

# the chinese public company dilemma

## OUTSOURCING TO THE UNITED STATES: THE NEW PARADIGM

By: Douglas Toth  
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**"IT ISN'T THAT THEY CAN'T  
SEE THE SOLUTION.  
IT IS THAT THEY CAN'T SEE  
THE PROBLEM."**

G. K. CHESTERTON

### INTRODUCTION.

China has the fastest developing economy in the world today and succeeded Germany in January 2009 as the world's third largest economy<sup>(1)</sup>. Yet, despite this economic momentum, Chinese companies are stumbling and face cultural barriers that inhibit their growth. This is particularly true for small and mid size Chinese companies seeking to expand their businesses using tools outside of China's economic domain. Considering that the United States is China's second largest trading partner, while China constitutes the U.S.'s third largest export market, a coalition between Chinese and American businesses is not only logical, it is inevitable. As such, China represents a must-win market within U.S. corporate growth strategies. At the same time, the U.S. possesses a critical market for Chinese businesses. Encouraged by these economic factors, Chinese businesses are looking toward the U.S. to finance their corporate growth through access to capital markets and the liquidity within them. However, despite the success of some of China's larger corporations, this economic option may be unavailable to small and mid size Chinese companies.

There exists a roadblock presenting opposition to Chinese businesses listed on the U.S. markets today, and it is the very same one that had confronted American businesses venturing to work within the Chinese export and

manufacturing market yesterday. It is the complicated barricade that is naturally erected as a consequence of cultural unfamiliarity.

The following allegory portrays a comical representation of the Chinese/American cultural conundrum:

*While walking down a street in Beijing, an American tourist noticed a sign in the window of a restaurant advertising: TODAY'S SPECIAL – RABBIT STEW. He thought to himself, "That's a favorite dish of mine," and went in to the restaurant, and ordered the stew. After taking three or four bites, something wasn't right to him. He asked for the owner. "Is there horse meat in this rabbit stew?" asked the American tourist. "Yes, there is some," replied the Chinese owner. "What is the proportion?" asked the tourist. "Fifty-fifty," came the reply. The American tourist pursued the issue. "What do you mean by 'fifty-fifty'?" he asked. The Chinese owner replied, "Fifty-fifty -- One horse to one rabbit."*

Although this short tale may be appreciated for its humorous merit, it is allegorical in nature and cleverly depicts the communication obstacles facing Chinese/American relationships. In the recent past, western companies needed to integrate Chinese cultural tenets into their business practices to assimilate into the Chinese marketplace and to bridge the cultural obstacles dividing the two nations. Likewise, Chinese businesses must presently reconcile with western business practices and conventions to achieve investor confidence and commitment.

### CULTURAL POLARITY.

Among the cultural differences between Chinese and American business operations is the perception of authority, accountability, *face* ('*mianzi*'), hierarchy, and risk avoidance.

Additionally, a blurring of relationships and understanding between professional and private conduct may cause unforeseen problems. For example, personal friendships among Chinese businessmen may induce fellow executives to enter into unsound alliances, creating conflict where business goals are concerned and, consequently, warding off U.S. investors as unsound business practices.

### Decentralized Marketization.

The conditions for Chinese economic growth, professional accountability, and business transparency, are quite different from the acceptable standards by which the western financial world models economic development. *Decentralized marketization* among Chinese businesses, such as the freedom to establish prices arbitrarily and the tendency to succumb to powerful cultural influences, a.k.a. *Guanxi*, promotes unstable networks of business obligations and associations that further broaden the cultural gap between Chinese business practices and western business ethics<sup>(2)</sup>.

A number of organizational restructuring propositions have emerged as the result of the Chinese's government attempt to address the gap between Chinese business practices and western business ethics. These propositions are concerned with local empowerment, entrepreneurial behavior, regulatory frameworks, ambiguous corporate governance, and the distribution of intellectual property at the privatization phase. The propositions seek to emulate the western standard and model for proper business and market development. Unfortunately, without testing and successfully surviving the scrutiny of traditional western business analyses, and ultimately that the scrutiny of investors, the Chinese design will continue to struggle and will ultimately require western intervention. As such, the engagement of western business consultancy at this critical phase of development is necessary to secure

confidence in the global financial audience.

### Talent Deficit.

Presently, China is experiencing an employment talent shortage at all levels, from skilled to unskilled, as its booming economy is outpacing its ability to sustain skilled workers. This dilemma is a consequence of an overall underdeveloped educational system. As Edward E. Gordon recently argued in an article for "MWorld," China's education is inadequate for the long-term support of a modern, globally competitive economy<sup>(3)</sup>. The average turnover rate for employees in Shanghai and Beijing is 20-25% (higher in other cities), further complicating matters. This figure includes multinational companies, as well as small and medium size. In a desperate attempt to address this problem, the Chinese government is drawing back its own *émigrés* to try to fill the employment gap.

### Leadership Deficiency.

The Chinese economy is out growing its leadership pool. In fact, some industry segments are growing by as much as 30% per year, according to a report by Heidrick & Struggles, a global executive search firm, and by the Stanford Project on Regions of Innovation and Entrepreneurship (SPRIE)<sup>(4)</sup>. Unfortunately, key leadership qualities, such as effective delegation, customer orientation, and corporate structuring are necessary to accomplish business goals, but they are lacking among China's corporate workforce. This dilemma is the result of conventions within the culture that produce a society of people predisposed toward succession and not toward leadership. Consequently, the result is a workforce with the high turnover rate among executives and a nation deeply in need of skilled leadership.

### CAPITAL AND LIQUIDITY.

In recent years, Chinese corporations have grown more pro-active in seeking investments

and liquidity in the U.S. capital markets. Correspondingly, with almost 20 million registered businesses and a rapidly growing economy, China represents a significant growth opportunity for U.S. and international investors. The bridging of China's businesses with the world's most advanced capital markets is a reflection of the risks and rewards of today's global economy. However, to achieve the maximum financial benefit from the convergence of the two economic entities, knowledge of both market infrastructures is essential.

### MARKET ACCESS.

China is a social market economy that has grown quickly over the past decade. The majority of the estimated 1,500 companies on both of China's stock exchanges are State Owned Enterprises (SOEs)<sup>(5)</sup>.

However, the growth in this economy has largely come about from small enterprises, in particular, township and village enterprises, which are micro, small, or medium in size<sup>(6)</sup>. They are primarily owned by local communities and are controlled, in part, by local government. In fact, 65% of the Chinese economy is driven by SOE's, commonly referred to on Wall Street as the "middle market."

Private ownership of businesses and assets is not only legal in China but is also protected and strongly encouraged by the Chinese government. This is due to the fact that the majority of the jobs in China are provided by the thriving private sector of businesses. However, despite the governmental encouragement, Chinese domestic listings are virtually impossible for middle market companies. This is, in part, due to an approximately three-year waiting period,

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resulting from the thousands of listing candidates waiting in the pipeline. As a result of the sheer volume of interested business candidates, and the time lag in listing private companies on the Mainland, global markets in Hong Kong, the U.S. and the U.K. have become viable alternatives for Chinese businesses. In the recent past, private sector Chinese companies such as Focus Media, Inc. and Shenda Entertainment, Inc. have realized enormous successes by listing in the U.S., an economy built on the principle of a free market and the free

flow of capital. The potential for success in the U.S. market for Chinese businesses is, however, dangerously counterbalanced by the possibility of failure. Without surrogate representation and experienced management, listed companies may end up without sponsorship, trading with limited

liquidity, and with valuations below expectations.

### DEPRESSED EVALUATIONS AND OBSCURITY.

Although foreign equity market management is not unique to Chinese listed companies, it is negatively affected by portfolio managers' reluctance to hold unfamiliar "emerging market" securities within their portfolios. Other portfolio managers have been "hurt" by Chinese investments and refuse, as policy, to get involved with Chinese investments regarded as "high risk." This overall negative association toward Chinese small cap stocks, within western portfolio management, has affected an investment paralysis in Chinese businesses. A confluence of market cycles, market uncertainty, and indiscretion within Chinese business conduct, provides further difficulty for this troubled market.

In a stable market, the highs and lows of market

cycles have a moderate effect on the financial market as a whole. Conversely, because China is an emerging market, the highs and lows of its market cycles have a significant effect on its overall market performance. For example, in 2008 the U.S. equity markets were down 38%, while the Chinese market, including U.S. listed Chinese equities, was down 68%<sup>(7)</sup>. Presently, as the Chinese market is nearing the end of its growth cycle (the lowest point of its growth cycle), the negative effect of the financial low point continues to result in a depressed Chinese market, followed by lack in liquidity in listed Chinese securities. Moreover, as growth cycles end, corruption within Chinese businesses becomes rampant. And emerging markets, China's specifically, lack security laws and corporate governance to protect investors.

To continue, the global financial climate strongly affects the Chinese market. A slowdown in U.S. and/or European markets will result in a reactive slowdown in China's market, particularly in its export market. As China's market growth is driven by demand from developed markets for the country's manufactured goods (including commodities), and capital flows downward from developed markets to emerging markets, China will not continued to grow at a time when mature markets are slowing down.

As China is unequivocally dependent upon its country's core business in the export market, it will will, thereby, be substantially affected by the current downturn in world markets, while, at the same time, the dollar continues to grow stronger. In the short-term the RMB exchange rate will be influenced by the fluctuation between the dollar and other currencies. However, in the long run, its value depends on the progress of China's exchange rate reforms.

Currently, China is still running a substantial trade surplus, which should support the currency, in the short-term. However, the surplus may decline substantially in 2009 due to

the world wide economic recession. Additionally, China is facing competition challenges. Its vast export sector now has a profit problem, and the demand collapse is now forcing exporters to close. Alternatively, the so-called "housing crisis" in the U.S. proved to be a worldwide market adversity, with banks lending money not only to marginal homeowners in the U.S. but also to the marginal "factory" in China. Consequently, banks will continue to restructure loans in the effort of correcting the financial havoc that has stunned the global economy. Many loans will, thereby, result in default.

## CONCLUSION.

This is a particularly crucial time for Chinese businesses listed on the U.S. stock exchanges. With a deeper understanding of investor communications, Chinese companies will be able to better appreciate business transparency, compliance and investor relations as powerful tools with which to succeed within both local and international financial markets. Additionally, listed enterprises from China in the U.S. need to learn more about the rapidly expanding and demanding financial frameworks of corporate governance and financial disclosure within the U.S. regulatory system. As one of the important financial regulators in China, the Shenzhen Stock Exchange has been commissioned to foster corporate governance and standardization in investor relation management of domestically listed companies. Although this initiative has yet to show rewards, the importance of this type of infrastructure to the Chinese exchange is paramount and its proper administration is necessary for the success of Chinese corporations. Likewise, Chinese businesses listed in the U.S. need to take heed of the policies implemented by the Shenzhen Stock Exchange and apply them to their corporate regulations regarding their U.S. listings.

Further, the development of communication

technology (i.e. the internet and mobile communication), the globalization of the world economy, and the changes to people's investment concepts -- particularly in light of recent economic decline worldwide, have collectively produced an investment framework requiring listed companies to attach great importance to their investors in order to continue to grow their investment wealth. Chinese companies must also realize that a long and stable relationship with their shareholders is necessary to enhance financing channels and to sustain development within the public markets.

Finally, the rapid expansion of Chinese enterprises and the shortage of experienced executives within the system (especially possessing an in depth understanding of the U.S. markets) have amplified the importance for foreign experts to intervene and provide experienced financial management and structure to Chinese companies. This gap may be bridged though consultancy or by interim employment of western professionals to Chinese businesses. Just as it is undeniable that one of China's greatest assets is its 1.3 billion people -- making up its vast labor force, it is equally undeniable that one of the U.S.'s greatest assets is also its people -- including experienced and qualified management executives, founded on education, a free market system, and social economic maturity. As the U.S. has outsourced its manufacturing needs to China, Chinese business owners should look to engage the U.S. management workforce as a repository for skilled corporate executives in order to assimilate into the Western standard of business conduct.

## GLOSSARY OF TERMS

*Face* refers to two separate, but related, concepts in Chinese social relations. One is *mianzi* (Chinese: 面子), and the other is *lian* which are both used commonly in speech rather than in formal writings.

*Lian* is the confidence society has in a person's moral character; while *mianzi* represents the social perception of a person's prestige. Maintaining *face* is critical in Chinese social relations, because it translates into power and influence, and it affects goodwill. A loss of *lian* would result in a loss of trust within a social network; while a loss of *mianzi* would likely result in a loss of authority.

*Émigré* is a French term that literally translates to mean a person who has "migrated out." It often carries a connotation of politico-social self-exile.

*Guanxi* describes the basic dynamic in the complex nature of personalized networks of influence and social relationships, and it is a central concept in Chinese society. In Western media, the *Pinyin* romanization of this Chinese word is becoming more widely used instead of the two common translations—"connections" and "relationships," as neither of those terms sufficiently reflect the wide cultural implications that *guanxi* describes.

*Marketization* is the process that enables the state-owned enterprises to act as market-oriented firms. This is achieved through reduction of state subsidies, deregulation, organizational restructuring, decentralization and privatization.

*Decentralization* is the delegation of power from a central authority to regional and local authorities.

*Pinyin (Hanyu Pinyin)* is the most commonly used Romanization system for Standard Mandarin. *Hanyu* is the Han (Chinese) language and *Pinyin* means "phonetics", or more literally, "spelling sound" or "spelled sound." Developed by a government committee in the People's Republic of China, the system was initially approved by the Chinese government on February 11, 1958

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Mr. Toth is responsible for advising and directing the internal business of **Groupmark Financial Services, Ltd.** He also manages special projects for financial, compliance, operations and information systems of the companies for which he consults. As a consultant, he reports all activities to senior management and to the boards of directors of his client companies. He works closely with external auditors and legal council to ensure professional propriety and business compliance for the publicly traded companies he represents.

Mr. Toth began working in China in 1992, and has developed, professional relationships with Chinese businesses and executives over the past 17 years. To his credit, he originated the first oil and gas Chinese Joint Venture (CJV's) between a State Owned Enterprise (SOE) and a foreign offshore oil drilling company in 1992. Additionally, he toured China as a lecturer on U.S. Capital Markets and has consulted numerous public Chinese companies. His industry experience includes manufacturing, retail and distribution, foreign exchange, media, advertising and technology. He also specializes in financial and SEC reporting, business modeling and internal control systems.

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