, marking the beginning of a dip in FWM's market share.

Post-Sales Service

Post-Sales Service (PSS) held great importance in the household appliance industry. Till

2002, FWM outsourced its PSS to local service suppliers, and it was the sales department's responsibility to identify those local service suppliers. By end-2002, FWM established its own PSS department. Jiang Dawei, a regional sales manager, was promoted as head of the PSS department.

During the first half of 2003, Jiang identified and recruited 15 young managers from the sales department and manufacturing plants and trained them intensively on PSS management. He also traveled extensively, meeting existing local PSS suppliers to figure out a way to establish the PSS network.

In June 2005, Jiang proposed a 30-page plan to establish a national PSS network. It required an initial investment of RMB 25 million, including spare parts. However, the plan was postponed because of the company's poor performance in 2005.

R&D Department

New product design was generally undertaken by a team of engineers at FWM. However, an R&D department was formed in 2001 amid stiff competition in the market. It was headed by Ping Yi, a Post Doctorate from Qinghua University. Ping's first project was the HDT-600.

Primarily an imitation of a Japanese model, the main features of the HDT-600 model included small wash room, low energy consumption, and low noise level. Another important project that Ping had worked on was the designing of a new model, the HDT-800, targeting the high-end market. The HDT-800 was launched in January 2005.

In order to improve the design of the washing machines, Ping frequently visited a washing machine designing center in Japan and also sent some of the model designers to the center for training.

Salary and Incentives

"To reward the diligent and punish the lazy" was the principle of FWM's incentive system. Based on this, FWM had three different incentive systems:

1. Each sales manager had his/her annual sales quota and their income was linked to the fulfillment of the quota. Each of them had a nominal salary of RMB 120,000 annually, while their real income was the percentage of quota fulfillment multiplied by the nominal salary.
2. The income of production assembly workers was mainly based on the number of units produced by them.
3. Employees in all the other departments earned a fixed salary with an annual bonus, based on individual performance and evaluation.

The Downfall

FWM enjoyed market leadership till 1998. The good days, however, did not last very long. In 1999, some strong local competitors, such as Little Swan and Little Duck, emerged.

Moreover, foreign washing machine giants, such as Siemens and National, had also started local operations with joint venture partners in China.

Failure of HDT-800

On January 1, 2005, FWM launched the HDT-800. It was smaller and lighter than any of the previous HDT models and reduced water consumption up to 20% in comparison to other washing machines. It also had an integrated drying system, which facilitated quick drying of clothes in humid areas.

However, its sales were much lower than expected. Owing to its additional drying feature, the price of HDT-800 was 25% higher than that of other products of the same capacity. Distributors and retailers were reluctant to sell HDT-800. Moreover, one of FWM' s competitors had launched a similar model at a lower price than the HDT-800 in February 2004, claiming that its product had a better drying system.

Fuqima planned to launch a second round of promotion for the HDT-800 in early March 2005. However, things took a turn for the worse when Wang had an accident while traveling to visit a major customer; he was recommended bed rest for at least three months. Both advertisers and provincial sales managers knew that without Wang's approval promotion could not be finalized. Because FWM's other models were not new to the market, the declining sales of HDT-800 led to a sharp decrease in FWM's market share.

Some provincial sales managers even thought of leaving the company because of low salaries. The sales manager of Guizhou Province, said, "I only fulfilled 55% of my quota, thus I got only 55% of my nominal salary". He was of the view that employees were bearing the brunt of the company's non-competitive products.

Questions were also raised about the novelty of ideas in the R&D department and its mode of functioning. A salesperson commented, "I do not know what our R&D department is doing. They never ask us for opinions. For its high price, HDT-800's plastic cover looked so thin that it is difficult to sell it as a high-end product." There was also a growing sense of resentment among the sales teams regarding the high dependence of the R&D department on their Japanese counterparts.

Ping, however, had a different opinion. "I agree that the plastic cover looks thinner, but it is the responsibility of sales managers to explain its benefits to customers. Actually, we spent weeks designing this cover. It is thin in order to save costs and make the washing machine lighter. According to our tests, the HDT-800's cover can last as long as the thick ones." Ping added that she had sold five HDT-800 models in two hours in a department store in Zhejiang, though she had no experience in sales. If she could do it, a large sales network like that of FWM's should not have problems selling this model. According to her, customers could be educated about the product if the people in the sales teams know the product well.

The plant manager at Shunde, was also not satisfied with the sales department. He said, "I do not think they work hard enough. In terms of technology and quality, HDT-800 had an edge over products of its competitors." He held the sales department responsible for the significant decrease in the income of the first-line assemblers.

Lack of Coordination between Three Plants

Wang had planned to use the Shenyang plant to support the north China market and the Chongqing plant to support the west China market; however, things were not as easy as expected. The Shenyang and Chongqing plants, each with an annual production capacity of 500,000 units, were so large that even if over 30% of the workers were laid off, the demands could still be met. However, if he let those two plants produce to their full capacities, he had to reduce the production volume of the Shunde plant. Consequently, this would reduce the income of the production line workers at Shunde and adversely impact their morale.

The division of production between the plants was also a concern. If all the three plants produced the same models, FWM would have to make significant investment in duplicating molds for the three plants. Moreover, the company needed suppliers to provide raw materials to all three plants.

Further, if the plants produced different models, balancing the production volumes between different models would be a problem as all the three plants would want to produce the "best selling" models.

Issues Faced by the Sales Department

Shen Jun, sales director, was worried about problems related to sales operations. Shen's first concern was his customers' bargaining power. Of the company's distributors, 14 accounted for more than 75% of the total sales and were, therefore, powerful negotiators. FWM could not also do away with them. If one of them joined a competitor, such as Little Swan or Haier, it would mean a 5% drop in FWM's sales.

Second, he was worried about the "cross-province selling." Because of the present incentive system, some provincial managers tried to sell their products outside their own territory via distributors. This led to conflicts among the provincial managers.

From his experience, Shen knew that this problem would be solved automatically if the sales were good. However, these conflicts could get extremely fierce in a bad sales year. He had even read reports about some nationwide distributors approaching different provincial managers for a lower wholesale price and better advertising support, though the company had already set the minimum price.

The growing tension between the sales department and the R&D department also worried Shen. Even he was not satisfied with Ping's explanation about the thin cover, he said:

> *The customer is God. If they want a thick washing machine cover, we must give it to them. The provincial sales managers are not happy due to the low sales volume. Most of them have reported to me and Ping several times about the thin cover. But nothing has happened to date. The sales department is equivalent to soldiers fighting on the front line who would need good weapons.*

Shen also felt a growing sense of distrust toward the R&D department. Ping had asked

Shen a number of times for detailed market information and competitor product analysis. Shen was not quite sure whether he should provide this information as the information was confidential and highly sensitive. "I once visited the research center and noticed that even their junior managers had access to highly confidential files. If this is the truth, it will be fatal for me to give such information to her." This distrust increased to a point where Shen Jun even suspected that the HDT-800 design was stolen by competitors due to R&D's negligence.

Shen also wanted to separate the marketing functions from the sales functions. He added:

Nowadays, my managers are focusing too much on sales due to the incentive system. They focus on big distributors and wholesalers and do not pay much attention to the small ones. I think we should establish a marketing department that would work on long-term branding and customer development.

Jiang, too, was unhappy with Wang's decision to postpone the plan for building the national PSS network. Jiang said:

I understand that 2005 was not profitable for both investors and the company. However, the PSS network was important. All the competitors have a PSS network.

Shen and Jiang wanted to convince Wang to hire a consultant to help them solve the problems that FWM was facing. They enumerated the problems as follows:

- How can sales be improved? What short- and long-term measures should the company take?
- How can the production and sales of the three plants be coordinated?
- Who should be held responsible for the poor performance of HDT-800 and how can similar situations be prevented in future?

Exhibit 1: Financial and Operational Data

	1985	1990	1995	2000	2005
Sales volume (thousand units)	1.38	155	550	1,764	1,075
Sales volume of HDT series (thousand units)	1.38	154	540	1,650	878
Gross profit (in RMB million)	0.69	62	165	265	129
Net profit (in RMB million)	0.08	7.5	35.8	85	-8

Exhibit 2: Organizational Structure

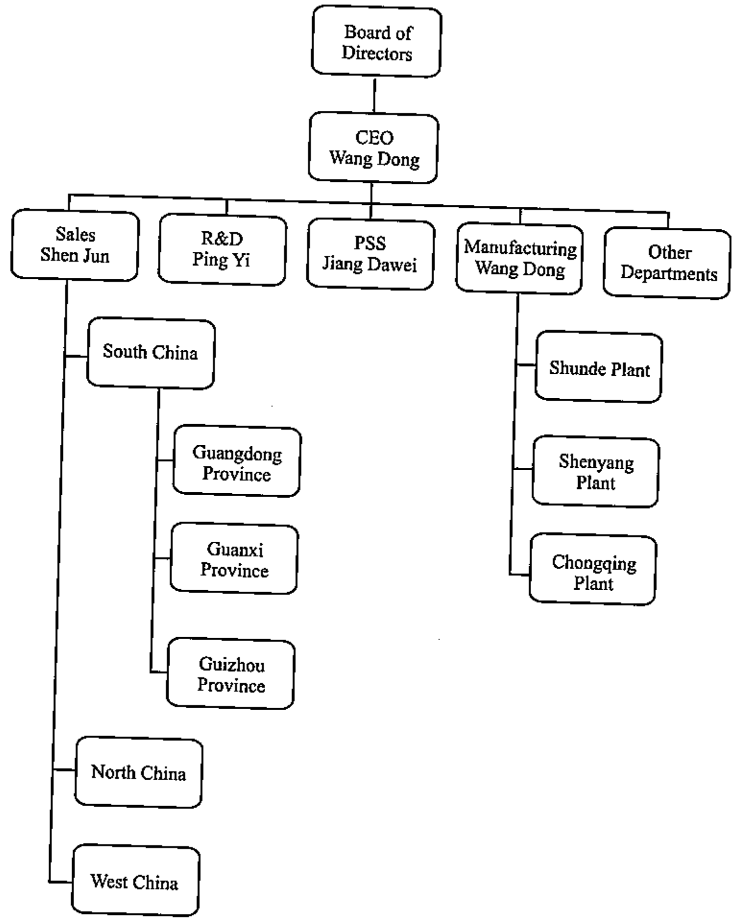


Exhibit 3: Selected Internal Memorandum

COMPANY CONFIDENTIAL MEMORANDUM

To: Shen, Director of Sales Department, and Ping, Director of R&D Department
From: Wang Dong, CEO
Date: June 2, 2005
Subject: Sales of First Quarter and the HDT-800 model

Dear Shen and Ping,

The sales of the first quarter were lower than expected. The HDT-800 seemed expensive for our traditional customers and one major problem with the design was identified.

The plastic cover of HDT-800 looks too thin. Haier uses a stainless steel sheet as a cover, which gives consumers a good impression about the quality of their products. I wonder if we could apply the same design to our products.

Besides, the doctor suggested that I should stay in the hospital for another two weeks and hence cannot come back to work till June 16. Consequently, the promotional campaign will have to be postponed for some time.

Regards,
Wang Dong

COMPANY CONFIDENTIAL
MEMORANDUM

To: Wang Dong, CEO
Cc: Shen, Director of Sales Department
From: Jiang Dawei, Director of PSS Department
Date: June 10, 2005
Subject: PSS Network

Dear Mr. Wang Dong,

Please find attached the plan for building the nationwide PSS network. The key points of the plan are as follows:

- We will build a PSS network covering 20 major provinces in China.
- Each of the provinces will have about 1–3 customer service centers. There will be four major regional customer service centers at Shanghai, Beijing, Chengdu, Guangzhou, and Qingdao.
- There will be one PSS manager for each province and each center will have 3–5 repairing engineers and a limited inventory of spare parts.
- Each provincial customer service center will be responsible for providing technical support to local contracted PSS service suppliers by solving the problems and providing necessary training and spare parts.
- Each regional customer service center will have an inventory of all spare parts and some transportation vehicles and will be responsible for providing technical support, training, and spare parts to local centers.

We would need an initial investment of RMB 2.5 million to carry out the proposal.

Regards,
Jiang Dawei

COMPANY CONFIDENTIAL
MEMORANDUM

To: Wang Dong, CEO
From: Board of Directors
Date: October 10, 2005
Subject: Performance in First Three Quarters

Dear Wang Dong,

The company suffered losses for three consecutive quarters. We are becoming increasingly worried about the performance of the company. We hope that you will take immediate action to ensure that the company regains its competitive advantage.

We, as the major investors in the company, expect you to implement necessary measures to improve this situation. We are looking forward to hearing your plans for 2006 in the next board meeting in January.

Regards,
Steering Committee

CASE COMMENTARIES

COMMENTARY 1

Xiao Zhixing

Professor Xiao Zhixing, Professor of Managements, CEIBS

Max Weber used the famous metaphor of the "Iron Cage" to refer to the unstoppable and irreversible trend of rationalization and bureaucratization of human society, "perhaps until the last ton of fossil fuel is burned out." Chinese scholars such as Max Boisot and his associates, however, have noticed a somewhat opposite phenomenon in China, the "Iron Law of Fiefs"—in other words, the "Iron Cage" of personal rule. Everything is done through personal relationships: dealing with colleagues (inside the organization), dealing with distributors (outside the company, in the market), and even when you need to deal with the government.

As a Chinese company, Fuqima is, of course, a case in point. Since the start-up, the personal charm (or charisma, in its more fully bloomed version) of Wang Dong has been the most important cohesive strength that holds the organization together. To make the organization run, he needs to establish personal relationships with every department head. This kind of personal relationship (guanxi) is a delicate mix of friendship and business, emotions and instrumentality, trust and vigilance. Or more precisely, it requires a chemical rather than physical process to develop such a relationship, the difficult balance of which can only be managed after a long period of trial and error.

Wang understands that his relationships with big distributors are his most important assets and spends a lion's share of his time in building relationships with these people (that is why he needs to "drink a lot with major customers," which explains why he was involved in a car accident while on his way to meet a major customer). His heavy control on the advertising budget can also be understood from this perspective: advertising is a means through which he cements his ties with his favorite distributors.

On top of that, Wang does not trust his management team. He uses a kind of micro-management style to control every detail of his company. As Shen (sales manager) observes, "He would check every single penny I have used and collected. He would review all the contracts that I have signed on behalf of the company and asked me a lot of detailed questions."

The case of Fuqima is a perfect example of how Chinese companies operate in reality. The landslide importance people attach to guanxi can find its explanation in the long history of dictatorship (first by the emperor, then by the ideology) when property rights and individual rights were not protected. These companies can still be very competitive when the cost of labor and other production factors are much lower than those in other countries. However, if they cannot relinquish their old style of organizing people, they will quickly be out-competed by any company that can build a rational organization on the basis of standard management principles (textbook version, really).

COMMENTARY 2

Chen Wei
Managing Director, Shanghai Zenisun Investment Group Co., Ltd.

FWM has a number of significant problems. First, there is the problem of leadership. The only decision maker in the entire organization is Wang. However, the increasing complexity of the business makes it difficult for him to make all the decisions. Wang also lacks the necessary management knowledge to take care of all the functions. There is no empowerment within the organization. In fact, this tends to be one of the major problems that many private Chinese companies face.

Second, there is a lack of cooperation, especially between the sales and R&D departments. The R&D department puts too much emphasis on the development of technology and new products, regardless of market needs. The sales department, in contrast, does not provide necessary information to the R&D department. Moreover, the development of new products is not based on the needs of the market but on a Japanese washing machine model that the head of R&D likes. Furthermore, the R&D department focuses on technology, regardless of cost.

Third, sales are largely dependent on a few major distributors. This gives these

distributors strong bargaining power against FWM. Sometimes, two distributors compete against each other with the same FWM products in the same store. Overdependence on distributors and "cross-province selling" are the two key problems faced by FWM.

Lately, it has not been very efficient for FWM to produce in three different factories. This increases the cost of production as the buying volume from local supplier reduces.

I have a few recommendations.

The provincial managers should have more power in controlling and spending the advertising budget; the sales operation should be based on the budget. Each provincial sales manager should be empowered to make all the decisions within the budget that he or she controls. It is critical to introduce performance evaluation and control systems.

The sales department must play a more active role in designing new products and the R&D department should quickly react to the sales department's feedback. The position of a product manager should be created to coordinate activities among R&D, production, and sales.

Sales managers' performance evaluation should include more dimensions. It should include a certain percentage of fixed and variable pay. The evaluation system should encourage sale managers to do the following:

- Build up a customer (retailer) information database
- Establish a long-term corporate image and brand recognition
- Provide accurate and timely market and competitor information
- Coordinate with programs initiated by the head office

The incentive system for the R&D department should also be changed. Instead of having just a fixed salary, a percentage of their salary should depend on the sales of the new products developed by the R&D department.

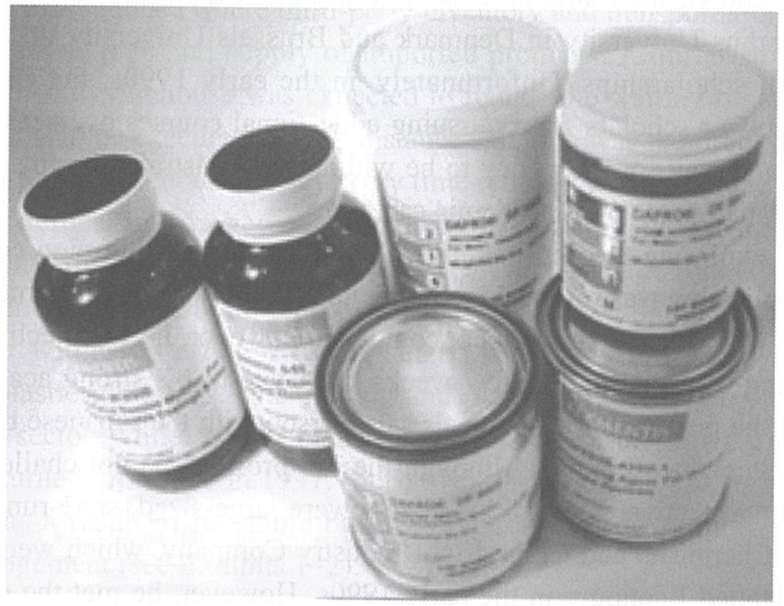
The provincial managers should be required to build up a retailer database. The objective is to reduce distributors' bargaining power. In the future, FWM should have its stores in the major cities of China. Distributors will still supply goods to small cities and rural areas. One benefit of this is that it will prevent cross-province selling. As the distributors will have limited bargaining power in future, the volume discount available to them will be controlled. Consequently, the price difference among distributors will be automatically minimized.

Finally, FWM should reduce its production base from three factories to two. The idea is to use the Shunde plant to produce for south China and the Shenyang plant to support north China. I recommend converting the Chongqing plant into an R&D center as well as the logistic and maintenance center for the west China market to support sales in Sichuan, Guansu, Xingjiang, and Tibet.

CHAPTER 8

Strategic Leadership and Execution

CASE STUDY
WWRC Shanghai: The Threat to the Middleman



It was 9:00 am on February 26, 2007, just after the Chinese New Year Holiday. Wang Huitao, the founder and general manager of Worldwide Resins & Chemicals Shanghai (WWRC Shanghai)—a distributor of special chemicals imported to east China—was concerned about the company's future despite the fact that it had posted strong profits and registered an annual growth rate of 30% in the past five years. He realized that many international producers were making large investments in expanding their production capacity and developing their own distribution systems. These producers were likely to depend on their direct sales force

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The case was developed by Professor Dr. Per V. Jenster and Research Fellow Xu Leiping of the China Europe International Business School in collaboration with WWRC Shanghai Company. The case was prepared for the purpose of class discussions rather than to illustrate either effective or ineffective handling of an administrative situation. Certain names and other identifying information may have been disguised to ensure confidentiality.

to approach their key target customers; some of them even developed professional websites to directly sell their commodities and standardized products to price-sensitive customers. This situation was further complicated by consolidation among customers and increasing market saturation. Did this mean the end for middlemen and distributors of imported special chemicals such as WWRC Shanghai?

Wang Huitao

In 1987, Wang graduated from Fudan University with a master's in chemistry and became a university lecturer. Within a short span, he displayed outstanding potential in the area of special chemicals. With support from the National Nature Science Fund, he published two papers in well-known international academic journals. In 1990, he was accepted for PhD programs at Aarhus University in Denmark and Brussels University in Belgium, for which he received full scholarships. Unfortunately, in the early 1990s, the Chinese government restricted students or scholars from pursuing educational courses overseas. Wang had to stay back in China and wait for the policy to be withdrawn. Frustrated by this lost opportunity to study abroad, Wang gave up his academic career.

He started exploring the opportunities offered by emerging foreign companies in China. His first job application was for the post of director of laboratory management in a JV between Union Carbide Corporation[1] and a local company. However, he was declined the position on grounds of being overqualified. A few weeks later, due to his strong academic background, he was offered the position of a chemicals salesperson with the Japanese trading giant Tomen Corporation[2] (Shanghai Branch). Although the job profile was not challenging for him, the salary was quite attractive. Most of his clients were large-sized, state-run trading companies such as China Chemicals and China Light Industry Company, which were the key agents of the Chinese Planned Economy in the early 1990s. However, he met the glass ceiling in this Japanese company soon. Wang realized that he had to relinquish his "comfortable" position and find an alternative career option instead.

He had a choice between joining another foreign company and setting up his own business. After considering the potential risks, Wang decided to join WWRC Hong Kong, a chemical trading house. He became a shareholder in the company, and set up a Shanghai office along with a colleague who was also a shareholder. Following this, he rented a hotel room that functioned as his office. In this way, Wang started his chemical trading business in end-1992.

After managing WWRC Shanghai successfully for 15 years, Wang applied for an EMBA program. He believed that the company could be managed better if he undertook this program (2007–2009).

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[1] It was merged with Dow Chemical in 2001.

[2] In the early 1990s, it was among the top 50 companies in the world in terms of annual revenue. It was earlier known as Toyo Menka.

WWRC Shanghai

Company History

Although Wang was not the largest shareholder in the company, he was trusted by other partners who allowed him to manage the company.

Initially, WWRC Shanghai distributed only three to five chemical products extracted from edible oil, and pigments for painting and coating. Wang and his colleagues collected orders from customers and arranged for their delivery. It was a small, commission-based business. The company could not generate any profit during 1993–1996. In 1995, realizing that quick delivery was an essential customer service, the shareholders of WWRC Shanghai decided to establish a warehouse where third-party inventory and transportation services could be provided to ensure storage and supply of imported products. A buffer stock of imported products in the Shanghai warehouse was expected to reduce the waiting time. Previously, an order took two months to be executed as long-distance shipping was required to import goods; however, with a domestic warehouse, the delivery time reduced to two to three days.

By 1997, an increasing number of multinational companies setting up their local production sites in China had led to the rise of a market for chemicals in the country. Multinational players could now build their own supply chain. Around this time, the Chinese construction sector witnessed a boom. Wang seized this opportunity and focused on the coating, ink, and plastic industries. The coating and plastic industries were directly related to the construction sector, while the ink industry was related to the growing printing sector. WWRC Shanghai turned profitable in 1997. Since then, the company's sales and profits have increased sharply as a result of its stable business processes and the innovative strategies adopted by its management (see Exhibits 1–2).

Business Model

Positioning itself as "a professional company focusing on special chemicals mainly in the areas of coating, ink, and plastic," WWRC Shanghai has established an effective business system and organization structure (see Exhibits 3–4).

According to the monthly rolling sales forecast, WWRC Shanghai purchased over 400 types of chemicals from about 20 producers worldwide. These imported products were stocked in three warehouses in Shanghai, Xiamen, and Danyang. Normally, enough stock was maintained to support sales for two to three months because of the two-month lead time for shipping from Europe or the United States, and one month from East Asia.

WWRC Shanghai built warehouses and maintained its sales force near its customer base to ensure excellent service delivery. The company had nine salespersons who served approximately 1,200 customers. When a customer placed an order, the sales coordination team followed the contract, informed the warehouse about the delivery, and worked with the finance team to collect payments.

Coating accounted for 50% of the company's sales revenue, while plastic and ink accounted for 35% and 15%, respectively. According to the original agreement with the parent company, WWRC Shanghai covered the business in east China. In 2006, approximately 85% of the total sales were generated in Shanghai (30%), Zhejiang (25%), and Jiangsu (30%); the remaining 15% came from Fujian (7%), Shandong (5%), Anhui (1%), and others (see Exhibit 5 for the market coverage).

The top 30 of the 1,200 customers accounted for 35% of the total sales; the biggest client contributed only 3%. Customers in the coating industry consisted of more than 1,000 factories, which mainly produced latex lacquer and plastic lacquer. The market was dominated by international players such as Nippon, ICI, and Akzo. Customers in the ink industry were also scattered. Most of them were small-size local companies. Unlike the decentralized customer base in the coating and ink industries, the plastic industry was rather concentrated: two of the biggest local companies dealing in engineering plastic compounds had a total market share of 40%.

Management Procedure

Although WWRC Shanghai was not the biggest or the strongest chemical distributor in China, it followed a unique style of producer and product selection, staff management, and customer service.

Producer Selection: WWRC preferred to collaborate with second-tier producers, rather than large companies across the world. This enabled the company to capture at least 50% of the total business of a relatively small foreign producer in the Chinese market. Therefore, it could easily become the most important distributor for these producers. Moreover, most of these producers did not have a strong sales force in the Chinese market, which also increased WWRC Shanghai's dominance in the market. In order to distribute special chemicals, a company was required to build a strong market position; WWRC Shanghai had done this by becoming the key distributor for second-tier producers.

Product Selection: WWRC did not want to distribute "me-too" products. Wang believed that product differentiation was essential for developing a successful business. After carefully studying other products, WWRC started focusing on niche products to avoid direct competition. These products were critical to customers' daily operation, but they were not required in large volumes. WWRC reaped dual benefits from this plan: first, these products were priced at a premium as they only formed a small proportion of the total cost incurred by clients; second, WWRC could provide greater technical support to clients who were not aware of the critical functions of these niche products. If a client faced problems, WWRC Shanghai would resolve them by providing inputs, which were not offered by ordinary distributors.

Staff Management: WWRC Shanghai introduced the Open-Book Management System, under which employees were apprised of the company's operations and the salary standard. Its employees enjoyed higher income than their peers in the industry. WWRC functioned differently from other private Chinese companies. Wang explained:

> *WWRC Shanghai focuses on relationships with people. It is different from international companies in which the local top management is not stable due to the global strategy adjustment. When there is a problem, the management of other companies does not react in time. It is also different from local private companies where the top management comprises family members and the staff does not play a key role in decision making in the company. I think that salary should be based on the effort put in by a staff member. Our company just provides this platform of development to its employees. Both the management and employees share profits. We reveal all aspects of the company's management to employees so that they have faith in the company. Therefore, our staff is very loyal; most of them have worked in the company for over 5 years.*

Customer Service: A majority of the sales force had extensive technical experience of working in factories that catered to similar clients. As a result, they could help customers in solving their technical problems, which was a value-added service. Although most of the sales personnel lacked communication skills, Wang believed that this shortcoming could be easily overcome unlike the lack of technical knowledge. In contrast, most of the chemical distributors preferred a "good speaker" (a person with good communication skills) and primarily focused on developing personal relationships with customers.

Challenges

Sluggish Market

Growth in the coating, ink, and plastic markets is expected to be sluggish in the future. During 1997–2004, the coating and plastic markets operated in tandem with the construction industry, which was considered to be the most important GDP generator by the government. With sharp growth, both markets attracted numerous companies to produce inner/outer wall coating, plastic pipelines, plastic windows, doorframes, etc. However, after 2005, because of the economic adjustment in the overheated construction industry, the coating and plastic markets reached their saturation level and witnessed a slowdown in growth (see Exhibit 6).

Aggressive Competitors

In the 1990s, it was easy to be a national special chemicals distributor in Mainland China because of the rapid economic development. There were three main types of distributors in China.

The first type was called "Nobel," which included trading companies based in Europe, such as EAC, Jabson, and Connell Brothers. Special chemicals formed only a part of their business. These companies had a long history of trading with China and occupied a comfortable position in the country's planned economy. However, they lacked the adaptability to compete with new entrants. Since 2000, they have had a limited impact on the market; moreover, some of them have even discontinued their special chemicals trading business.

The second type of distributors was known as "Local Grown-Up," which included many private local companies such as WWRC Shanghai, Sunny, Waidian, Hai Yi, Daiquan, and Deuchem. These companies were set up in the early 1990s (see Exhibit 7 for the introduction of typical players; see Exhibit 8 for P&L comparison). With extensive experience in operating locally, managing full-line products, and attaining reasonable margins, these players enjoyed high market penetration and valued long-term relationships with their customers. They were the mainstream players in the market. Some new trends observed among these companies were as follows:

Building production capacity: Usually, distributors produced high-margin products. For these products, the distributors also had a dominant market share and considerable sales volume. For example, Hai Chuan, a well-known water-based coating chemicals distributor for Henkel, produced water-based coating chemicals under the brand name OCEAN POWER.

Acquired by the producer to function as an internal distribution system: Normally, these distributors collaborated with and helped producers establish a strong market position. When producers wanted to expand their business aggressively in China, they hired the services of local distributors as part of their own sales force.

Entering new industries: Some distributors started investing in various related and unrelated industries, not only in various manufacturing processes, but also in real estate, restaurants, etc.

The third type was called "Shock-Wavers." This was a huge group and difficult to identify due to distributors' short lifecycle and frequent changes in company names. These new players preferred a simpler business model. They had only one or two core products that were made available at a low price through special channels. They aimed at achieving high sales volume and market share rather than high profits. Although these companies were susceptible to substantial profit fluctuations due to huge cash requirements, their business model affected traditional businesses such as WWRC Shanghai. If Shock-Wavers were successful in attaining a dominant market share for some products, they immediately expanded their product lines, which impacted Local Grown-Up distributors.

Local Producers

Both local and international producers offered a vast array of special chemicals. Local producers provided bulk chemical materials and offered limited product variants at a low price. They focused on region-based or export-oriented sales. Therefore, they did not require third-party distribution service in Mainland China.

Conversely, international producers required distribution services in Mainland China to offer a wide range of niche products. Although international producers had their own sales and marketing teams, they primarily focused on key accounts with strong marketing promotions. The third-party distribution system was critical for them to operate a nationwide business and WWRC Shanghai cashed in on the opportunity by becoming a distributor for international producers. However, international producers increased the pace of their localization process due to the following factors:

- As producers grew in size, customers started requesting for localized direct services,

instead of services from distributors. International producers had to strengthen their local sales teams and build a direct sales and service system, which increased their operations cost sharply.
- As the Chinese market grew rapidly, some international producers invested in building their local production sites, which were located close to their clients' locations. They also formed their own sales force to replace distributors for their key accounts.
- By launching an e-commerce system such as a sales website, a few producers eliminated the distance between themselves and their customers. For example, Dow Corning started selling products through its website. If this process becomes successful, traditional distributors such as WWRC will face a problem.

Concentrated and Demanding Customers

As a distributor for international producers in China, the most important objective of WWRC Shanghai had been to cover its decentralized clients. In fact, customers in China were geographically scattered and small in size as compared to those in the developed markets of the United States and Europe. As a result of the frequent M&A activity and fierce competition in the market, this situation was expected to change in the future. Chinese customers were expected to be more concentrated than ever (see Exhibit 9).

If customer concentration is high, the bargaining power of distributors reduces. At the same time, producers will be able to serve key accounts directly, thereby impacting distributors' businesses strongly. Therefore, the remaining customers may demand reduced prices and improved services from distributors.

- Customers from multinational companies had a sound knowledge of technology. Their production formulae were fixed and there were not too many alternatives for their ingredients. To address their cost concerns, they frequently negotiated with distributors to obtain a cheaper supply price.
- By contrast, customers of local companies were mainly private, small factories using inferior technology. They needed distributors to provide end-to-end solutions and not just to supply products. These customers requested for more value-added services from distributors.

Wang wanted his company to overcome the challenges in the market. Therefore, in 2005, he tried to forecast the company's growth path, considering and projecting the market scenarios in 2001, 2005, 2007, and 2010, by using the BCG method (Cash cows/Stars/Question marks/Dogs). He found that the company would have less potential if there were no strategic changes (see Exhibit 10). In 2010, he expected the number of Dog products to increase and that of Star products to decrease, while the percentage of Cow products was to remain high.

Possible Directions

Since 2005, Wang had been considering the various strategies that WWRC Shanghai could adopt, which included starting a new business, introducing another brand, devising new applications of existing products, and developing new products. In fact, WWRC Shanghai had tested some of these ideas.

Entering a New Business

After 10 profitable years, WWRC Shanghai had enough funds to invest in a new business. In fact, Wang registered a small company to try out a new business—pest management—in 2000. He thought that it would be a new platform for WWRC Shanghai to launch various businesses. This business was new in Mainland China and broke even after five years of operation (see Exhibit 11).

This was the first time that Wang did not chart out a detailed business plan. He wanted to build a business platform and an operation system to explore a larger number of new businesses opportunities in the future. Following this plan, WWRC became a key investor in the chemical- and biology-related professional services industry. Although this move led to encouraging results, it was not the right time to introduce additional businesses as the market was immature and highly regulated.

Setting Up Self-Branded Products through OEMs – Increase Capacity

In China, many distributors were exploring the possibility of developing their own brands through independent resources or original equipment manufacturers (OEMs). For this purpose, they selected products that had an attractive margin, sales volume, and market share. However, their future was uncertain. They faced threats from both producers and clients. In case of a wrong move, the distributor's reputation could be damaged as a result of the principles' reaction. Although it was attractive for WWRC to undertake similar activities, Wang felt that this move was not correct for future development. However, he had to give this option a serious thought as an increasing number of competitors were building their self-branded product system.

Exploring New Applications of Current Products

Concerned about the sluggish market growth, Wang was looking for new applications of current products in other industries. He, along with his team, visited a number of industry exhibitions. After intense deliberation, they identified the scope of introducing their applications in the areas of stationery, leather, and textiles. China accounted for 80% of the global production in these industries. More importantly, the Chinese companies were not consolidated and had numerous small-size factories, similar to the erstwhile coating industry. Many special chemicals distributed by WWRC could be applied to these new industries directly. Wang had been making efforts to enter these industries since 2004.

However, he realized that due to decentralization in these industries, international suppliers did not cater to them. He found this as an opportunity to use WWRC's successful application experience in the coating industry in these areas. The matured technology in the coating industry would be an advanced one in these industries. It was the time for WWRC to start investing in these new areas.

Adding New Products

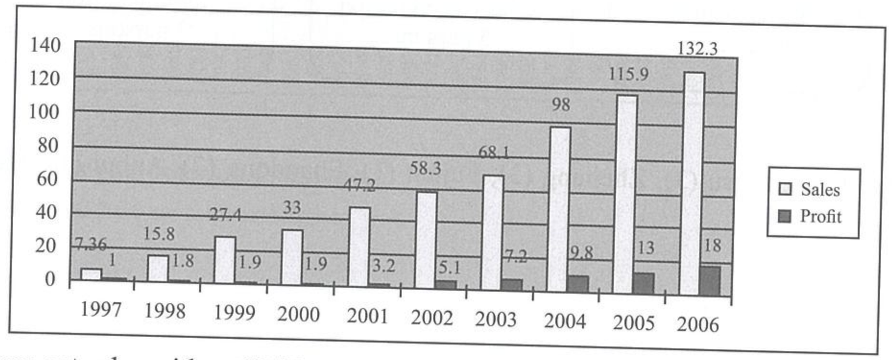
Wang thought that there was a possibility of further growth in WWRC's markets of operation. He believed that there were unexplored opportunities in this emergent market.

The investment-oriented Chinese economy was showing signs of transforming into a consumption-oriented one. As a result, the market was expected to witness new segmentation. For example, although the market for outer wall painting shrunk, that for inner wall painting was booming; similarly, there was reduction in the use of plastic in windows/door frames, while the market for home appliances and consumer electronics increased significantly.

In addition, some important directives, such as RoHS and REACH,[3] were introduced in Europe and other developed areas in the world, which led to greater demand for environment-friendly products. As China became a member of the WTO and a large exporter to developed countries, an increasing number of existing products had to be customized to global or regional legal requirements. For example, by 2008, environment-friendly additives, following the new regulations issued by the International Marine Organization, would work as the replacement for the traditional anti-fouling marine coating, which contained harmful tin compounds.

Wang prepared an evaluation table for these possible directions (see Exhibit 12) and discussed his findings with the company's board. As the EMBA program was to start in March 2007, Wang wanted to consult his professors and classmates as well.

Exhibit 1: Sales* and Profit of WWRC Shanghai 1997–2006 (in RMB million)



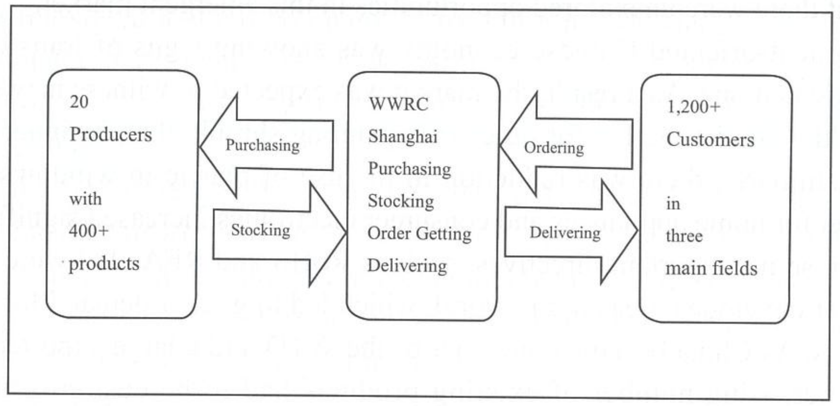
* Note: Sales was net sales without VAT.
Source: WWRC Internal Data

[3] ROHS: Restriction of the Use of Certain Hazardous Substances in Electrical and Electronic Equipment
REACH: Registration, Evaluation, and Authorization of Chemicals Restriction.

Exhibit 2: Number of Employees in WWRC Shanghai (1997–2006)

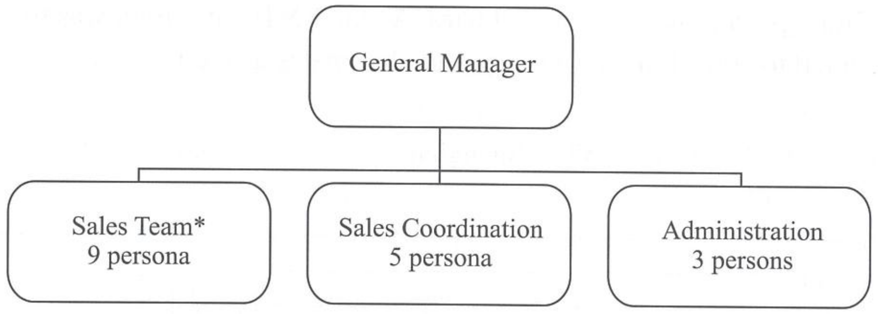
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Total staff	7	10	11	12	13	14	15	15	18	18
Sales staff	4	5	6	7	8	8	8	8	9	9

Exhibit 3: Business System of WWRC Shanghai



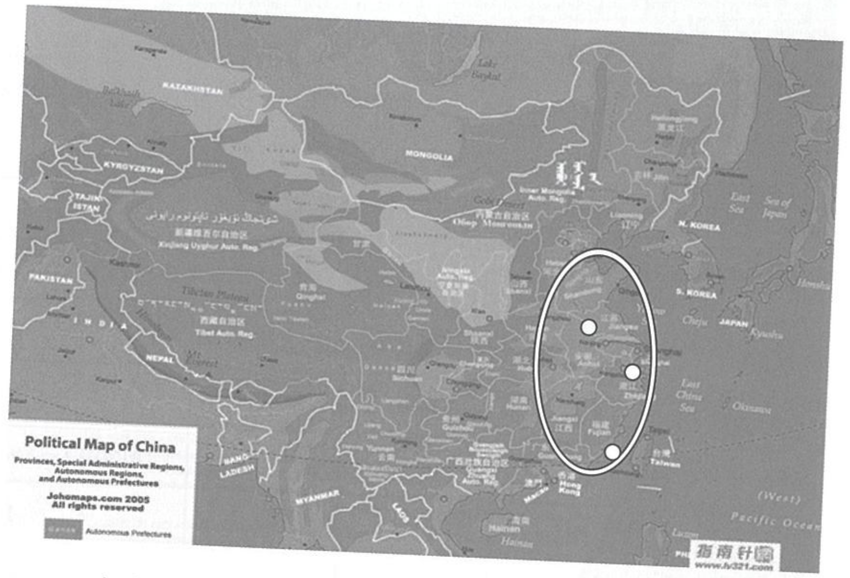
Source: WWRC Internal Data

Exhibit 4: Organizational Structure of WWRC Shanghai



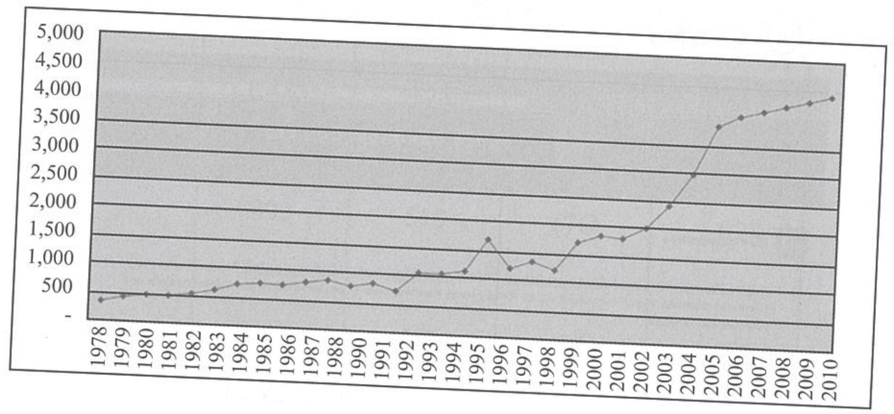
Note: Shanghai (3), Jiangsu (3), Zhejiang (3), Fujian (1), Shandong (2), Anhui (1), Jiangxi (1), with overlaps

Exhibit 5: Market Coverage of WWRC Shanghai
(The ellipse with white line depicts the market coverage; the white circles depict three of WWRC Shanghai's warehouses.)



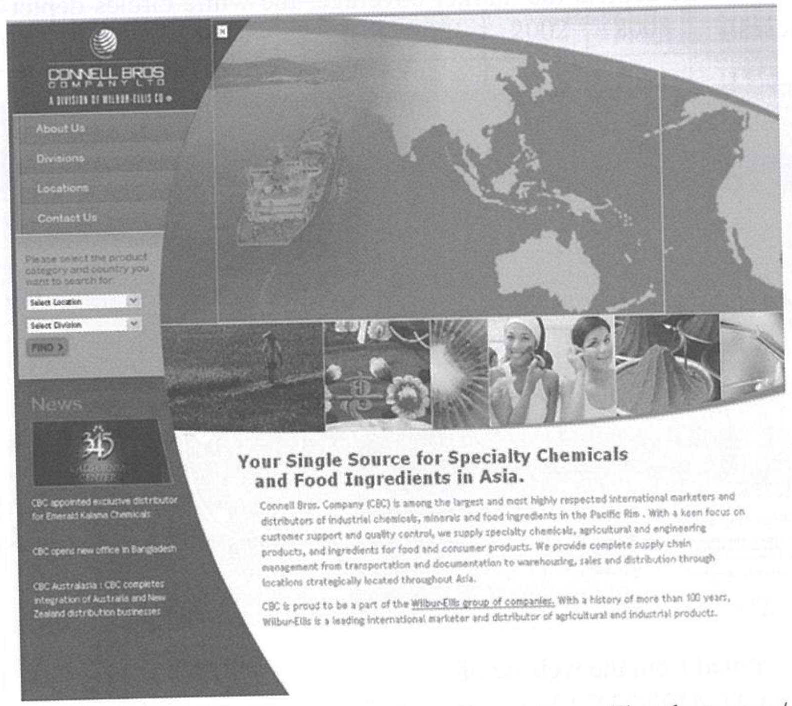
Source: the map was copied from the website of
http://www.xxcha.com/All/449/8224_1.htm

Exhibit 6: Coating Industry in China, 1978–2010 (in tons)



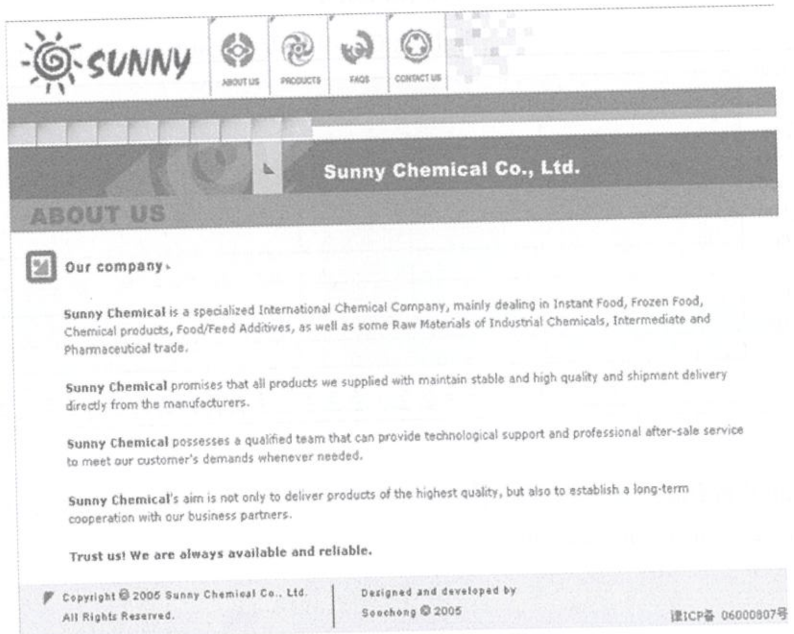
Source: WWRC Shanghai Internal Estimation*
* The figures for 2009 and 2010 are estimated figures.

Exhibit 7: Introduction of Typical Players



http://www.connellbrothers.com/

(Continued Exhibit 7)



Source: http://www.sunnychems.com/

Exhibit 8: P&L Comparison of Key Players (in RMB thousand)

Itcms	Player A	Player B	Player C	Player D	WWRC Shanghai
Sales	49,303	62,307	111,823	34,659	115,893
Less:Cost of sakes	44,255	58,344	105,731	29,707	94,219
Less:Salestax	——	25	28	——	46
Gross profit	5,048	3,938	6,064	4,952	21,628
Less: Provision for inventory	——	——	——	——	0
Selling expenses	1,639	2,651	4,269	1,304	4,647
G & A expenses	1,986	601	1,768	2,370	852
Finance expenses – Others	25	——	45	43	**(12)**
Operating profit	1,398	686	**(18)**	1,235	16,141
Investment income	——	——	——	——	0
Subsidy	——	——	——	——	0
Nonoperating in come	97	109	6	——	143
Nonoperating expense	12	22	21	——	60
Other operating in come	——	——	——	——	0
Profit be fore taxation	1,483	773	**(33)**	1,235	16,224
EIT	490	254	43	207	112
Profit after taxation	993	519	**(76)**	1,028	16,112
Minority in terest	——	——	——	——	0
Netprofit	993	519	**(76)**	1,028	16,112

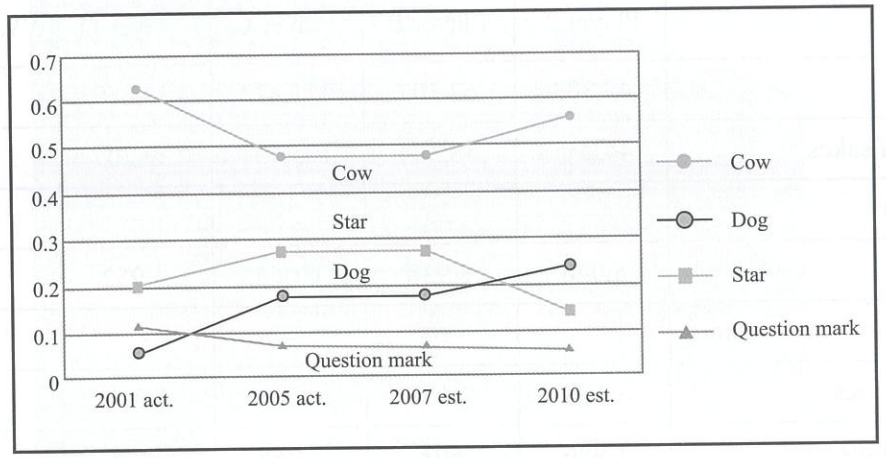
Note: Net sales in east China without VAT; the competitors were anonymous
Source: Shanghai Tax Bureau

Exhibit 9: Comparison of Customer Concentration

Area	Top Customer	Market Share – 2005 (%)Est.	Market Share – 2010 (%)
USA	Top 5	80	80
Europe	Top 5	50	60
China	Top 10	19	30
China	Top 150	50	70

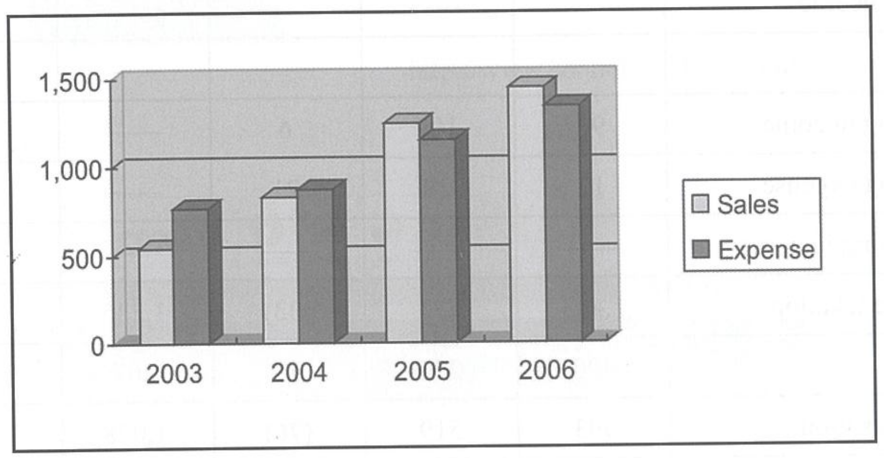
Source: WWRC Internal Data

Exhibit 10: Scenario Analysis, 2001–2010 (%, weighting of each product type)



Source: WWRC Shanghai Internal Analysis

Exhibit 11: Performance of Pest Control Business (in RMB thousand)



Source: WWRC Shanghai Internal Data

Exhibit 12: Evaluation on Possible Directions

(Attractive Index: +++ high; ++ medium; + low)

Criteria	New Business	Own Brand	New Application	New Products
Relevance to current biz	+	+++	++	+++
New resources required	+	+	++	+++
Market potential	+++	+	+++	++
Entrance barriers	+	+	++	+++
Total Assessment	++	++	+++	+++

Source: WWRC Shanghai Internal Data

CASE COMMENTARIES

COMMENTARY 1

Dr. Charles A. Ingene,

Distinguished Chair of Business Administration, The University of Mississippi

The WWRC Shanghai case, written by Professor Per Jenster and Research Fellow Xu Leiping, illustrates the evolution of a company, an industry, and an economy. In this commentary, I highlight the relationship between these intertwined evolutions. My main argument is that a company's achievements depend on its environment (the macro-economy and its industry) as well as on its own actions. This is critical as it is easy for executives to attribute their company's success largely (or even solely) to their own actions. Such attribution is dangerous, as it focuses the executive's attention on internal processes rather than on the more important, but harder to read, external environment. It is important to recognize that the evolution of the environment, while beyond managerial control, is largely predictable. The executive who understands the environment and how it will evolve has a substantial advantage over his or her competitors—most of them behave reactively.

To understand my arguments, consider a mature, well-developed economy that is growing at (say) 1% per year: for example, Japan and many Western European countries. Further, suppose the economy has reached a steady-state equilibrium—by which I mean that the focal industry is fundamentally stable (i.e., also growing at 1% per year). In such a situation, there is little change from year to year, so a company can grow only by taking market share away from one or more of its rivals. Success in a stable environment can be likened to a chess game: it is predicated on the company doing a better job of using its marketing mix[4] than its rivals. This is the implicit model of business that is held by many (not all) Chinese executives. They would deny this, of course, for they know that their environment is changing, but because they often do not understand what causes environmental change, they act without evaluating environmental evolution—and are inevitably buffeted by external events. In sharp contrast to this stable scenario, China has been growing at double-digit rates for many years, as have most industries in China. This rising tide of economic prosperity initially tended to "raise all ships." But, just as different boats are needed for shallow rivers than for deep rivers, and for gentle streams than for rapidly moving waterways, so too are different business models needed as an economy transitions from slow to rapid growth.

Now let us turn to the focal company in the case: Worldwide Resins & Chemicals (WWRC) Shanghai, a distributor of special chemicals imported to China. WWRC began in 1992 as a two-person company taking orders for a handful of chemical products; it then placed the orders with overseas suppliers; finally, it arranged product delivery. Its revenues

[4] The "marketing mix" refers to the tools that are under managerial control; the primary tools are price, product, place, promotion, and personnel—"the 5 Ps."

were a percentage of sales (i.e., a commission plan). By starting small, WWRC's expenses were minimal.[5] Therefore, it did not need many orders to keep going—it could survive lean months while enjoying the fruits of good months. Although it is not spelled out in the case, the primary expenses in the early years were presumably salary, food, and travel costs for the two people. What is unclear is the nature of product delivery. The chemicals may have been "drop-shipped" from the supplier (i.e., sent directly to the client) or the chemicals may have been shipped to WWRC for delivery. In the former case, each sale would have translated directly to the bottom line, while in the latter case WWRC would have incurred delivery expenses, necessitating WWRC to set prices that were revised by the client in order to cover differential transportation costs. Note that the key feature is not the hard work of the employees, but the fact that clients were willing to wait up to two months for delivery of their order. For the clients to be willing to wait for delivery means that their customers were also willing to wait for the delivery of their finished products. Such tolerance is rare in developed economies but is common in less-developing countries where what matters most is eventually getting the product.

By 1995, the growth of the Chinese economy had reached such a high level that delayed delivery became intolerable—clients expected to receive their orders within days. With an overseas supply source, this necessitated maintaining inventory. Such a buffer stock entails money tied up in the inventory owned by WWRC as well as holding costs in the form of renting warehouse space. This indicates that in a growing economy, a company cannot survive long enough to make a profit unless it has deep pockets. Undercapitalization is a major cause of stagnant growth or bankruptcy. Indeed, WWRC's early years were lean—it did not register profit for about five years. It also highlights that any company that holds inventory needs a higher margin than one that does not maintain a stock of the merchandise on-hand for immediate delivery. The success of this strategy can be seen by the fact that by 1997 it was eking out a profit. Thereafter, sales and profit growth were substantial.

WWRC's tremendous success was driven by a careful reading of environmental change. In particular, the growth of construction (therefore paint) and printing (therefore ink) facilitated the demand for specialty chemicals. But it also imposed demands on the distributors of those chemicals; construction firms are specialists in building, but they do not hold large quantities of concrete, paint, or other raw materials. Similarly, printers are specialists in producing newspapers, magazines, and brochures; they do not hold much inventory of newsprint or printer's ink. And, of course, neither industry comprises firms that can afford to wait for two months for delivery. Successful distribution to the construction and printing industries required WWRC to build three warehouses and stock two- to three-months' supply of chemicals (note that the case is not designed to determine the optimal number of warehouses nor their best locations). Another factor that has helped WWRC's profitability is

[5] Many MBA graduates who start their own business begin by renting office space, buying computers and furniture, and hiring support staff. While this makes them feel good, even important, it also burdens them with high overhead expenses. A downturn in orders quickly drives such businesses to bankruptcy.

that the industries that it sells to are decentralized, that is, firms in each industry are inherently local, serving spatially distinct markets. As a consequence, a few of them have much power vis-à-vis WWRC (its largest customer accounts for only 3% of its sales). And because WWRC distributes products from second-tier chemical companies, WWRC has power vis-à-vis its suppliers; indeed, WWRC accounts for up to 50% of the sales of some of its suppliers. Taking all of this into consideration, it can be inferred that

- WWRC's strong position in the upstream market gives it higher bargaining power.
- WWRC specializes in niche products, which means that its clients are somewhat price insensitive.
- WWRC has downstream market power, which allows it to get high prices.
- WWRC has a very high gross margin (because of the last two points mentioned above)

Financial data from Exhibit 8 confirms this: WWRC has a gross profit of almost 19%; this is almost one-third higher than that of its next competitor (Firm D).

WWRC also has an excellent human resource management policy (including high pay), so it has low staff turnover. This means that it has some of the more knowledgeable employees in the chemical distribution business. Further, the more developed the economy, the more important is sales force's technical expertise—and the less important is its guanxi. Thus, it appears that WWRC has taken the necessary steps to ensure continuous success.

Of course, one should not reach such a conclusion without assessing WWRC's competitors, for they might be doing a better job. However, the financial data in Exhibit 8 reveals that this is not the case. Augmenting its higher gross profit, WWRC spends less than 1% of its revenue on general and administrative expenses—it runs a tight ship. By way of comparison, Firm D's G&A expenses are almost 7% of its revenue (note that Firm D spends almost three times as much as WWRC on G&A expenses, illustrating the phenomenon mentioned in footnote 2; however, in all fairness, we do not know if Firm D's management has MBA graduates). In combination, this gives WWRC a healthy profit.

There are, however, serious challenges facing WWRC. Economic growth is leading to consolidation in many industries, which means that it may become economically efficient for chemical companies to serve them directly by setting up their own sales forces. WWRC's enormous profit margin also signals to chemical companies that there is plenty of money to be made in China by establishing captive distributors. Thus, one option that is available to WWRC (not mentioned in the case) is to consider positioning itself as a candidate for a friendly takeover.

The options that are mentioned are difficult to evaluate without additional information. Certainly, some of the proffered options are problematic as they entail areas for expansion that do not flow directly from WWRC's current success. Self-branding makes sense in consumer goods industries, but generally requires substantial advertising (branding is not likely to add much value to industrial paint or printer's ink). Overall, solving the "what do we do next?" question entails putting oneself in the position of the consumer and the intermediaries through whom one carries out distribution. For example, interior paint is a natural extension for WWRC (although it entails the expenses of branding), but WWRC is not set up to sell to consumers. Therefore, it would have to cultivate retailers as distributors of its paint, which will involve a larger sales force. Since retailers require margins on the merchandise they sell, this must be factored into the business plan.

Finally, at the center of any analysis of business opportunities must be projections of the evolution of the environment, including consumer desires. WWRC has shown a remarkable ability to accurately read evolutionary trends over the past decade, but projecting trends is a never-ending task that becomes more difficult with time as the number of competitors decline, with only the best surviving.

COMMENTARY 2

Wang Huitao
Founder of WWRC Shanghai

Since 2005, I have been considering all the possibilities that WWRC Shanghai could adopt, including starting a new business, creating another brand, devising new applications of existing products, and developing new products. However, the writing of this case helped me clarify my thoughts and narrow down the possibilities.

In the beginning of 2008, our company outlined a three-point agenda to pursue its growth plans:

1. Exploring new applications for current products—Since 2004, WWRC has been trying to enter some new industries so as to enlarge its customer base without launching new products.
2. Generating more revenue from each client by introducing new product suppliers
3. Establishing effective and efficient operational platforms—Better operations will assure clients that a better value-added experience is offered by distributors than direct suppliers.

The new strategy will be coupled with improvements in the organizational structure and personnel policies.

1. The sales teams will be evaluated according to regions and suppliers. The current 6 divisions will be divided into 30, and suppliers will be classified into core suppliers, stable suppliers, new suppliers, and big projects.
2. Client visit reports produced by salesmen will be classified according to regions and suppliers before being analyzed. Afterward, monthly business information will be reported to regional managers and suppliers for feedback. Analysis of the profitability of each product will be reviewed from a financial perspective based on account items such as inventory, receivables, payables, turnover, and gross profit. The sales teams and logistic teams will be provided with sufficient financial data for each market segment.
3. In order to evaluate the operations of each sub-region and each product, 60% of the operational expenditure (in import, storage, and transportation) will be allocated to 30 sub-regions and 60 products, which will help quantify budgetary decision making.

Earlier, operations used to be sales oriented. The sales staff enjoyed bonuses in addition to their salary. Staff in the finance and purchasing function was paid only on the basis of experience. However, now, sources of loss and profit need to be identified: for example, in purchasing, transportation, and storage; price strategy; overall market expansion and shrinkage; and change in market share. Reward and punishment will be based on clearly defined criteria and performance evaluation. Those who act in line with the company's policies will be rewarded and those who do not, or act against the policies, will be punished. Royalty to the company will also be taken into consideration. The company will continue to follow qualitative measures before introducing some quantitative ones.

WWRC will adopt differentiated sales modes for different suppliers. Each sales representative is responsible for both regional sales and for a vendor. Therefore, coordination among the entire sales team is crucial.

Percentage of Sales	Supplier	Focus	Distribution of Labor (100%)	
			In Charge of Suppliers	In Charge of Regional Sales
25	Core	Above average profit margin and sustainable	60	40
45	Stable	Stable revenue and profit margin	40	60
20	Big project	Uncertainty	80	20
10	New product	Input overweighs output	90	10

In order to generate higher profits for the company, its suppliers, and the clients, WWRC aims to optimize the whole supply chain, which entails taking orders, keeping inventory, and selling products. Operations based on quantitative analysis enable the staff to understand the source of growth—whether it comes from the external market, or through better sales skills and lower cost.

CHAPTER 9

Building an International Business

CASE STUDY
The "Fruitful" Journey of China Haisheng Juice

On August 15, 2006, shares of China Haisheng Juice slid to HKD 0.62 from HKD 1.22 just a few months ago.[1] The falling share price compelled Gao Liang, the president and founder of China Haisheng Juice,[2] to ponder over the company's growth in the past decade. There were several questions in his mind: "Was the expansion in danger and the strategy wrong? Did the firm have the capability to continue for another 10 years?"

"We had the IPO idea for a long time. In recent years, we expanded more quickly and invested substantially in building five plants; however, because of considerable loans, we did not have too much capital." A modest man in his mid-forties from northwest China, Gao was quite forthright about the challenges facing his firm. He admitted that Goldman Sachs, which held a 25% stake in Haisheng, had hinted at increasing its stake in the latter before the launch of its IPO. However, although it was an exciting and lucrative proposition to win the trust of this prominent investment bank, certain concerns loomed large.

Gao felt that:

> *If we inject more capital from Goldman Sachs, we might lose our position as the majority shareholder, which we don't want.*

After careful consideration, Goldman Sachs gave in to Haisheng's concerns and committed itself to initiating the IPO process. The bank reposed complete faith in the concentrated juice industry and Haisheng's seasoned management team.

Gao Liang's Beginnings

Gao Liang graduated from Shaanxi University of Finance and Economics, following which he took up a government job in Xi'an, the capital of Shaanxi Province. However, he quit his settled government job in 1988 to venture into the business world, which is marked by independence. In the process, he committed Xia Hai, which traditionally meant leaving a

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1 On November 4, 2005, China Haisheng was listed on the Main Board of the Stock Exchange of Hong Kong, with an initial offering of 30,555 shares among a total 122,220 shares.

2 A provider of concentrated apple juice in southern Shaanxi, an inland province of northwest China

respectable occupation, such as a government job or teaching, and embracing a disdainful one, such as a business or acting. For several years, he served as an agent for beverage giants, such as Dynasty Wine, LuLu (a Chinese almond drink), Coca Cola, and Nestle. Working as a beverage agent was a challenging job, but it offered Gao an opportunity to learn all the aspects of the beverage industry—from operations and team management to marketing and sales.

When the former chairman of China's Central Military Commission, Deng Xiaoping, delivered a series of speeches during his 1992 southern tour, he urged his countrymen to expedite reforms and open the country to the outside world with the famous quote, "Being rich is glorious." In order to explore profitable business opportunities, Gao and a few of his colleagues left Shaanxi for Hainan, the southernmost island province of China, with Gao's "first bucket of gold." Here, Gao forayed into the real estate business and gradually made a fortune. Subsequently, Gao and his team moved to Xinjiang Uygur Autonomous Region to expand his real estate ambitions and carry out trade with Russia. He continued with this business until 1995, when he realized that it could not fulfill his aim to become a successful entrepreneur.

The period from 1988 to 1995 was one of learning. During these years, he accumulated valuable experience in resolving problems and managing crises. It was during this time that he also built strong business relationships and a loyal team. Once he had established himself, Gao started looking forward to the "real performance."

Launch of China Haisheng Juice

In 1995, Gao returned to Shaanxi and learned that there were good business prospects in the concentrated apple juice industry. There was a strong demand for apple juice worldwide, and Shaanxi Province was one of the major apple-producing areas in China. This was expected to enable the purchase of raw materials at a relatively low price. For Gao, however, the lack of start-up capital was a major constraint, though it did not remain a barrier for too long. Gao had earlier visited the US with a few officials from the State Ministry of Trade and Commerce, and knew that small enterprises could apply for long-term government loans from other countries at a low rate of interest if the projects were suitable. Gao decided to discuss his ideas with Tetra Pak. The management at Tetra Pak had even better news for Gao. It informed him that he did not even require a government loan; a long-term credit with an equipment supplier would be enough. This encouraged Gao to enter into a new round of negotiations with all the well-known juice production equipment manufacturers. These included Tetra Pak, Unipektin, APV, and Bucher. Haisheng Juice was eventually established in 1996 with the purchase of production facilities from Bucher, a leading player in the industry, headquartered in Switzerland.

Gao chose Bucher because of its stellar reputation, long-standing presence, and considerable size. In fact, Bucher not only provided the necessary equipment, but also brought in relevant production and management experience. Further, it was willing to send four professionals to China for one year. Bucher would help set up the plant, install equipment, and educate Gao's employees on all aspects of the concentrated juice business, from production to end sales.

Contemplating his partnership with Bucher, Gao said:

For Bucher, it was not too risky to support us. It wanted to increase its presence in the Chinese market. Besides, we paid an extremely high price for the first production line and related services. However, I still think that partnering with Bucher was the right choice.

Gao strongly believed that a supplier who could provide more than just equipment would be a major asset. Reflecting on the partnership, Gao concluded that if it had not been for Bucher, Haisheng would have been wiped out from the market, like many other small companies in China. In the mid-1990s, there were approximately 70 companies in China that produced concentrated juice, but only about 17 of them survived. Intense competition, substandard equipment from Italy, and the inability to incorporate proper processing procedures were the major reasons for the collapse of most companies.

The first pressing season in the Qianxian factory started in late-September 1996 and ended in January 1997. The period, albeit short, was a critical time for the employees of Haisheng as they needed to get acquainted with the production lines and factory management. As a sign of appreciation of Bucher's state-of-the-art equipment and experienced management, Haisheng subsequently imported another 6 production lines, including 30 pressing machines from the company. By 2006, Haisheng had become Bucher's largest customer. Interestingly, Gao bought the first 10 metric ton production line from Bucher for about USD 4,000,000, but subsequently paid only USD 5,000,000 for six similar production lines in 2003. Haisheng gradually became one of the leading names in the global apple juice concentrate market because of its low costs and high quality. Four more plants were built—in Weinan, Shaanxi Province; Qingdao, Eastern Shandong Province; Dalian, Northeastern Liaoning Province; and Yuncheng, Northern Shanxi Province. These areas produced the maximum apples in China and enabled Haisheng to procure the fruit at low cost.

By end-2004, China Haisheng's apple and pear juice concentrate production capacity reached 135,000 metric tons per pressing season, and by end-2005, the capacity increased to 205,000 metric tons. The company's sizable production capacity and stringent quality control standards helped it bag the prestigious "China Top Brand" Award. The USD 20,000,000 investment from Goldman Sachs in 2005 and the USD 15,500,000 long-term facility credit from DEG helped China Haisheng launch its IPO on the Main Board of the Hong Kong Stock Exchange in 2005.

Looking at the rapid development of Haisheng in hindsight, Gao said:

Expanding at such a rapid pace didn't figure in our initial plan; we were forced to do so in order to survive.

Even during the initial phase, Gao and his team had preferred not to expand until they fully understood production and marketing management. Their first priority was to train people, standardize the quality control system, and perfect the marketing and sales process. However, hounded by more than 70 aggressive competitors, it seemed that the only way out was to follow the expansion trend to reduce costs and gain economies of scale.

At the same time, the international demand for juice concentrates was increasing. When Haisheng started operations, the global market demand for concentrates was approximately 600,000–700,000 metric tons.

The global annual increase averages 40% every year. If we hadn't expanded, we would have lost a great opportunity.

In the final analysis, then, expansion was not only a means to keep competitors at bay, but also a promising and lucrative strategy.

External and Internal Crises

The Pesticide Menace

A major crisis related to the excessive use of pesticides in apple cultivation erupted during the company's first year of operations (1996–1997). Along with other Chinese firms, Haisheng suddenly found itself blacklisted by the US Food and Drug Administration. Products worth more than RMB 4 million were rendered useless. The company almost went bankrupt.

It was neither because of our products or the production technique, nor because of our management. We were in the same boat with others, and the problem had to be resolved.

The original Bucher production facility was designed for European quality apples' juice production, yet it was unexpectedly at the center of a critical situation: In China, apples were relatively cheap, but not of as high a quality as those available in Europe. Consequently, the sophisticated Bucher system was not prepared for the additional washing processes required, as most Chinese apple growers at that time used pesticides quite liberally.

We adjusted our production lines and strengthened the washing process to cater for the quality of our apples. In the middle of the crisis, we could only face it and try to address it. Of late, the Chinese government has been urging farmers to reduce the use of pesticides, which has also helped us a great deal.

The Anti-Dumping Crisis

On November 10, 1998, the US Apple Association's anti-dumping taskforce recommended that an anti-dumping petition be filed against foreign suppliers of low-cost apple juice concentrate. The recommendation followed reports of concentrate dumping by several countries (mainly China) in the US market. Findings showed that imports of apple juice concentrate from China had increased 953% over the past three years, while the price of Chinese concentrate had fallen 12.5%—from USD 4 per gallon to about USD 3.50 per gallon. Therefore, the government set the new floor price at USD 700 per metric ton for low-acid concentrates from China (about USD 4.50 a gallon by the time it reached the US market) and USD 730 per metric ton (approximately USD 4.75 a gallon) for high-acid concentrate from

the South Asian country. According to the US trade law, domestic producers could seek relief if they could prove that foreign suppliers were "dumping" products, that is, selling products at a price lower than the cost price. If dumping was proven to be harmful to domestic producers, the US government would impose a tariff on the incoming product to level the playing field.

In 1998–1999, China was not considered a market economy; thus, US petitioners identified India as a reference country for calculating the fair cost and the selling price. The initial verdict was a 12.03% duty on Chinese fruit concentrates.

Recalling the hard times, Zhu Fang, who worked for Gao for more than 16 years, and was the CFO of China Haisheng, said:

It was an unfair comparison as India's economic situation was quite different from China's; we defended ourselves by using data from another reference country, Turkey, whose situation was similar to China's at that time.

However, events soon took a turn for the better. In 2001, Chinese producers, including Haisheng, won the lawsuit and regained the duty-free status for their exports to the US. However, that was not the end of their struggle. Chinese producers appealed against anti-dumping laws in general, and sought permanent exemption from them. According to Zhu:

For us, the anti-dumping verdict was not the final judgment, and this time it was "we" who did not want to concede. With a substantial amount of evidence, we appealed that Chinese producers should be permanently removed from the anti-dumping list, and at last, in 2004, we won.

Upon being asked the reasons for succeeding, Vice President Wang Xue-mei said after careful consideration:

First, because of the strong team spirit of the Chinese concentrated juice producers, under the leadership of the China Chamber of Commerce for Import and Export of Foodstuffs, Native Produce and Animal By-products and with support from the government. Second and more importantly, because of the courage to directly face the crisis, openly speak about it, and resolve it in a constructive manner.

This was also a reflection of Gao's personality and leadership qualities. In his own words, "One should either try to find a solution or give up while admitting failure. We did not have many choices if we wanted to move ahead."

Integrating the "Old" with the "New"

In spite of Gao's able leadership and prudent decision making, Haisheng China, like any other start-up, continued to face all types of challenges, not the least of which included talent management.

Haisheng's Xi'an subsidiary had 64 employees in marketing and sales, and support functions, such as administration, finance, and HR. During production months, the number of full-time workers at the five plants totaled about 1,200; however, many of them became redundant after the peak production season.

"The scenario had completely changed from the first year of operations, when we had only about 20 people in Xi'an," recollected Wang Xue-mei, who had been working at Haisheng for more than a decade. "The company was like a family. We spent more time with colleagues than with our families. We worked together as well as went out together, relaxing with seniors," he added.

Wang cherished the opportunity to communicate directly with the top managers. The interactions not only helped her perfect her job but also proved to be a strong influence on her development.

As the firm grew, however, things did change. After the establishment of new factories, an increasing number of professional production managers were "stolen" by Haisheng from its competitors and other beverage companies. While these additions helped enrich Haisheng's culture, they also ushered in an era of conflicts and "interruptions." These professionals brought their old habits and mindsets, which was seen to dilute the values that Haisheng stood for. Another problem, which was reflected by a Hewitt survey conducted at Haisheng, a professional HR consulting company, was that a few newly recruited members who had usually ranked high in terms of performance in earlier roles performed poorly at Haisheng. This was a matter of concern and therefore needed to be investigated thoroughly. Two possibilities existed: They either knew little about Haisheng's culture and values, or they were dissatisfied and unhappy with Haisheng's way of doing things.

Wang pointed out that the employee turnover rate was as high as 300% at the Qianxian plant, the oldest plant of the Haisheng Group. She was worried that Haisheng's corporate culture was not being properly communicated by the managers to the line operators, and that the lack of a comprehensive HR management system, including an attractive payment system and a sound retention policy, would pose several problems. The workers at the plants were paid according to their positions, not on the basis of performance.

Wang added:

> *However, these so-called parachuters didn't really affect the company staff since they were moving along different career paths. We have two groups of employees: One, managing production, and the other, handling general management, such as marketing and sales.*

Integrating the "original staff" with new recruits was an enormous challenge for Wang. She began her tenure at Haisheng as a junior staff member who was responsible for fund raising, and had been recently appointed the vice president in charge of HR management and administration. By "original staff," Wang and Gao implied employees who had joined Haisheng in its nascent stage. Most of the team members who went to Hainan and Xinjiang had followed Gao, and seven of them were now working as senior managers at Haisheng.

These members were good at marketing and sales, but did not have much knowledge about international trading and production management. Some of them believed they had made significant contribution to the company, and now wished to reap the benefits. They were considerably respected and were urged to enhance their knowledge on international business and production management. If they agreed to increase their skill sets and showed progress, Haisheng would entrust them with more responsibilities. However, if they were unwilling to do so, Haisheng would arrange for another person in the particular department to gradually take over major responsibilities.

Worldwide Industry Developments

By 2006, China's share in the world market had grown from 3% to more than 50%, if trade with the EU was excluded. According to the US Department of Agriculture, the global apple juice trade grew 116.3% from 506,349 metric tons in 1999–2000 to 1,095,090 metric tons in 2003–2004.

Although Chinese producers had benefited from this growth, it had also necessitated the consolidation of several small producers with capacity less than 10,000 metric tons, leaving 50% of the domestic market to Zhonglu, North Andree Juice, and Haisheng Juice—all with a relatively similar size.

Exhibit 1 depicts the world's major apple juice concentrate producing countries. The US was expected to remain the major net importer as its demand for apple juice continued to tread upward. Apple juice imports in the US in 2005–2006 were forecasted to increase 4% over the year-ago period to about 313,000 metric tons. Germany was also a major importer as its domestic production was low.

In the years spanning 1999–2000 through 2003–2004, the major apple juice exporting countries were China, Poland, Germany, Argentina, Italy, and Chile. However, in 2001–2002, China surpassed Poland to become the world's largest exporter of apple juice **(Exhibit 1)**.

China's main competitive advantage over other apple-juice-exporting countries stemmed from the low cost of apples and labor, which enabled it to supply apple juice at relatively low prices. Export prices for apple juice concentrate varied from USD 0.65/kg in China to USD 1.00/kg in Chile.

However, China's apple production in 2005–2006 declined 15% from the last year's bumper crop to 20.4 million metric tons. Low temperatures in late spring seemed to have had adversely affected the northern apple-producing region. Major apple-producing provinces, such as Shandong, Hebei, Henan, and Shaanxi, witnessed a 1–20% decline in apple production. China's concentrated apple juice production in 2005–2006 was suggested to plunge about 10% from the last year to 585,000 metric tons.

To manage the shortage, apple juice production gradually shifted to the western regions of the country, primarily to Shaanxi Province. Traditionally, Shandong Province had been the center of apple juice production in China, accounting for about half of the country's annual output. However, several farmers in Shandong had started switching to cultivating other fruits that offered better returns. Fruit juice plants in Shaanxi continued to introduce advanced processing equipment and expand their investments. Thus, Shaanxi was fast emerging as the largest apple-juice-producing province, followed by Shandong.

Juice production in Germany declined about 40% from the high levels of 2004–2005, and higher juice imports was forecasted to offset the shortage.

Apple juice production in the US declined to 109,000 metric tons in 2005–2006 (the lowest in the past 10 years), and many US farmers encountered difficulty in even recruiting apple pickers. The decreased domestic US supplies led to an increased demand for imports of low-priced apple juice.

China produced a limited amount of high-acid apple juice; it primarily exported low-acid apple juice concentrate. By contrast, Poland shipped mostly medium- and high-acid apple juice concentrate to the Japanese and European markets.

In 2004–2005, Poland was the world's second-largest apple juice concentrate producer, as virtually all the production was aimed for export. Retail prices of fruits and processed fruit products in Poland were much lower than in other European countries. They were, however, higher than the prices in China. However, China's exports of apple juice concentrate continued to face tariff barriers in Japan (19–25%), the EU (30–35%), Australia (5%), and Canada (8.5%). In addition, non-tariff barriers, such as certification and inspections, played a significant role in market access.

Argentina was ranked fourth in terms of production. Increased apple production bolstered the country's exports in 2005. Chile's production primarily reflected international demand; interestingly, although production declined 5% in 2005, exports declined just 3%. Further, although Chilean exports increased to Japan and Mexico, the Latin American country's market in the US declined about 8%, according to the Global Trade Atlas.

Intense Competition

China in general and Haisheng Juice in particular faced fierce international competition in the apple juice concentrate market. Poland, Germany, Italy, and Argentina were the other major apple juice concentrate exporters. Within China, several apple juice concentrate producers were located in Shaanxi, Liaoning, and Shandong provinces. The largest of these companies were SDIC Zhonglu Fruit Juice Co., Ltd. and Yantai North Andre Juice Co., Ltd., whose apple juice concentrate's quality and production costs were comparable to Haisheng's. A comparison of the three main Chinese competitors is shown in Exhibit 2. Zhonglu and Andre accounted for a major share of the Japanese market, which demanded high quality at low price. A note on SDIC Zhonglu Fruit Juice Co., Ltd., Yantai North Andre Juice Co., Ltd., and China Haisheng Juice can be found in the CEIBS Case Note on Competitors in the Chinese Juice Concentrate Industry.

China Haisheng's Competitive Strategy

China Haisheng stated its competitive strategy on its website.[3]

It involved:

Customized Products

China Haisheng produces clear apple juice concentrates with varying acidity levels on a large scale to meet its customers' requirements. Its products include clear apple juice concentrate and deionized apple juice concentrate, as well as an apple juice concentrate product—Apple Aroma. Since August 2004, the group has also been engaged in the production and distribution of a pear juice concentrate product, Clear Pear Juice Concentrate.

Diversified Coverage

China Haisheng has established a diversified market network. Its products are exported to the US, Canada, Germany, France, Australia, Russia, and Japan, thereby hedging the risk inherent in a single market.

Strict Quality Control Standards

China Haisheng places strong emphasis on the quality of its fruit juice concentrate products, and imposes stringent quality standards across its raw material procurement, production, and delivery processes.

Sizable Production Capacity

By the end of 2005, the total production capacity of China Haisheng reached 205,000 metric tons per pressing season. According to data from the PRC Customs Information Center, the export volume of the group touched approximately 85,000 metric tons in 2004, ranking first among apple juice concentrate producers in China.

Advanced Production Equipment

China Haisheng deploys state-of-the art production facilities at each of its production plants and a majority of the equipment deployed for production is imported from the most technologically advanced overseas suppliers.

Strategic Location of Production Plants

The company's five production plants are located in Shandong, Shaanxi, Liaoning, and Shanxi provinces, and they produce the maximum volume of apple juice in China. Strategic locations enable China Haisheng to procure apples at low cost.

[3] http://www.chinahaisheng.com

Strong Research and Development Capabilities

China Haisheng's research and development department has collaborated with and commissioned third-party research institutes to develop new products and improve production know-how.

When this comprehensive strategy was discussed with Haisheng's marketing team, a few members voiced concerns about the future, though they were confident about their competitiveness:

> *In the past, our products could not meet some of the requirements of customers, especially Japanese customers, who usually have higher standards and demand greater variety. Further, apple production is not uniform and we face some risks in terms of pricing.*[4] *In the Asian market, we lost market share to Zhonglu and Andre. Besides, we have a policy of limited brand promotion and thus have minimal presence by way of advertisements and trade fairs.*

To make matters more difficult, even substantial production levels could not support the considerable international demand. One of the marketing managers who had recently returned from South Africa said that though a number of customers had shown interest in Haisheng's products, the company did not have any products in its warehouse to supply.

Haisheng's Future Plans

Speaking of the future, Gao was optimistic, yet cautious:

> *I believe that we have a host of opportunities before us, but in the next 1-2 years, we will try to reorganize internal management, including our financial system, marketing efforts, supply chain management, and HR development.*

Hewitt helped Haisheng establish a new set of HR performance and retention systems to find qualified professionals for different functions and chart the career paths of its employees. The company was also in talks with IBM to discuss the design of a more efficient internal enterprise management system.

> *We also need to learn how to coordinate with our main investors after the recently launched IPO; our efforts will continue to focus on business development and maintaining the best quality. We need to better understand investors' ambitions and risk tolerance capabilities, and devise a strategy for rewarding them.*

[4] Half the products of Haisheng were sold on fixed contracts before the start of the picking season. The remaining products were sold at spot prices.

Efforts in these directions were expected to lay a solid foundation for the development of the company in the next 10 years. Besides internal revamping, Gao and his team were also looking at the world market for lucrative M&A opportunities.

> *M&As are the best way to expand in a short time, and will definitely usher in good results. We are tracking foreign competitors and analyzing their growth stories, but if we need to carry out M&As, we might just start with domestic competitors.*

Most juice concentrate producers in other countries were small in scale. For example, two large-scale plants in Chile collectively produced 60,000 tons of concentrate every year, whereas a plant of a single Chinese competitor in Shandong or Shaanxi produced 100,000–120,000 tons of concentrate every year. Thus, acquiring a Chinese competitor implied doubling the production capacity.

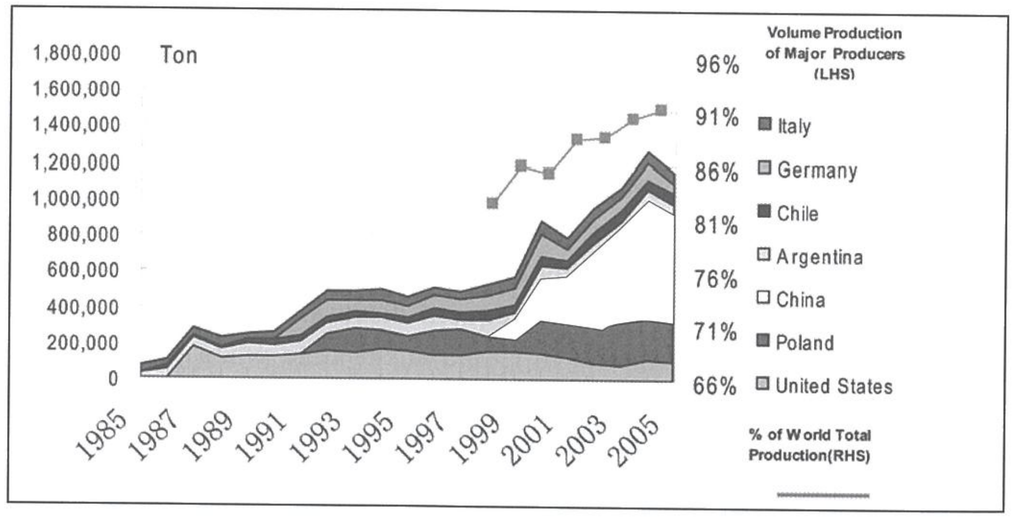
In addition to expanding its size and capacity, Haisheng sought to explore new opportunities and introduce new varieties of fruit products, such as orange juice, pear juice, grape juice, and tomato jam.

Currently, Haisheng has no plans to construct more factories to add to its existing facilities. Instead, its leaders are considering other options to reduce the risks arising from varying apple production and price fluctuations.

According to Zhu, "In the future, we hope to be self-sufficient in catering for at least 30% of our apple stock, which would guarantee a stable supply."

The emphasis on "self-sufficiency" highlights Haisheng's plans to develop or acquire apple farms, with the assent of the government and farmers. This is expected to not only cut down costs related to purchasing apples, but also make the company a vertically integrated unit.

Exhibit 1: World's Major Apple Juice Concentrate Producing Countries



Source: US Department of Agriculture, 2006; CICC Research, 2006

Exhibit 2: Export Volume of Apple Juice (metric tons)

Export Volume of Apple Juice (metric tons)					
Country	**Marketing Year**				
	1999-2000	2000-2001	2001-2002	2002-2003	2003-2004
China	70,710	177,147	264,555	370,128	485,699
Poland	84,000	183,000	187,000	197,600	201,500
Germany	76,048	88,819	118,000	130,823	132,102
Argentina	37,574	69,449	14,590	63,600	60,000
Italy	100,000	102,000	92,000	95,000	70,000
Chile	35,307	53,743	42,525	56,800	58,600

CASE COMMENTARIES

COMMENTARY 1

Dr. Terence Tsai
Associate Professor of Management, CEIBS, Shanghai, China

This case is a much welcome addition to the collection on Chinese business. It is unusual in that it depicts the growth dynamics and management decision making style of a small- or medium-size enterprise in China. Such cases are rare in any of the mainstream case distribution networks.

China is a dynamic country, with one of the highest growth rates in the world. Nonetheless, the actual working of Chinese enterprises is poorly understood, and this can be considered as a pitiful void in global business education. The case on China Haisheng Juice attracts readers' immediate attention by quoting the stock price of China Haisheng Juice in Hong Kong and introduces the involvement of a blue-chip investment bank, Goldman Sachs. This creates an excellent platform for subsequent discussion, considering the sensation surrounding the booming stock market in China at the time when the case was written. The case then narrates the success of Haisheng by suggesting its key success factors, and meticulously describes the pathway to the 10-year-20-percent market share miracle.

The case also puts China Haisheng Juice's prominent leader Gao Liang in the limelight while delivering an interesting management story. Gao is a typical example of a Chinese manager who has embraced contemporary management concepts, yet retained the old iron-bowl mentality. The case later highlights Gao's background and his early management experience as obvious obstacles to the growth of China Haisheng Juice. This is a good example for the case users to debate on the leadership styles employed during the different stages of the company's growth. The case has then rightly provided ample details for analysis. It is particularly worth noting that to sustain users' interest in the analysis, the case raises a number of controversial issues relating to the external environment of managing a firm in China. Both the often-taken-for-granted pesticide residue problems in China and the anti-dumping crisis are likely to ignite fervent discussion in the classroom and accurately portray the growing pain of a Chinese firm.

Another interesting point discussed in the case is "cultural" conflict. This has become counterintuitive by not assuming the geographical or the national culture. Cultural conflict, as described in the case, refers to a mentality arising from different stages of national development within China. It is essential to understand that China embraces different stages of development concurrently, with the coastal provinces being the most advanced. Apart from this, the case also hints at a serious problem of effective cultural/value infusion within a Chinese enterprise. One may say that this is inevitable, considering the fast growth of China Haisheng Juice, as value infusion takes a long time to achieve, and Chinese firms seldom have the luxury of simultaneously pursuing growth and establishing a concrete value system.

Competition cannot be ignored while discussing growth strategy. Competition brought with it a thorough internal analysis of China Haisheng Juice and its associated competitive edges. This prompts readers to develop strategic options to counter China Haisheng Juice's international and domestic competition. This exercise is particularly logical and meaningful in light of the earlier discussion on leadership, crisis management, growth stages, and cultural or people management.

The case on China Haisheng Juice embodies vital elements of leadership, growth strategy, and entrepreneurship within the context of the dynamic Chinese market. Further, it provides the reader with several discussion points and presents a realistic picture of growing Chinese enterprises. It is a "must use" case on any course with a China management orientation.

COMMENTARY 2

Commentary by the FounderzTwo years after Haisheng was listed on the Hong Kong stock market, Gao, the founder and CEO, was pleased to see his company reaching a new production scale and development stage.

At the end of 2005, China Haisheng's total production capacity was 205,000 tons per pressing season; in the past two years, the figure reached 300,000 tons. The current annual global production volume is approximately 1,600,000 tons. Haisheng is the largest producer of apple juice in the world market, with about 20% market share. The company's sales revenue for 2006–2007 was over USD 200 million and is expected to exceed USD 300 million in 2008.

As far as I can foresee, the global demand for apple juice will continue to grow. In order to maintain leadership in the industry, Haisheng is preparing for further volume growth. Besides enhancing competitiveness in apple juice and apple essence segments, Haisheng is actively developing other juice products. We are one of the leading producers of pear juice and essence, and are introducing new juice varieties, such as orange juice, grape juice, and tomato juice, in some parts of China.

In the past two years, Haisheng has expanded its production facilities and has established two more plants. Moreover, a new department has been set up to deal with increasing land acquisition and leasing activities, in order to stabilize production. We are also looking for opportunities to set up production bases in other countries, such as Chile, Argentina, Brazil, India, South Africa, Poland, and Ukraine.

The most positive outcome of the initial public offering (IPO) was an increase in incentives and motivation to innovate for better performance within the holding company. The new management mechanism known as "horse-racing," which was initiated in 2005 and formally implemented in 2007, yielded excellent results. The seven plants of the company are now competing with one another in terms of quality, volume, cost, profit margin, and staff royalty, which helps managers evaluate performance, set clear goals, and improve efficiency. I think the competition within the seven plants is more intense than that in the industry. By introducing competition within the holding group, we have transferred the pressure from the stock market to each of the centers. They are now becoming the profit centers of Haisheng, competing for higher efficiency, lower cost, and better ROA.

Haisheng could have grown bigger without the IPO as well, but the IPO facilitated the process. After the IPO, the company has been constantly in public view. Our financial performance is compared not only with that of our peers in this industry but also with players in other industries. In fact, exposure to the media, industry analysts, and fund managers compels Haisheng to perform to its fullest potential.

One of the biggest hindrances to Haisheng's high-growth plans is HR and talent management. This became a major problem when the employee turnover at our oldest plant reached as high as 300%. In recent years, we have raised our staff recruitment requirements—proficiency in English, a master's degree, and technical qualifications are the three major parameters on which candidates are judged. The sustainable learning ability of postgraduates is what we value the most. These three criteria will help prepare Haisheng's future managers. The new set of standards was implemented in 2007 and is expected to make a difference within 3–5 years.

I strongly believe that the growth of an organization should precede the growth of the business. Haisheng has sent all its top managers to the top business schools, including Cheung Kong Graduate School of Business, China Europe International Business School, Peking University, and Columbia University in the US. We are also planning to open a new department to manage strategy formulation and execution.

CONCLUSION

China's Evolving Entrepreneurship from a Global Perspective

Entrepreneurship is not new to the Chinese, but it is a relatively young phenomenon in the China of today. The Global Entrepreneurship Monitor Survey[1] reveals that countries all over the world show different levels of entrepreneurial activity. Countries with similar per capita GDP tend to exhibit similar levels of entrepreneurial activity. Early-stage entrepreneurial activity is generally higher in countries with lower levels of GDP, though there are exceptions. There is also variation across countries in terms of motives for setting up new businesses. Generally, necessity-driven entrepreneurship is relatively more common in middle-income countries than in high-income ones.

China's Competitiveness

According to the International Monetary Fund's 2007 projections, China, for the first time, has dislodged the United States from its top position as the main engine of global economic growth; the Chinese economy grew by more than 11%, eclipsing the 2% growth in the US economy.[2] Chinese entrepreneurs are aggressively tapping the emerging opportunities in the country's booming economy. Success stories of Chinese entrepreneurs are reaching far and wide in the business world. In China, early-stage entrepreneurial activity was 16.2% (that is, among 100 persons, 16.2 were involved in early-stage entrepreneurial activity) in 2006, a 3.9% increase over 2002, ranking sixth worldwide. The proportion between opportunity-driven and necessity-driven early-stage entrepreneurship is gradually shifting in China—from 40% and 60%, respectively, in 2002 to 59.2% and 38.7%, respectively, in 2006. Chinese entrepreneurs increasingly view entrepreneurial activities as a good way to exploit a perceived business opportunity rather than a forced option when all other options for work are either absent or unsatisfactory. People in the age group of 25–44 years are the most active when it comes to taking up entrepreneurial activities. Those in the age group of 18–24 years constituted 18.34% of the total number of entrepreneurs in 2006, indicative of the younger generation's growing interest in starting up their own businesses.[3] Most of the Chinese entrepreneurs have been middle-school and high-school graduates; however, increasing participation of university

1 Global Entrepreneurship Monitor, China Report, 2006.
2 Patrice-Hill, "China Powering World Economy," Washington Post, July 26, 2007.
3 Global Entrepreneurship Monitor, China Report, 2006.

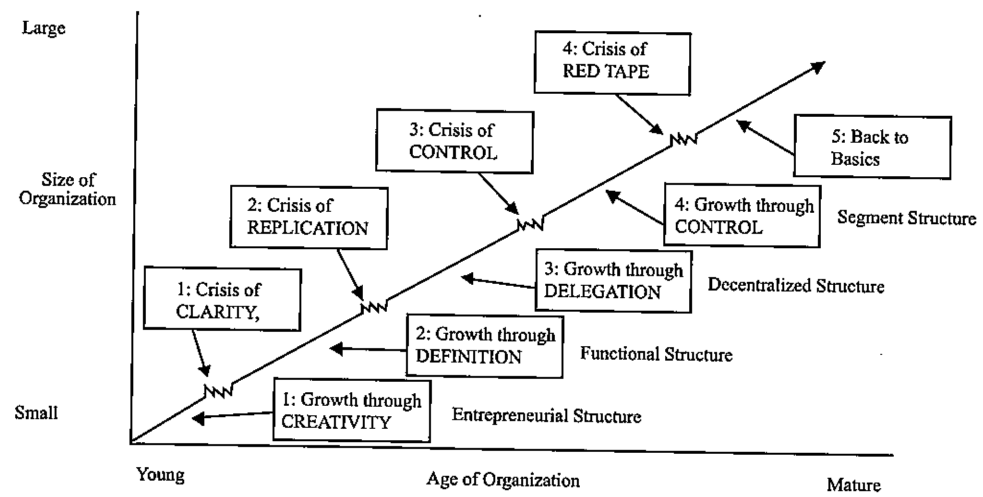
graduates has raised the average level of educational qualification among entrepreneurs. Growing enrollment in Chinese universities has heightened the competition in the graduate job market. Even the country's exceedingly high growth rate has not been able to absorb the graduates. Of approximately 5 million graduates in June 2007, about 1.45 million were still unemployed in the fall of that year, according to a study published by the Chinese Academy of Social Sciences.[4] Now, the government is encouraging university graduates to work in remote and economically backward areas or start their own businesses.

As Organizations Grow

In the early 1970s, Professor Larry Greiner developed a framework that identifies a series of developmental phases through which companies tend to pass as they grow.[5] He drew from the legacies of European psychologists who argue that the behavior of individuals is determined primarily by past events and experience, rather than by what lies ahead. Extending that theory to problems of organizational development, he identified five phases through which companies tend to pass as they grow. The model takes into consideration five key parameters—an organization's age and size, the stages of its evolution and "revolution" (crisis situations), and the growth rate of its industry. The life span is the most obvious dimension of any model of development. The size of an organization, including its headcount and sales volume, is another determinant of its development. Along with organizational growth, evolution and revolution are the two parameters used to describe the developmental phases: evolutional periods are the years of continuous growth without a major economic setback, when only modest adjustments are necessary for maintaining growth. Between smoother periods of evolution are periods of revolution or substantial turbulence. The speed at which an organization experiences phases of evolution and revolution is related to the market environment in which it operates. The following figure (see Exhibit 1) depicts the "The Five Phases of Growth" together with the major management challenges associated with the different phases **Exhibit 1** The Five Phases of Growth.

[4] Degree no job guarantee in China, Los Angeles Times, February 18, 2008.

[5] Larry Greiner, "Evolution and Revolution as Organizations Grow," Harvard Business Review, July–August 1972.



Adapted from Greiner, "Evolution and Revolution as Organizations Grow," Harvard Business Review, July–August 1972

The young Chinese economy displays a spectrum of entrepreneurial activities—from the nascent stage to the mature stage—even more lively and diversified than the matured economies. The collection of case studies presented in this volume helps lend support to the framework of issues and crises described in Professor Larry Greiner's conceptualization of organizational development. For example, the Wanbo company (seethe tables 1-4 in the Chapter 2), the computer component distributor enjoyed an exceedingly high growth rate (with the annual sales increasing from RMB 10 million to 105 million, and the expansion of employees from 20 to 50 persons) in the first five years. It targeted the right market (small- and medium-level cities), constantly adapted to its customers' needs, and observed good work ethics. Such high growth rate and profit margin were often found among start-up companies, where decisions and motivation were highly sensitive to marketplace feedback. When the company's operations expanded to more cities, Wanbo increasingly found its functional structure deficient, especially in financial reporting and HR performance. The company was moving to the second growth phase, calling for an improved accounting system for inventory and purchasing, as well as for adoption of proper incentives, budgets, and work standards.

In the case of Fuqima Washing Machine Corporation (see Exhibits 2-3 in the Chapter 7), the two founders maintained tight control over business operations, and the sales department could not make decisions even on issues related to small advertising expenditures. Lack of empowerment within the organization became a major obstacle when the market situation and the organization became increasingly complex. The company enjoyed tremendous growth in the second phase, but a crisis of autonomy eventually occurred when most of the responsibility was assumed by the top management.

Ahua (see Exhibit 1 in the Chapter 6), a mother-baby care industry pioneer, was losing its control over the service level of its franchisees. The franchising system enabled Ahua to develop 101 outlets all over China with the least input of resources. After years of rapid growth, the company was facing a critical problem as some of its franchisees did not abide by the rules and were jeopardizing the brand image. Each franchisee enjoyed great authority and incentives, rapidly tapping the new markets in China. The problem was that the parent company's control over a highly diversified field operation was fading, creating a crisis of control.

Larry Greiner's work provides an intriguing framework for viewing the general growth pattern of an organization. The business world has undergone great changes since the time the article was published; however, major development phases highlighted in Greiner's theory are still observed in the lifecycle of a growing company. The growth of many Chinese firms will, to a large extent, follow Greiner's pattern. Wanbo, Fuqima, and Ahua have been through the revolutionary period, struggling to solve the dominant management problems before setting out on a growth trajectory. Their ability to address the issues will define their future.

Cultural and Political Contexts

The Chinese entrepreneurial pattern is shaped not only by economic development but also by cultural values and institutional environment. What role does Chinese culture play in shaping the entrepreneurial culture in the country? David Kirby and Fan Ying conducted a study in the mid-1990s to examine whether Chinese culture was conducive to entrepreneurship. They identified that some basic tenets of traditional Chinese culture, such as persistence, diligence, intelligence, and harmony, encouraged entrepreneurship. However, various other entrepreneurial attributes, such as a positive view toward change, initiative, and profit-orientation, appeared to be in conflict with Chinese values. Moreover, the most important entrepreneurial values—creativity, innovation, and flexibility—were lacking in the Chinese set of values.[6] However, with accelerating reform and increased exposure to the West, Chinese cultural values are changing constantly. As the perception of entrepreneurs is improving, the Chinese society is now better prepared to foster entrepreneurial spirits.

If personal attributes explain the internal impetus for entrepreneurial activities, the institutional environment is the external driving force for creating an entrepreneurial generation. Before the reforms and introduction of the opening-up policy, when the Chinese society was dominated by communist ideology, private and individual business activities were deemed as the root of evil. The change in the government's stance initiated two periods of boom for the private sector. The Third Plenum of the Chinese Communist Party's 11th Central Committee in 1978 emphasized economic development and individual incentives, which gave impetus to the revival of private business. But the private sector continued to play a marginal role in the national economy as a supplement to the state and collective sectors. Deng Xiaopeng's "South Touring Talk" in 1992 unveiled the second important period. Deng's theory propagated that governments at both central and local levels should start implementing expansionary policies for encouraging private business activities. The number of employees serving in state-owned units declined from 112,610,000 in 1995 to 85,720,000 in 1999. In contrast, the number of managerial staff and workers employed in private

[6] David Kirby and Fan Ying, "Chinese Cultural Values and Entrepreneurship: A Preliminary Consideration,"

enterprises increased from 4,850,000 in 1995 to 10,530,000 in 1999. Tsinghua University once conducted a survey with 2,854 respondents from 20 cities in China to assess the impact of the institutional environment on the private sector. The study strongly supports the role of institutional environment, including protection of private property and contract enforcement, in entrepreneurship decision making. For example, the surveyed respondents were more likely to become entrepreneurs after the grant of legal status for private enterprises, which took place in 1988. In early 2000, Zeng Peiyan, the minister of the state development planning commission, announced, *"We will eliminate all restrictive and discriminatory regulations that are not friendly toward private investment and private economic development in taxes, land use, business start-ups, and import and export. In the area of stock listings, private enterprises should enjoy the same opportunities that were enjoyed by the state-owned enterprises."*[7]

The past 30 years have seen the emergence of different types of entrepreneurs. Before the economic reform and in the early 1980s, entrepreneurship took the form of very small-scale, "self-employed" businesses, normally involved in services, such as street vendors, and retail. The underprivileged section of the society—due to poor education and low social status—and most of the self-employed people took the initiative to explore the unclaimed business opportunities. In the late 1980s and early 1990s, there emerged highly educated individuals, who quit their secure jobs in the public sector and started their own businesses. In the beginning of the twenty-first century, foreign-educated people took up entrepreneurial activities in the country. Regional diversity also has an important influence on the development of the private sector. In southeastern coastal China (Wenzhou and Taizhou in Zhejiang Province and Shunde and Dongguan in Guangdong Province), a market economy had developed to some extent before the economic reforms were rolled out.[8] People in these regions were keener to adapt to a market economy. They knew how to make money by operating their own businesses. As a result, these regions took the lead in shaping the private sector.

Challenges Ahead

Entrepreneurship takes different forms in different countries. The Chinese entrepreneurial pattern is shaped by economic development, political ideology, institutional environment, and cultural values. At the policy level, the private sector has been recognized by the Chinese government as an integral element of economic development. Although China ranks 83rd in the list of 178 countries in terms of the business environment for the private sector, the Chinese government has shown strong determination to gradually eliminate the institutional

Journal of Enterprising Culture, 3(3) 1995.

[7] James Kynge, "China Plans Support for Private Sector," Financial Times, January 5, 2000.

[8] Debbie Liao and Philip Sohmen, "The Development of Modern Entrepreneurship in China," Stanford Journal of East Asian Affairs, Volume 1, 2001.

barriers to the growth of the sector. At a microeconomic level, entrepreneurs continue to face challenges. The nine cases selected in this book are an attempt to touch upon the current issues and challenges faced by the Chinese firms. Lessons revealed in each case are the snapshots of widespread entrepreneurial activities and help outline the complete picture.

Given the context of a thriving Chinese economy, many companies are enjoying phenomenal top line growth and profitability but remain unaware of the underlying flaws that could impact their businesses in the long run. Some successful business owners, allured by new business opportunities, are likely to fall into the trap by investing hastily in new business sectors outside their domain of expertise. Other entrepreneurs are so engrossed in the day-to-day business management that they fail to foresee and address fundamental issues such as non-standardized products and a flawed financial system, when the company outgrows its capacity. So far, most Chinese firms are still operating within China. By global standards, the country's outward investment is still insignificant. China's economic growth has been mostly attributed to its trade and export dominance, as well as foreign direct investments (FDI). In 2006, FDI inflow into the Chinese market hit a historic peak of USD 1.23 trillion, while FDI outflow totaled only USD 16.1 billion, which was merely 1.3% of the inflow.[9] But the year-on-year growth of China's outward direct investment has been remarkable in the view of a flurry of high-profile acquisition deals initiated by Chinese firms in the international market. By moving operations beyond domestic borders, Chinese companies can overcome trade and tariff barriers in other economies and seize opportunities in new markets. In a survey conducted by Roland Berger and the business magazine Global Entrepreneur, in 2007, more than two-thirds of the top 50 Chinese companies with global competitiveness were from the private sector. Among these top 50 companies, 15 had made efforts to build plants in foreign countries, 30 had already set up subsidiaries abroad, and 14 made attempts at overseas acquisitions.[10] Overseas expansion poses new challenges for Chinese firms that are used to managing local teams in a domestic setting.

A report on the Development of Private Sector in China, released in 2006, estimated that by the end of 2005, privately owned businesses invested in by Mainland Chinese accounted for 50% of China's GDP. The number has been rising ever since. In 2007, China's economic growth hit a 13-year high of 11.4%, while registered capital in the private sector totaled RMB 10.1 trillion, an increase of 22.7% year-on-year.[11] Entrepreneurial activities will continue to speed up innovation and economic advancement in China. This book provides an overview of the nationwide entrepreneurial activities in China, with an aim to pave the way for future studies.

[9] 2007 Report on Chinese Companies with Global Competitiveness, Global Entrepreneur, June 2007

[10] 2007 Report on Chinese Companies with Global Competitiveness, Global Entrepreneur, June 2007

[11] www.chinaview.net

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